The End of Innocence: An Actual Knowledge Threshold for Intermediaries Holding Fiduciaries'/Clients' Assets

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I. Introduction

Enron, Andersen, Worldcom, Parmalat, Tyco, Pimco, Spear Leed & Kellogg, Dick Grasso, Martha Stewart and Peter Bacanovic. The past couple years have shown us a smorgasbord of malfeasance among corporate directors and within the primary and secondary markets. The troubles in the financial world extend well beyond companies to the markets themselves. In the end of the last century, the US and the world witnessed the effects of some of the worst misconduct ever. Yet, we must be careful not to let one type of problem provoke fears and justify unnecessary, deleterious burdens on the economy as a whole and losing sight of global, long-term effects. Unnecessary costs can blow through the economy like a strong breeze at this time when the economy needs a push back from the brink. In these scandal-ridden times, it is all too easy to support restrictions everywhere so that we can feel confident that these isolated scandals will not be repeated.

What would this country be without effective, efficient financial markets? Financial markets, mostly the indirect financing market, play an essential role in the function and growth of our economy.¹ The financial markets provide a mechanism for directing excess, idle funds to borrowers in need of money for new projects. Without an effective financial market, the US economy would contract, examples of which have been seen over the last century in many developing and

¹ The indirect financing system in the United States plays a central role in the economy as the primary source of funding. Among the largest producing economies in the world, most of which have a more highly-regulated financial market, the role of indirect financing is even larger. For a good overview of the operation of financing systems, see Colin Mayer, Financial Systems, Corporate Finance, and Economics Development, Asymmetric Information, Corporate Finance, and Investment 307-332 (Univ. of Chi. Press 1990).
non-functioning economies. Even a slight increase in the costs of financing could severely inhibit long-term growth prospects.

In the highly efficient US markets, added costs to market participants will lead to increased prices in the market. The added costs will ripple through the economy and cause exponential contraction of economic output. Similarly, if a market participant reduces costs, that cost savings will be reflected in the market price. An increased likelihood of liability arising from loan services will not allow lenders to compete with each other at the current price. This higher cost of financing will lead to less funds being loaned to growing businesses. The decrease of funds will in turn lead to less capital investment and decreased long-term growth in productivity and output. Likewise, a decrease in the cost of financing via the indirect markets would boost long-term economic prospects.

This article focuses on a very specific type of transaction handled by securities intermediaries that has not been in the news yet but which can have large economic ramifications. Specifically, this article discusses statutory protection of securities intermediaries effectuating transactions for client-trustees. In the typical example, a trustee may manage funds for a beneficiary but deposit the funds with a third-party bank. The bank accepting the funds will receive a copy of the trust agreement but otherwise have no direct connection to the bene-

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2. In recent years, the hyperinflation economies of developing countries have been a drain to world development. Even with the assistance of the International Monetary Fund, no real solution has been found to create a stable, efficient market in some countries and to increase the livelihood of the people in these developing countries. The near collapses of Russia and Brazil provide a forewarning of what could potentially occur if the local financial markets collapsed.

3. Very generally, if the associated risk is lowered, the price will be lower. This allows borrowers to obtain capital cheaper. This in turn allows for investment in more projects. Such effects occur according the Money Multiplier Effect. See Section IV for further explanation.

4. Higher financing costs for investment would lead businesses to choose to extend current operations rather than seeking financing to expand business operations. A shift in the choices that businesses make would have large effects in the economy. On the contrary, lower costs of financing would spur business to borrow more and expand production.

5. Making financing more affordable would lead businesses to expand. The lower financing cost would spur capital spending much like a lowering of interest rates. In turn, the capital spending now would increase capital stock for the future, leading to higher natural output for the economy.

6. The law of trusts and securities is admittedly broad in scope. Trustees themselves can be anything for a group of individuals working for a single, wealthy family to a trustee company to the largest bank in the country. Moreover, trustees can have a wide range of power, including unlimited power. This article will focus on trustees who have deposited assets in an independent bank. The article will also be practically focused on the gray areas of trustee power. It is clear that a bank should take note of whether it has received a copy of the Power of Attorney or Trust Agreement, but problems mainly arise where a trustee has acted beyond its power in the trust agreement. This article also focuses on problems where a trustee acted negligently or converted the funds, yet is judgment-proof for whatever reason.
Intermediaries holding assets

In such a case, several parties typically have an interest in the transaction: the intermediary responsible for holding the funds and effectuating the transfer, the trustee, and the beneficiary. Every state has at least one statute providing protection to such banks against liability to the trustee and beneficiary, but this article focuses on exactly how much protection is and should be afforded to the holding bank.

One may ask why such a transaction is of any importance given the overall size of the financial markets. Though pension funds and corporations and others are the major participants in secondary financial markets rather than trustees, the level of protection afforded the respective trust holding banks may have a dramatic impact on the functioning of financial markets. Even small changes in the costs of financing will lead to changes in the demand for financing across the entire economy. In the arena of trust management, a holding bank usually does not play a role other than to effectuate transfers. If a fiduciary breaches its duty, it will be responsible for the loss. In some circumstances, however, the holding bank that also effectuated the transfer may be a prime target for beneficiaries looking for relief when a fiduciary has breached its duty. An example may be the case when the fiduciary is judgment proof. Though most states grant a statutory safe harbor to securities intermediaries holding funds for fiduciaries to simplify transactions, this article argues that these safe harbor statutes can be too easily pierced thus leaving banks holding the funds with a large risk of liability and high administrative costs.

Securities intermediaries play a central role in the functioning of the overall financial system in the United States. Protection for financial intermediaries not only protects these large firms and the people associated with their businesses but also protects all of those who seek funding in the indirect market, the majority of firms in the developed world. If financial intermediaries are burdened with high, unex-

7. Generally, the policy behind a safe harbor for securities intermediaries holding funds for fiduciary clients proposes to simplify the transaction process for intermediaries by allowing them to make assumptions as to whether entitlement orders from fiduciary clients are proper. The underlying basis for most of these statutes is to make such transactions faster and less costly, often in order to keep up with the increasing speed and volume of transactions in the indirect and direct financing systems. See Scott E. Nutter & Bryan T. Pratt, A Practitioners' Guide to Revised Articles 5 and 8 of the Uniform Commercial Code, 63 Mo. L. Rev. 325 (1998). The statutory safe harbors, however, do not render intermediaries completely immune from liability.

8. See supra note 1.

9. Financial firms and large corporations dominate the direct finance markets. Studies of major developed countries, however, show that lending usually passes through the indirect financing system and not by going directly to debt sellers in the securities markets. In Japan and Germany, financing from financial intermediaries has been almost ten times greater than that in securities markets. See Mayer, supra note 1. The role of financial intermediaries in these coun-
pected costs in the form of potential liability, there is a risk of hindering the indirect market. If higher costs are imposed on intermediaries, some intermediaries may be forced out of the market. This in turn leads to a greater risk of problems associated with asymmetric information problem and liquidity.

Moreover, if higher costs are imposed on financial intermediaries, those who utilize them will have to pay the costs passed off to them resulting from a less efficient market. The result of these higher costs will logically be a change in decisions regarding business spending, a key component of economic output and wealth.

The broad purpose of this article is two-fold: to explain the current statutory framework in this area and to argue for broader protection of intermediaries. Several model statutes have been drafted and adopted by the states to lessen the costs of transacting entitlement orders by client-fiduciaries. In order to provide a context for discussion, this article will begin by giving an overview of the standards for imposing liability on securities intermediaries holding funds for clients serving as fiduciaries in Section II. The background of the common law standard will be described in Section II-A. Moreover, a discussion of the proper role of industry standards, such as the N.Y.S.E. “Know Your Customer” rule, will be discussed. Next, in Section II-B, the Uniform Fiduciaries Act (“U.F.A.”) will be summarized. The U.F.A., drafted in 1922, was the first model statute drafted in this area of the law. Then, a brief overview of subsequent statutory reforms and protections will be discussed and summarized.

tries has been even larger than in the United States due to regulations and economic structure. Japan, for example, has been dominated by the Keiretsu structures anchored by a securities intermediary.

10. Several uniform statutes will be discussed including Chapter 8 of the Uniform Commercial Code. All states have adopted at least one form of statutory protection for intermediaries holding funds and conducting transactions for fiduciaries.

11. Hereinafter, “fiduciary” and “trustee” will be used interchangeably; although, personal representatives, agents, and others are included in the broad category of fiduciaries. The statutes discussed apply to the entire category; however, “trustee” will be used primarily. Likewise, “settlor” and “trustor”; “securities intermediaries” and “financial intermediaries”; and “bank” and “agent” will be used interchangeably. “Client-fiduciaries” refers to bank clients who have a fiduciary duty to a separate third party. The designation “securities intermediary” can refer to several categories of firms acting as conduits in the indirect financing system. Commercial banks, however, are the largest category of securities intermediaries. See Table 1 for a breakdown of securities intermediaries. In the economic sense, “securities intermediaries” refers to firms that take ownership of an asset. For example, a bank may take ownership of an issue, repackage it, and then sell the repackaged issue. In contrast, a broker-dealer or firm taking a company public merely acts as a “facilitator” and takes no long-term ownership of the asset.

12. It should also be noted that the statutes to be discussed do not all deal with the same categories of fiduciaries. Some pertain specifically to trustees whereas others also apply to fiduciary agents and others. Moreover, the statutes often pertain to different transactions. For ex-
The statutory background section, Section II, will include an explanation of how the modern uniform statutes adopted by most states apply in conjunction with the common law and exchange rules. The discussion will include how the standard of protection can be determined in states where several of the uniform statutes have been adopted. Specifically, the discussion will include states where successive uniform statutes have been adopted and older uniform statutes, such as the Uniform Act for Simplification of Fiduciary Securities Transfers have not been repealed.

Next, Section III will focus on the current trend towards greater protection of securities intermediaries dealing with fiduciaries. It will be argued that the statutory trend supports uniform adoption by all states of the broadest statutory protection—an actual knowledge standard for imposition of liability. It will be argued that the underlying purpose of each successive uniform statute shows a trend toward greater protection, namely an actual knowledge standard, of securities intermediaries holding for fiduciaries. Moreover, a discussion of the economic and policy justifications for an actual knowledge standard will follow. A discussion of the impact of an actual knowledge standard will be discussed. Some critics argue that greater protection of securities intermediaries will leave beneficiaries without recourse whereas the securities intermediaries are able to act with lesser care than would otherwise be required.\(^\text{13}\) Answers to the concerns of these critics will be offered in Sections III and IV. Section IV provides a summary of the arguments in Section III and offers a forecast of the potential effects of adoption of an actual knowledge standard nationwide.

II. BACKGROUND: CURRENT PROTECTIONS AFFORDED SECURITIES INTERMEDIARIES DEALING WITH FIDUCIARIES

Securities intermediaries, the majority of which are commercial banks, hold funds for any number of organizations.\(^\text{14}\) The number and ample, the U.T.P.A. does not apply with regard to government securities. See Unif. Trustees Powers Act, 7C U.L.A. 388 (1964) [hereinafter U.T.P.A.]. The focus of this article, though broadly looking at fiduciaries, is on large-firm trustees as clients of securities intermediaries. The arguments in this article generally hold with respect to each of the respective uniform laws discussed.

13. Jerome J. Curtis, Jr., The Transmogrification of the American Trust, 31 Real Prop. Prob. & Tr. J. 251 (1996) (arguing that the trend has been to prefer the third-party bank holding the funds over the beneficiary except where there is evidence of actual notice of breach of fiduciary duty and that maybe the drafters never intended such a standard because it does not allow beneficiaries to force third-party banks to exercise the reasonable care otherwise required). 14. Due to the fact that most securities intermediaries are commercial banks, hereinafter the terms "bank" and "securities intermediary" will be used interchangeably. It should also be
variety of business organizations holding funds for others is as wide as the creative energies of the global financial industry. The following analysis shall be limited specifically to the duty that arises when securities intermediaries hold funds for clients acting as fiduciaries and/or trustees for third-parties. It should be noted, however, that many of the rules discussed below apply very broadly to any securities broker or bank holding funds.

Financial intermediaries are categorized as depository institutions, contractual savings institutions, and investment intermediaries. Table 1 provides an overview of Financial intermediaries in terms of assets. The flexibility of modern trusts means that trustees are often administering trusts funded by assets in any of the categories given in Table 1.

**Table 1. Assets of Principal Financial Intermediaries**

<table>
<thead>
<tr>
<th>Financial Intermediaries</th>
<th>Value of Assets ($ billions, end of year)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Depository Institutions</strong></td>
<td></td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>517</td>
</tr>
<tr>
<td>Savings and Loans</td>
<td>250</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>18</td>
</tr>
<tr>
<td><strong>Contractual Savings Institutions</strong></td>
<td></td>
</tr>
<tr>
<td>Life Insurance Companies</td>
<td>201</td>
</tr>
<tr>
<td>Fire and Casualty Insurance</td>
<td>50</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>112</td>
</tr>
<tr>
<td>State and Local Government Retirement Funds</td>
<td>60</td>
</tr>
<tr>
<td><strong>Investment Intermediaries</strong></td>
<td></td>
</tr>
<tr>
<td>Finance Companies</td>
<td>64</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>47</td>
</tr>
<tr>
<td>Money Market Mutual Funds</td>
<td>0</td>
</tr>
</tbody>
</table>

The modern money and banking system has evolved into a complex network of entities performing a wide-variety and high volume of transactions around the globe. Financing is provided by the market through indirect or direct financing systems. In the indirect financing noted that many of the statutes discussed also extend protection to broker agents and others even if not explicitly mentioned.


16. Id. (citing Federal Reserve Flows, which are available on a daily, weekly, quarterly, and annually basis on the Federal Reserve Board website at www.federalreserve.gov/releases).
system where most people will go for financing, commercial banks will be the primary movers of money.

A fiduciary breach can be especially troubling in the case where the beneficiary has been deprived of rightful funds and did not have any interest in the drafting of the trust agreement. One can imagine a case where the trust was created merely for sheltering assets, but the beneficiary instead finds him or herself without the funds due to the fiduciary's breach.

Trusts created to take advantages of more favorable tax codes or to shelter assets are common trusts involved in this scenario. Testamentary trusts may also be common due to the complexity of estate planning and possible tax benefits. A less common type of trust where social policy might be different is that of trusts where the trustor is also a beneficiary. An example of a correlated situation would be where a beneficiary of an insurance policy, settlement agreement, lottery winnings, or otherwise has his or her lawyer draft a trust agreement to provide for more tax-favorable distribution of the proceeds and management of the funds by someone of experience.

Banks will also hold funds for any number of companies and private individuals alike. These banks will have a variety of standards for inquiry into the actions of clients imposed by both common law and statutory law. The banks are motivated to know more about their clients in order to avoid liability on contribution theories. As a result of the fallout from the recent scandals, a greater pressure has been put on those who deal with companies acting improperly. As an example, the Sarbanes-Oxley Act includes an informant provision that seems to impose a burden on law firms and others assisting company-clients acting wrongfully. A duty is also imposed depending on the client. The USA Patriot Act has provided more stringent duties on banks with respect to turning over information about particular clients to the federal government. Focusing the loss on the firm with the most

17. It should be noted that some of the statutory protections apply to securities intermediaries while others apply to brokers and agents. This article will focus on securities intermediaries; however, the support for an actual knowledge safe harbor applies to both equally. The underlying purpose of all the statutes applies to both the direct and indirect holding systems. Moreover, while securities intermediaries are the main players in the indirect holding system, agent-brokers play the same sort of role as conduits in the direct holding system.


funds to absorb it only serves to obfuscate the underlying problem. In the example above, the problem clearly is the wrongdoing of the fiduciary against which the trustor may have little recourse in the case of, *inter alia*, fiduciary insolvency or disappearance.20

Typically, however, the bank’s client will not be acting in a fiduciary capacity in regards to a third party. In the most egregious circumstances, even officers of the securities intermediary may be liable as co-participants in, but not an enabler of, the transaction.21 The duty of ordinary care will not impose an inquiry duty where the client is not holding funds for another.22 Lastly, there are a host of other reasons why a securities intermediary may need to inquire into the identity and powers of its clients. One of the most recent and noteworthy of these is the USA Patriot Act, which requires banks and financial institutions to investigate clients to assure that they are not funding so-called terrorist activities.23 This article focuses on negligence and conversion theories in the case where a securities intermediary holds funds for a client acting as a trustee pursuant to a trust agreement with a third party.

A. *The View of The Common Law and Exchange Rules*

Under the common law, securities intermediaries must exercise ordinary care.24 While securities intermediaries generally do not have a special relationship requiring a higher standard of care akin to that of a fiduciary duty, they still must exercise a level of care consistent with

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20. For an overview of balancing the burden between fiduciary and beneficiary, see Charles M. Bennett, *When the Fiduciary’s Agent Errs—Who Pays the Bill—Fiduciary, Agent, or Beneficiary?*, 28 REAL PROP. PROB. & TR. J. 429 (1993).


22. As the enabler of the action, a bank, agent, or any other may not intentionally turn a blind eye to wrongdoing and thus must make an inquiry under certain circumstances. Ohio Cas. Ins. Co. v. Bank One, 1997 WL 428515, *5 (N.D. Ill. 1997) (liability for willful blindness). The bank will be required to exercise reasonable care and inquire accordingly in order to avoid liability under negligence theory.


that of the industry. The common law duty of care imposes upon securities intermediaries a duty of performing due diligence under suspicious circumstances such as notice that the client is acting as a fiduciary or adverse claims to the funds. When receiving directives from clients, the common law requires that securities intermediaries ensure that the funds transferred are properly applied.

Under the common law standard, securities intermediaries must be judged based on industry standards, which in many cases can be supported by evidence of industry rules and regulations. Most securities intermediaries now represent a massive collection of resources and services in order to gain from economies of scale and in order to attract larger clientele desiring one provider for a multitude of services. Therefore, most securities intermediaries are members and/or are listed on the New York Stock Exchange ("N.Y.S.E.") or a similar exchange. The N.Y.S.E. lists nearly 2,800 of the largest companies in the US. Similarly, the NASDAQ market, which is a network of broker-dealers as opposed to a physical trading floor like the N.Y.S.E., lists over 4,000 companies, over half of the companies traded in the US primary markets, and trades more shares than any other US equities market.

The N.Y.S.E. has set forth a number of rules for members conducting transactions within the exchange. N.Y.S.E. Rule 405, commonly referred to as the "Know Your Customer Rule," is often cited to support the argument that a bank has a duty to perform due dili-

25. See generally Allison-Williams, 519 N.W.2d 176; Chilson, 306 N.W. 2d 893 (both cases holding the duty of care would be judged by reference to the degree of care exercised by other securities companies in similar circumstances).

26. Lowry v. Commercial & Farmers' Bank, 15 F. Cas. 1040 (D. Md. 1848) (issuers will be liable for registering a transfer on the orders of registered owner acting wrongfully against a third person).

27. Mutual Serv. Cas. Ins. Co. v. Elizabeth State Bank, 265 F.3d 601, 623 (7th Cir. 2001) (stating that a bank has a duty to inquire into the authority of one cashing a check to ensure that the proceeds are properly applied).

28. Mihara v. Dean Witter & Co., 619 F.2d 814, 824 (9th Cir. 1980) (agency rules do not provide a cause of action but "these matters may be considered on the issue of scope and extent of a broker's duty of care owed his customer.")


32. Exchange rules are only loosely applied currently; however, the SEC has pushed for greater application of the rules in all exchanges following the trading violations and other controversies engulfing the N.Y.S.E. of late. Kopin Tan, SEC Prods Exchanges to Step Up Enforcement of Trading Rules, WALL ST. J., Mar. 9, 2004, at C3.
gence any time funds are received under the ordinary care standard.\textsuperscript{33} Rule 405 requires securities intermediaries to perform due diligence in order to ensure that funds are not misappropriated.\textsuperscript{34}

While the industry standard may require due diligence to prevent misappropriation of funds, most states have passed laws superseding any common law duty and liability.\textsuperscript{35} In the context of fiduciary transfers of securities, most states have adopted various uniform statutes to promote the transfer of securities by fiduciaries.\textsuperscript{36}

Most commercial banks will perform a minimal background check before accepting funds from an individual or company. In so doing, the securities intermediary will often become aware of the underlying trust agreement. With the knowledge that the funds are being held under a trust agreement, the bank will thus have an obligation at common law to request a copy of the trust agreement. The bank will also have an obligation not to perform any transactions which are known to be in direct violation of the trust agreement’s provisions.\textsuperscript{37}

Most of the statutory safe harbors impose liability only when the securities intermediary had some level of knowledge of the breach of fiduciary duty in initiating the particular security transfer. The statutes differ slightly in their breadth: some require constructive knowledge of the breach of fiduciary duty versus actual knowledge to impose liability. With “knowledge” being the basis for imposing liability, the focal point then becomes the duty of inquiry imposed on the securities intermediaries.

A spectrum of inquiry duties has thus been created by the statutory schemes. Under a statute requiring constructive knowledge, a bank would have a duty of simple inquiry much like the common law duty. Other statutes include a good faith requirement imposing a duty to inquire further under circumstances of reasonable suspicion.\textsuperscript{38} At the far end of the spectrum is protection for securities transfers unless the

\begin{itemize}
\item \textsuperscript{33} In re Blech Sec. Litig., 2003 WL 1610775, *2 (S.D.N.Y. 2003).
\item \textsuperscript{34} N.Y.S.E. R. 405; see De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1310 (2d Cir. 2002) (use of Rule 405 as evidence of industry standard requiring due diligence accepted by the court).
\item \textsuperscript{35} Unif. Fiduciaries Act §2, 7A U.L.A. 135 (1978) [hereinafter U.F.A.]; see also BOGERT, THE LAW OF TRUSTS AND TRUSTEES (Rev. 2d ed) § 905.
\item \textsuperscript{36} Id.
\item \textsuperscript{37} Hertz v. Record Pub. Co. of Erie, 105 F. Supp. 200, 201 (W.D. Pa. 1952) (no duty to inquire into rightfulness simply because registered owner holding funds for a third); United States Fidelity and Guar. Co. v. Royal Nat’l Bank of New York, 545 F.2d 1330, 1335 (2d Cir. 1976) (broker has no duty to inquire into rightfulness of order absent knowledge of suspicious circumstances)
\item \textsuperscript{38} See, e.g., UNIF. COMMERCIAL CODE, 2C U.L.A. 267 (1994) [hereinafter U.C.C.].
\end{itemize}
INTERMEDIARIES HOLDING ASSETS

securities intermediary has actual knowledge of the breach of fiduciary duty, which effectively eliminates any inquiry duty.

B. Uniform Fiduciaries Act (U.F.A.)

The U.F.A. was enacted to relieve securities intermediaries of the common law duty of inquiry. As long as the securities intermediary acts in good faith, the U.F.A. affords protection from liability stemming from the breach of fiduciary duty. The U.F.A. protects a securities intermediary or agent "who in good faith pays or transfers to a fiduciary any money or other property which the fiduciary as such is authorized to receive, is not responsible for the proper application thereof by the fiduciary." Furthermore, the payment or transfer from fiduciaries to securities intermediaries and others "is not invalid in consequence of a misapplication by the fiduciary." The good faith requirement, however, implicitly includes a duty to inquire into the rightfulness of transfers. The good faith requirement, therefore, provides a loophole in the safe harbor otherwise provided by the U.F.A. for securities intermediaries without actual knowledge of the trustee's breach.

Liability can only be imposed under the U.F.A. if the securities intermediary transferred the securities in bad faith or with actual knowledge that the directive was in violation of the fiduciary's power. Liability under the U.F.A. thus requires an allegation rising to the same standard as an intentional tort. Actual knowledge requires an awareness on the part of the securities intermediary that the fiduciary is defrauding the principal and/or breaching his or her duty at the mo-

40. See U.F.A., supra note 35.
41. Id.
42. Uniform Fiduciaries Act drafted in 1922.
43. Wetherill v. Bank IV Kansas, 145 F.3d 1187 (10th Cir. 1998) (because bad faith includes willful blindness and other situations where a reasonable person in the same circumstances would have inquired into the rightfulness of the transfer).
45. An intentional tort requires that the "actor knows that consequences are certain, or substantially certain, to result from his act, and still does ahead" under the Restatement (Second) of Torts § 8A cmt. b (1965) (emphasis added). Likewise, under the U.F.A., a claimant must allege the actor had knowledge and still followed the instructions of the client.
ment the transaction takes place.46 Although the U.F.A. utilizes an actual knowledge standard, the requirement of good faith necessarily lowers the standard to a constructive knowledge standard.47 The existing facts must be taken into account to determine if a bank, in exercising ordinary care, would have a reasonable probability of discovering the wrong being done.48 Under this standard, therefore, a securities intermediary must inquire into the rightfulness of instructions where suspicious circumstances exist or the securities intermediary has reason to know that the instructions may be contrary to the principal's fiduciary powers. If required to investigate, a bank will be charged with heightened actual knowledge.

The purpose of the U.F.A. was to protect entities dealing in good faith with fiduciaries.49 When drafting the U.F.A., an effort was made to shift the burden of ensuring funds are properly applied from the intermediary to the principal who selected the fiduciary.50 By shifting the burden to the principal, the U.F.A. aimed to increase the efficiency of securities transfers and thus promote the effectiveness of fiduciaries.

C. Further Statutory Protections

1. Revised Section 8-115 of the Uniform Commercial Code

A broker is not obliged to take risks on behalf of a customer.51 A broker or bank, however, may be liable if it has constructive knowledge that the trustee transactional order was improper. Section 8-115 of the U.C.C. states that a securities intermediary will generally be liable for the a transfer of securities in breach of fiduciary duty if (1)

47. Although the U.F.A. does not use the “constructive knowledge” language, bad faith has often been found under circumstances akin to constructive knowledge. Willful blindness has been found to be bad faith, which may amount to an imposition of a constructive knowledge standard. Decker v. Yorkton Sec., Inc., 131 Cal. Rptr. 2d 645, 650 (Cal. Ct. App. 2003) (citing Goodman v. Simonds, 61 U.S. 343, 366-67 (1858) (“Every one must conduct himself honestly... While he is not obliged to make inquiries, he must not willfully shut his eyes to the means of knowledge which he knows are at hand... for the reason that such conduct, whether equivalent to notice or not, would be plenary evidence of bad faith.”) (emphasis added)).
48. Id. (citing § 8105 cmt.4).
acting in opposition to a court directive or (2) acting in collusion.\textsuperscript{52} Official Comment 1 to Section 8-115 indicates that this section deals with the related problem of liability of "securities intermediaries—the ‘conduits’ in the indirect holding system—and brokers and other agents or bailees—the ‘conduits’ in the direct holding system."

Under the second premise, liability will be imposed for acting in collusion with the fiduciary in breach of the fiduciary duty.\textsuperscript{53} In several cases, parties have argued for an expanded reading of the term "collusion."\textsuperscript{54} The Official Comment 5 to Section 8-115 indicates that the "collusion test" should be interpreted according to the meaning of "collusion" from the Restatement (2d) of Torts.\textsuperscript{55} There is little support for a broadened reading of "collusion" beyond this standard.\textsuperscript{56} The securities intermediary, according to Comment 3, "should not be placed in the position of having to make a legal judgment about the validity of the claim at the risk of liability either to its customer or to the third party for guessing wrong." The purpose of this section and many of the other provisions under Article 8 of the U.C.C. is to grant agents and organizations in the direct and indirect holding systems the privilege to act on the instructions of customers unless it has been served with a restraining order, its actions rise to the level of collusion, or it acts in bad faith.\textsuperscript{57} The aim of Article 8 is to promote greater

\textsuperscript{52} U.C.C. § 8-115 (1994). This section, entitled Securities Intermediary and Others Not LIABLE to Adverse Claimant, states:

A securities intermediary that has transferred a financial asset pursuant to an effective entitlement order, or a broker or other agent or bailee that has dealt with a financial asset at the direction of its customer or principal, is not liable to a person having an adverse claim to the financial asset, unless the securities intermediary, or broker or other agent or bailee:

(1) took the action after it had been served with an injunction, restraining order, or other legal process enjoining it from doing so, issued by a court of competent jurisdiction, and had reasonable opportunity to act on the injunction, restraining order, or other legal process; or

(2) acted in collusion with the wrongdoer in violating the rights of the adverse claimant; or

(3) in the case of a security certificate that has been stolen, acted with notice of the adverse claim.

\textit{Id.}

\textsuperscript{53} See U.C.C. § 8-115, cmt.5.


\textsuperscript{55} U.C.C. § 8-115, \textit{supra} note 52, cmt.5.

\textsuperscript{56} Official comment 3 states that this section provides protection even where the securities intermediary has notice or knowledge of an adverse claim. In order to promote the settlement of securities transfers, liability will not depend on notice or knowledge of adverse claims.

\textsuperscript{57} Comment 3 to Section 8-115 states the overall purpose of this section as relieving securities intermediaries and agents in the indirect and direct holding system of the fear of liability for acting on the instructions of a client where an adverse claim exists. Comment 2 states that the "policy of this section is similar to that of many other rules of law that protect agents and bailees
efficiency in settlement of securities transfers by relieving entities in the direct and indirect holding system of having to make judgment as to claims between their clients and third parties.\textsuperscript{58}

In addition to the "collusion test," the U.C.C. also includes a requirement of good faith.\textsuperscript{59} Bad faith has been defined as suspicion that a fiduciary is acting improperly and deliberately refraining from investigating to avoid actual knowledge of a fiduciary's breach of duty.\textsuperscript{60} Most bad faith actions, however, will be encompassed by the "collusion test," which covers the typical bad faith acts, such as willful blindness.\textsuperscript{61}

Given the protection afforded by Section 8-115, securities intermediaries are thus relieved of a duty to inquire into adverse claims on funds held by clients.\textsuperscript{62} Under the "collusion test," however, securities intermediaries will also have to perform a good faith inquiry when receiving instructions from clients.\textsuperscript{63}

2. Revised Sections 8-401, 402, 403 of the Uniform Commercial Code

Revised Section 8-115 provides protection to securities intermediaries dealing with fiduciaries. In understanding Section 8-115, however, the other sections of Chapter 8 of the U.C.C. provide a further context for interpretation.\textsuperscript{64} Moreover, the revisions to these sections may provide an understanding of the purpose and intent of Section 8-115, which was only added in a later revision of Article 8. As discussed, Section 8-115 pertains to securities intermediaries holding funds for fiduciary clients. The other provisions provide safe harbors for similarly situated entities effectuating transfers.

\textit{from liability as innocent converters." (emphasis added). Similar to general tort law, the purpose of this section is to protect agents and bailees from liability when acting properly on the instructions of their clients or bailors.}

\textsuperscript{58} See U.C.C. § 8-115, cmt.1.


\textsuperscript{61} Id.

\textsuperscript{62} See Official Comments to § 8-115.

\textsuperscript{63} Id.

\textsuperscript{64} U.C.C. Section 8-115 includes substantial official comment to explain the purpose of the section and give further explanation for its intended application. The comments include several factual example situations. Though the comments to Section 8-115 make the meaning of the section relatively clear, a full understanding of the section can only be properly had by relating Section 8-115 to the rest of the Chapter 8. For this reason, an explanation of similar sections will be explained herein.
The prior version of Section 8-403 specified that if an issuer had written notice of an adverse claim it would have to inquire into the claim by reasonable means.\textsuperscript{65} It could discharge its inquiry duty by notifying the adverse claimant that the transfer would be registered unless the adverse claimant obtained a court order or gave an indemnity bond.\textsuperscript{66}

The Revised Article 8 amends the principle of liability by protecting the transferring agent against liability unless acting against a court directive or in collusion with the breaching fiduciary. The Revised Article 8 does not impose a duty of inquiry when simply given notice of an adverse claim.\textsuperscript{67} The former Section 8-403(3) was therefore no longer necessary to negate the inference of constructive knowledge based merely on notice of an adverse claim.\textsuperscript{68} The revised section purportedly provides a higher standard than constructive knowledge.

Under the current Revised Chapter 8, notice of an adverse claim does not impose actual knowledge of a breach of fiduciary duty; however, knowledge that a client is acting in the capacity of a fiduciary can impose a duty to inquire into the adverse claim.\textsuperscript{69} If a bank knows that a client is acting in the capacity of a fiduciary, under the rules of good faith, it must request a copy of the fiduciary agreement to assure that it informs itself of the extent of the fiduciary's powers. The bank, therefore, still has a duty of inquiry when it has even the mere knowledge that a client is acting as a fiduciary.

The current standard for liability under the U.C.C. seems to be on the basis of what the holder should know or negligently failed to uncover. Those who refuse to investigate will be imputed with actual knowledge.

Section 8-403 can be read as providing support for the argument that the inquiry duty should generally be triggered by the knowledge of the transferor of a breach of a fiduciary duty (by the client) rather than knowledge of an adverse claim (by a third party). Section 8-403(2) states that "the fact that the issuer has notice that the registered owner holds the security... in the name of a fiduciary does not create a duty of inquiry into the rightfulness of the transfer. If, however, the issuer... has reason to know that such proceeds are being used or that the transaction is for the individual benefit of the fiduci-

\textsuperscript{65} Former U.C.C. § 8-403.
\textsuperscript{66} See U.C.C. § 8-403 and comments thereto.
\textsuperscript{67} U.C.C. § 8 (no duty to inquire is imposed based merely on an adverse claim).
\textsuperscript{69} See U.C.C. § 8-115. See generally U.C.C. § 8.
ary, the issuer is under a duty to inquire into the rightfulness of the transfer.'\textsuperscript{70} Article 8 of the U.C.C. can thus be read as usurping the common law duty of due diligence in all circumstances and limiting the inquiry duty to cases where the securities intermediary has reasonable suspicion of the rightfulness of clients' instructions.\textsuperscript{71}

In light of the higher standard in the other sections and the mention of actual knowledge, Section 8-115's constructive knowledge standard stands as an anomaly. A possible explanation for this may be that it strikes a compromise between the good faith principles of the U.C.C. and the trend towards affording financial institutions greater protection.


"Whereas the responsibility of a corporation to inquire into the propriety of transfers of their shares is an anomaly never included in the common law and equity of England . . . whereas this responsibility is anachronistic in light of the modern rule of negotiability of shares . . ." an "actual knowledge" or "bad faith" is appropriate to eliminate the imposition of duty based simply on notice of adverse claim from U.C.C.\textsuperscript{72} At the time of adoption of the U.A.S.F.S.T., many corporations appeared to be adhering to burdensome documentation and ignoring the U.F.A. to assure protection based on the then-existing 1947 U.C.C. standard; therefore, the N.C.C.U.S.L. felt the need for an additional statute protecting corporations.\textsuperscript{73} The U.A.S.F.S.T. strengthened the protection of intermediaries to eliminate the need for such preventative actions that were not intended to be required under the U.F.A.

Many of the provisions of the U.A.S.F.S.T. and similar statutes are identical or similar to those of the prior version of the U.C.C.; although, most states retained the U.A.S.F.S.T. and similar statutes.\textsuperscript{74} The protection of the U.A.S.F.S.T., however, supersedes the U.F.A. and prior U.C.C. The duty of inquiry imposed by the U.A.S.F.S.T. is narrower than that of even the prior U.C.C. because the U.A.S.F.S.T. allows securities intermediaries to assume fiduciaries are acting prop-

\textsuperscript{70} U.C.C. § 8-403(2).
\textsuperscript{71} Other sections of Article 8 including for example § 8-304 specifically limit the duty of inquiry into the rightfulness of transfer instructions or adverse claims.
\textsuperscript{73} Id.
\textsuperscript{74} Rapson, supra note 68.
erly except in the narrow circumstances specified in the specific statute of the adopting jurisdiction. Generally, a securities intermediary will be protected under the U.A.S.F.S.T. unless it had actual knowledge of the breach of fiduciary duty at the time of executing the transaction.


Fifteen states have adopted a form of the U.T.P.A. The U.T.P.A. expands the powers of trustees and promotes trustee self-regulation over trustor monitoring. In the event that a trustee is in breach the trustor will often look to the wealthy third-party bank. This circumstance happens more often than thought because trustees usually do not have nearly as much capital as banks unless they are part of a large bank or insurance company. Many trustees still act on their own as individual companies and not part of a bank. In such cases, the trustee often may not be able to satisfy the judgment and the third party bank becomes the sole defendant. Thus, in cases of breach, the U.T.P.A. does as much for third-party intermediaries in the case of trust bankruptcy as it does for trustees properly administering a working trust.

The U.T.P.A. serves as the linchpin for protection of banks because the protection afforded by the U.T.P.A. is broader than that of the U.F.A. and Common Law. Under the U.T.P.A., securities intermediaries do not have a duty to inquire into whether trustees are exercising their powers properly. The U.T.P.A. does not provide protection if the securities intermediary has actual knowledge of the breach of fiduciary duty, meaning, protection extends to intermediaries without actual knowledge of the breach.

76. "A third person, without actual knowledge of breach of trust, dealing with the trustee is protected." Unif. Trustees' Powers Act, 7C U.L.A. 388 (1964) (emphasis added). Similar to the U.F.A., the U.T.P.A. also extends the powers of trustees. Under the U.T.P.A., the trustee has any power not expressly restricted in the trust agreement as well as the power to carry out permissible acts listed. See Jason L. Smith, Siegmeier v. Magness, An Analysis of a Trustee's Fiduciary Duty in Self-Interested Transactions, 14 Quinnipiac Prob. L.J. 605, 623 (2000). All powers within the U.T.P.A. are within the power of the trustee. Id. A trustee, however, must seek court approval if an action poses a potential conflict of interest. Id. at 624.
77. The U.T.P.A. incorporates solely an actual knowledge standard whereas the other statutes utilize a constructive knowledge standard or good faith at least in the alternative. See U.T.P.A., 7C U.L.A. 388 (1964).
III. Analysis

A. Current Level of Protection

Today, the financial system in the United States is heavily regulated. The duties required by these regulatory agencies stand in addition to those of the common law and state statutory laws. Table 2 lists some of the major regulatory agencies involved in the US financial system. Most of these agencies oversee the business of firms in financial markets and/or impose specific duties. There is little interaction between these regulatory agencies with the issues discussed in this article. Generally, the duties imposed by exchange rules and regulatory agencies serve as evidence for interpreting reasonableness at common law.80

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<thead>
<tr>
<th>Agency</th>
<th>Scope</th>
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<tr>
<td>Securities &amp; Exchange Commission</td>
<td>Exchanges and financial markets</td>
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<tr>
<td>Federal Reserve</td>
<td>All depository institutions</td>
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<tr>
<td>State Banking and Insurance Commissions</td>
<td>State depository institutions</td>
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<tr>
<td>Federal Deposit Insurance Companies</td>
<td>Banks, mutual funds, etc.</td>
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<tr>
<td>Office of the Comptroller of the Currency</td>
<td>Federally chartered commercial banks</td>
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<tr>
<td>Commodities Futures and Trading Commission</td>
<td>Federally chartered commercial banks</td>
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<td>National Credit Union Administration</td>
<td>Federally chartered credit unions</td>
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At common law, as discussed above, banks have a duty to investigate adverse claims. The U.F.A., drafted in 1922, has been adopted by 26 states.82 The U.A.S.F.S.T. was drafted in 1958. It has been adopted by 24 states.83 While the U.F.A. aimed to protect corporations dealing with trustees, many corporations adhered to the common law inquiry and documentation duty to assure that they would not be exposed to liability.84 The drafters apparently believed that the standard set forth in the U.F.A. needed to be broadened and clarified in order to eliminate the need for what it felt was excessive documen-

80. Mihara v. Dean Witter & Co., 619 F.2d 814, 824 (9th Cir. 1980).
Part of the reason for corporations adhering to the common law duty of inquiry and documentation was the ambiguity of the then-existing Chapter 8 of the U.C.C. At that time, the U.C.C. imposed a duty of inquiry based on knowledge where knowledge could be imputed when the holding company had notice of an adverse claim. Now that Chapter 8 of the U.C.C. has been revised and Section 8-115 has further been added, there is little need for the U.A.S.F.S.T. Therefore, in states that adopted the revised U.C.C. and simply did not repeal the U.A.S.F.S.T., the U.A.S.F.S.T. is not applicable.

The U.T.P.A. has been drafted to increase the flexibility in the exercise of investment power attendant upon trustees by raising the level of protection to that of prudent man rule investment statutes. The U.T.P.A., drafted in 1964, has been adopted by 16 states. The U.T.P.A. provides the broadest protection.

The U.T.P.A., however, does not necessarily control. Whereas the U.F.A. and U.T.P.A. were drafted many years ago, the U.C.C. has gone through constant revisions and will be continually revised. Likewise, Section 8-115 is the most recent statute related to this subject matter. It is also the most widely accepted given its inclusion in the U.C.C.

B. The Trend

Revised Article 8 has only been adopted in the late 1990's and thus has not played a significant role in the courts until the last few years. The revision of Article 8 shows the trend towards expanding the protection of parties in financial markets in order to increase the efficiency of markets.

85. Id.
86. See U.C.C. § 8-115.
87. See Nutter, supra note 7. All the states that adopted the U.A.S.F.S.T. have since repealed the statutes except for Louisiana and Washington D.C.
88. See prefatory note to U.C.C. revision stating that after the revision of the U.C.C., the U.A.S.F.S.T. becomes redundant and expressly inapplicable; see also Rapson, supra note 68.
91. Actual knowledge rather than good faith or constructive knowledge.
92. Revised Article 8 of the U.C.C. was drafted in 1977. Section 8-115 has been adopted by all jurisdictions including the District of Columbia and Virgin Islands. No cases have yet had the chance to fully interpret Section 8-115.
93. Section 8-115 was drafted in 1994. The U.T.P.A. predates even the revised Chapter 8 of the U.C.C. drafted in 1977.
The trend has been to enact laws providing more protection for securities intermediaries doing business with fiduciaries and shifting the burden onto beneficiaries. The U.F.A. relieved banks holding funds for fiduciaries of the common law duty. The U.A.S.F.S.T. expanded this protection to assure banks that they would not be liable in the case of notice of adverse claims. The U.T.P.A. increased the scope of protection even further by only allowing a cause of action where a bank had actual knowledge of the breach of fiduciary duty.

The U.C.C., revised later in 1977, included several safe harbor sections with regards to different transactions. Section 8-115, drafted in 1994, maintains the typical constructive knowledge and good faith standards of the U.C.C. Section 8-115, however, does not indicate a retreat from the actual knowledge standard of the U.T.P.A. Section 8-115 does not make any reference to the U.T.P.A. Nonetheless, it mentions an actual knowledge standard and only the U.C.C. good faith requirement also included serves to limit its scope. Therefore, it is unclear whether the drafters of the Section 8-115 intended to assure a constructive knowledge standard in place of the actual knowledge standard of the U.T.P.A.

In the twentieth century, American law moved away from imposition of liability on issuers for registering transfers ordered by registered owners held to be acting wrongfully towards beneficiaries. Several statutes, as discussed above, were enacted to eliminate delays in securities transfers that hinder fiduciaries' ability to serve beneficiaries' interests.

Professor Wendel and others argue that perhaps the drafters of the U.T.P.A. did not intend to go so far as the literal language suggests. Professor Wendel notes that the common law recognized both negligent inquiry and intentional bad faith.

96. See U.A.S.F.S.T., 7C U.L.A. 332 (1958); see also supra Section A.
98. Chapter 8 of the U.C.C. deal broadly with business dealings. Several of the sections provide safe harbors with regards to depository institutions and check-writing and purchases for value. Only Section 8-115 deals specifically with fiduciaries and securities intermediaries.
100. The drafting of statutes by the NCCUSL typically does not include the same documentation as state or federal legislation drafting. Moreover, due to the fact that the uniform statutes were drafted many decades ago, little in the way of drafting history was available in interpreting these model statutes today.
101. See Rapson, supra note 68.
102. Id. (discussing enactment of uniform statutes protecting securities intermediaries discussed above).
103. See Curtis, supra note 13.
104. Id.
Wendel and Mr. Curtis argue that prior uniform acts retained intentional bad faith as a basis for imposing liability, but exonerated issuers shown to have acted negligently. The actual knowledge standard of the U.T.P.A., however, is clear. Professor Wendel is correct to note that prior statutes retained the constructive knowledge standard for imputing knowledge on banks and agents who intentionally refuse to inquire. Nonetheless, the trend, has been to increase protection for banks and agents dealing with fiduciaries in order to make processing of transaction orders more efficient. The U.T.P.A. only moves one step further from the constructive knowledge standard. After several decades and an explosion in the financial industry, the U.T.P.A. is a logical step further.

Curtis also argues that an actual knowledge standard “frustrates the intentions of settlors by making it impossible to create a trust that would force third parties to exercise that degree of care they would undoubtedly display in other contexts.” Curtis argues that treating third parties as good faith purchasers even when they ignore signs that trustees are acting ultra vires creates unjust results. Normally the banks and agents would exercise a degree of care comparable to that exercised under an actual knowledge standard. This still imposes a duty to provide the care to be expected and precludes disregard of wrongful conduct by the trustee. In the case of dealings with non-fiduciary clients, the worry of rightfulness of transactions and powers of the client are not present. The bank must only assure that it does not act in collusion with a client acting wrongfully.

Curtis suggests that the drafters may not have intended this result. The language of the U.T.P.A. does not contain any ambiguity. There does not seem to be any indication that a good faith requirement was unintentionally omitted either. Rather, the omission of the good faith requirement may be seen as an intentional desire to assure that banks and agents have no investigative burden given increasingly complex and fast-paced financial transactions.

105. Id.
106. Id. The U.F.A., U.A.S.F.S.T., and U.C.C. all contain good faith requirements and/or constructive knowledge standards barring issuers from being shielded under facts supporting willful blindness.
107. Curtis, supra note 13, at 251 (arguing that the actual knowledge standard of the U.T.P.A. goes too far in relieving securities issuers of liability).
108. Id.
109. Id. at 307-08 (arguing the drafters may not have intended to let issuers shield themselves from liability by deliberately failing to investigate).
110. Charles Horowitz, chairman of the committee that drafted the U.T.P.A., argued that the elimination of the constructive knowledge standard is necessary for trusts to be efficiently administered. Id. at 304.
The result of an actual knowledge standard cannot be said to be entirely unjust since the U.T.P.A. actually allows banks to put their faith in fiduciary-clients in whom third party settlors have already invested their faith. The burden has shifted further onto the settlor to assure that the fiduciary selected will act in conformance with his or her status and the powers with which he or she has been entrusted. The trust with which the fiduciary has accepted are of the highest order and it cannot be argued unjust to allow others to thus rely on this relationship as well, especially given the fact that the beneficiaries are the ones who benefit from more efficient transaction processing. The beneficiaries may still disengage themselves from the administration, but they should still be required to show at least some interest in choosing the trustee wisely.\textsuperscript{111} The law is not meant to allow beneficiaries to choose trustees frivolously.

Furthermore, in a historical context, the U.T.P.A. actual knowledge standard is arguably the broadest and latest in the series of model statutes affording a safe harbor to securities intermediaries holding funds for fiduciaries.\textsuperscript{112} Of the separate uniform laws mentioned above involving securities intermediaries, the U.T.P.A. is the broadest and most recent. Section 8-115 of the U.C.C. incorporates a good faith standard foreclosing willful blindness as opposed to the U.T.P.A. actual knowledge standard.

Nonetheless, Section 8-115 serves as an investment security rule within the Uniform Commercial Code. Section 8-115 can be seen as a compromise between the timidly accepted U.T.P.A. and the widely accepted U.C.C., which includes a good faith requirement throughout. Had the rule been drafted standing on its own, one cannot be certain that it would have incorporated the collusion test as opposed to an actual knowledge standard.\textsuperscript{113}

In fact, given the other uniform laws relating to securities intermediaries, the good faith safe harbor would be superfluous. As mentioned above, Section 8-115 even includes an actual knowledge standard.

\textsuperscript{111} See Bennet, \textit{supra} note 20, for more information on balancing the loss of fiduciary agent errors between the fiduciary and beneficiary.

\textsuperscript{112} The U.T.P.A. was drafted in 1964 and sU.C.C.ceded drafting of the U.F.A. (1922) and U.A.S.F.S.T. (1958) discussed above. Section 8-115 of the U.C.C., however, was just very recently added in 1996 but deals with a broader and relatively different subject matter than the U.F.A., U.A.S.F.S.T., and U.T.P.A. It should also be noted that the U.F.A., U.A.S.F.S.T., and U.T.P.A. deal with the powers of trustee-fiduciaries whereas the U.C.C. focuses on business transactions. Section 8-115 focuses specifically on placing orders by fiduciaries simpler for securities intermediaries for the benefit of the market; the U.F.A., U.A.S.F.S.T., and U.T.P.A. aim to make the transactions simpler in order to make the fiduciary more effective. See above for specific underlying purposes of U.C.C., U.F.A., and U.A.S.F.S.T.

\textsuperscript{113} Section 8-115 was added as a new section on its own after the latest revision of Article 8.
standard. Given the inclusion of the U.C.C. good faith, however, the actual knowledge standard becomes meaningless. Section 8-115 seems to allow the possibility that at some point in the future the constructive knowledge and good faith language may be deleted. As a rule of statutory interpretation, a statute should not be interpreted so as to make it redundant. In this respect, the U.T.P.A. stands as the last in a line of uniform laws relating to intermediaries and fiduciary clients. Thus, the trend appears to be granting broader protection rather than narrowing the protection already afforded under more widely-adopted, older model statutes.

C. The Necessity of Uniformity

Currently, there is a lack of uniformity in provisions adopted by the states.114 In some states, a complainant must show an adverse third party was acting for personal gain or in furtherance of his or her own financial advantage in order to have the right to sue a third party for participating in a breach of fiduciary duty.115 Most states provide a constructive knowledge standard for protection of securities intermediaries holding funds for fiduciaries. A small number of states adhere to the onerous common law standard in conjunction with exchange rules and other industry standards. A small number of states also have adopted the broader actual knowledge standard. Some states have adopted all the statutes discussed and failed to repeal prior versions. Some states have only adopted the U.C.C. All the jurisdictions have adopted at least one of the uniform statutes. For this reason, it is often difficult for banks doing business in each state to determine the standard for imposing liability when dealing with trustees.

Even if a bank is aware of which model codes have been adopted, it cannot always be sure of the applicable standard. For example, a bank may not always be so sure of the duty of inquiry in a particular

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114. Fifteen states have adopted the U.T.P.A. Forty-four states have adopted the U.C.C. The 2000 revision of Article 8 and Section 8-115 has been adopted substantially by all fifty states, the Virgin Islands, and the District of Columbia. Twenty-five states and the District of Columbia have adopted the U.F.A. 115. Restatement Second Trusts § 326, cmt. a., 124 (No liability on the part of an agent effectuating a transactions unless the agent had knowledge of the breach of fiduciary duty); see e.g., Certain Defendants v. Lucas & Co., 2002 Cal. App. Unpub. LEXIS 6966 (California appellate court affirming summary judgment for defendant where defendant accountant could not be shown to have gained personally nor personally involved with the breach of fiduciary duty); see also In re Cooper, Inc., 2000 WL 1664167, *9, (Del. Ch. 2000) (agent acting as intermediary may be liable if participating in the wrongful transaction and unjustly enriched as a result of the transaction).
state where the legislature has adopted the U.F.A. but not the U.T.P.A. or Section 8-115 of the U.C.C.\textsuperscript{116}

In the opposite case where the legislature has adopted all the statutes, a bank may also be unsure of whether the actual knowledge of the U.T.P.A. or the constructive knowledge of Section 8-115 of the U.C.C. controls.\textsuperscript{117} In such instances, the statute adopted last will typically control; however, the order of adoption may be due to factors other than the actual intent of the legislature.\textsuperscript{118}

In \textit{Wetherill v. Bank IV Kansas} a Kansas court held that no cause of action existed under Kansas’s Uniform Trustees’ Powers Act without a showing of \textit{actual knowledge} where a plaintiff attempted to proceed under the common law standard and U.C.C. constructive knowledge standard.\textsuperscript{119} The court in \textit{Wetherill} stated that “a fundamental premise of statutory construction is that a specific statute dealing with a subject controls over the general statute on the subject, unless it appears the legislature intended the general act to control.”\textsuperscript{120} Thus, a bank holding funds for a fiduciary client cannot be sure if what the standard for imposing liability will be in states that have adopted the U.T.P.A. and U.C.C. Similar to what happened when the U.F.A. was adopted, rather than following the latest U.T.P.A. standard, banks will have every incentive to adhere to the constructive knowledge standard to the detriment of the service of the fiduciary in order to lessen exposure to liability.

In contrast to the territorial variation of the standard, many securities intermediaries operate transnationally and even globally. In this respect, the inconsistency of statutory protection increases the unpredictability of outcomes for securities intermediaries operating on a

\textsuperscript{116} As mentioned above in Section II, under the U.F.A., it is not entirely clear that banks will protecting from liability under the common law when given notice of an adverse claim to the funds.

\textsuperscript{117} Wiley v. Toppings, 556 S.E.2d 818, 820 (W. Va. 2001) (when two enactments conflict, courts generally follow the black-letter principle that “effect should always be given to the latest . . . expression of the legislative will”) (citing Joseph Speidel Grocery Co. v. Warder, 56 W. Va. 602, 608 (1904)); Travelers Ins. Co. v. Carpenter, 313 F.3d 97, 101 (2d Cir. 2002) (courts should credit “the latest expression of legislative will” when existing law conflicts) (citing St. Paul Fire & Marine Ins. Co. v. Surdam, 595 A.2d 264 (Vt. 1991)).

\textsuperscript{118} Travelers Ins. Co. v. Carpenter, 313 F.3d 97, 101 (2d Cir. 2002) (in the case of conflicting statutes, the later statute will control). As a hypothetical, the legislature may simply adopt the model statutes as scheduling permits. The legislature in adopting the U.T.P.A. may intend to have an actual knowledge standard yet create ambiguity by adoption of the Revised Chapter 8 of the U.C.C. In such an example, the legislature may simply have intended to adopt Chapter 8 of the U.C.C without changing the application of the U.T.P.A. . Though only a hypothetical, given the conditions of modern legislative bodies, such a situation is not implausible.

\textsuperscript{119} 145 F.3d 1187 (10th Cir. 1998).

\textsuperscript{120} Id. at 1193.
large scale and a disincentive to expansion in some states. Not only will securities intermediaries need to investigate which model statutes have been adopted, but they will often have to invest considerable funds to determine the applicable standard.

As an example, the U.A.S.F.S.T., one of the earliest uniform statutes dealing with securities intermediaries and fiduciaries, currently conflicts with some of the newer uniform statutes. In particular, the principles set out in the U.A.S.F.S.T. statutes are almost identical to those of the prior Article 8 of the U.C.C. and therefore not consistent with the Revised Article 8 of the U.C.C. The prior Article 8 of the U.C.C. and the U.A.S.F.S.T. and other similar statutes base liability on notice of an adverse claim; the revised version of the U.C.C. conditions liability on constructive knowledge of breach of fiduciary duty or acting in opposition to a court order. Under the Revised Article 8, the third party should not and is not required to interfere in the relationship between the fiduciary and beneficiary. The U.A.S.F.S.T., however, is an old provision and likely has been superseded by newer statutes in the states in which it has been adopted. Many state legislatures have specifically repealed the statute although the U.A.S.F.S.T. still remains in force in some jurisdictions. For this reason, the U.A.S.F.S.T. does not normally apply, but it provides a background for determining the intent of the drafters of later statutory protections.

As discussed in Section B, adoption of the Revised Chapter 8 of the U.C.C. should not necessarily be interpreted to repeal the actual knowledge standard of the U.T.P.A.. Due to the constant revisions of the U.C.C., an adopting legislature may not take the care to specifically single out the situation of securities intermediaries dealing with fiduciaries every time it adopts a new revision of the U.C.C. The requirement of good faith runs through the entire U.C.C.; therefore, specific modification with regard to dealing with fiduciaries may undermine the practicality of the U.C.C. A more practical solution would be adoption of the U.T.P.A. actual knowledge standard by all states. If the U.T.P.A. were adopted uniformly, the standard would clearly be actual knowledge when dealing with fiduciaries and

121. Nutter, supra note 7.
122. See U.A.S.F.S.T., 7C U.L.A. 332 (1958); U.C.C. Chapter 8. See also Nutter, supra note 7.
123. The U.A.S.F.S.T. has been repealed in all jurisdictions other than Louisiana and Washington D.C.
124. The first revision of the U.C.C. was in 1997 and Section 8-115 was drafted in 1994. Periodic revisions of the U.C.C. have been made over the years and will likely continue as the commercial business environment continues to change.
good faith (or constructive knowledge) when dealing with others and for other types of commercial dealings.

A uniform actual knowledge standard among the states would eliminate the risk of potential liability and provide clarity in determining the available protection. Failure to adopt a uniform standard leaves the courts to decipher complex, often overlapping and seemingly never-ending number of laws in order to determine the level of protection. Currently, the afforded protection and duty imposed on an intermediary depends on geographic happenstance rather than careful analysis and general consensus.

The recent consolidation of the retail banking industry adds to the confusion now that most banks operate nationally in dozens of states with respect to both the commercial and retail operations. The conflicts of law analysis itself has become so confusing that it is often more efficient for parties to perform an analysis for a couple of the most likely governing jurisdictions and leave the actual determination for the court.

The notes in the Uniform Commercial Code and other uniform laws express the desirability of avoiding second-guessing in any transaction. The current asynchronous standards do just that. The banking industry serves as a foundation for the entire economy and any effect felt by the banking industry due to this confusion will likely ripple throughout the economy. Thus, there is a heightened need for predictability and regularity in these particular banking and commercial transactions.

D. *Justification for an Actual Knowledge Standard*125

Because fiduciaries owe the highest duty of care to beneficiaries, the liability of third-party banks usually becomes important in instances when the fiduciary is judgment proof.126 However, a broker, as opposed to a trustee-fiduciary, generally does not have a fiduciary

125. *See also* Subsection III.B.

126. In the event of a loss of the funds, the fiduciary will obviously be the first one to whom the beneficiary will look having been the one with control over the funds. Moreover, the fiduciary owes the highest duty to the beneficiary and can therefore be subject to even greater liability. Meinhard v. Salmon, 249 N.Y. 458 (1928) ("Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."); cf. *In re* Baylis, 313 F.3d 9, 21 (1st Cir. 2002) (when a trustee is not acting in his or her own interest, the duty of care "standard fixed for his behavior is only that of a reasonable degree of care, skill, and caution. But when the trustee acts in his own interest in connection with the performance of his duties as trustee, the standard of behavior becomes more rigorous. In such a case his interest must yield to that of the beneficiaries.").
duty to his or her client unless the client has entrusted the broker to act on his or her behalf in selecting investments.127 "The duty of care owed by a broker carrying a nondiscretionary account is an exceedingly narrow one, consisting at most of a duty to properly carry out transactions ordered by the customer."128 If the broker is not acting as a fiduciary, its duties will thus be limited to taking orders, executing trades, and dealing with customer funds.129 Nonetheless, under these circumstances, when the beneficiary has lost his or her funds, the only recourse left may be an action against the bank that was holding the funds.

Though securities intermediaries do not have any contact with third-party beneficiaries other than effectuating transactions for the indirect benefit of beneficiaries, current laws in almost all states allow holding companies and agents to be held liable for the full amount of the funds lost. Bad faith and/or constructive knowledge of a fiduciary client’s breach of duty are the typical standards for imposing liability as opposed to the broker or securities intermediary’s own acts of negligence or intentional wrongdoing.

Imposing anything less than an actual knowledge standard holds banks and agents dealing with fiduciaries to a liability where it would not reasonably be expected simply on the basis of the heightened duty of care owed by the client to the third party. A bank holding funds for various clients might reasonably expect to owe the same duty of care to all clients regardless of the individual business dealings of clients.130

In essence, clients serving as fiduciaries increase the risk to banks and impose a de facto heightened standard. Normally, if a bank acts with ordinary care, it will not be subject to liability unless it is advising the client or operating a discretionary account.131 A typical account will consist of funds under the ownership and control of a single entity or group. A trust account for a fiduciary, however, has a natural tie to another unrelated party—the beneficiary. Moreover, in the more

128. Index Futures Group, Inc. v. Ross, 199 Ill. App. 3d 468, 475 (1990); see also Commodity Futures Trading Comm’n v. Heritage Capital Advisory Services, Ltd., 823 F.2d 171, 173 (7th Cir. 1987) ("Only a broker operating a discretionary account - in which the broker determines which investments to make - is viewed as a fiduciary").
130. The USA Patriot Act might now be an exception to this argument if interpreted to impose a duty on banks to freeze funds or report clients that might be linked to terrorist activities. In such a circumstance, as opposed to ordinary care, banks would be required to investigate dealings and named owner of each and every client account and affirmatively act if suspicious of certain activities.
131. See supra notes 13 and 14.
common instance of a non-fiduciary client, the question of the power to direct funds is avoided or at least more readily answered. For example, if a single individual made unwise investments, the loss would lie with the client at fault. If the account, however, had been opened by a fiduciary, the beneficiary will certainly look to anyone and everyone to recover the lost funds. Assuming the bank at least knew that the client was acting as a fiduciary, the bank will have had to take precautions in case the entitlement orders by the fiduciary exceeded the scope of his or her powers.

It is readily apparent that banks will have to take greater precautions with some clients versus others, but in the case of a client acting as a fiduciary, there is no economic justification. The market provides banks with an economic incentive to hold a large amount of funds for more particularly demanding clients with complex accounts. Clearly a bank benefits financially from large transactions for a Fortune 1000 company or holding large deposits for institutional investors. A fiduciary client poses a more unique situation where the bank exposes itself to greater risk and must devote more resources for care of the account than a similarly situated non-fiduciary individual account; yet, the bank does not receive any economic reward. The bank will not receive a risk premium for the risk of holding assets for fiduciaries. The law has created an imbalance by subjecting holders of funds for fiduciaries to greater risk without any corresponding benefit. A safe harbor thus provides a balance to ensure the presence of banks willing to hold these funds.

The real issue then becomes what should be the extent of the statutory safe harbor. A low standard would not provide enough of an incentive for banks to enter the market for holding funds for fiduciaries. The default standard, as discussed above, typically tends to be based on good faith efforts or reasonable care without constructive knowledge of the breach of fiduciary duty.

Most of the uniform statutes have been based on a slightly different reasoning. The uniform statutes drafted by the N.C.C.U.S.L. began with a focus on making transactions ordered by fiduciaries more efficient for the benefit of the fiduciary. Prior to drafting of the U.F.A., all the way back to 1921, Professor Scott noted the onus imposed on trustees dealing with commercial paper under the traditional rules. The U.F.A. reflected the views of Professor Scott and others in affording protection to securities intermediaries holding funds for fiduciaries

132. See generally Curtis, supra note 13.
as those holding funds for other clients.\textsuperscript{133} As Professor Scott argued, the U.F.A. provides protection unless the securities intermediary has actual knowledge of the breach or acts in bad faith.\textsuperscript{134} Professor Charles Horowitz, chairman of the drafting committee of the U.T.P.A., argued that the "efficient administration of trusts requires repudiation of constructive notice of trustee's breach."\textsuperscript{135}

The trend today is towards a preference of third parties (i.e. the banks) over trust beneficiaries when funds are misappropriated.\textsuperscript{136} More modern statutes impose liability when third party holders of funds have actual notice rather than constructive or inquiry notice of a breach of fiduciary duty.\textsuperscript{137} The actual knowledge or bad faith standard offered by the U.F.A. at once acknowledges a need for broad protection and retreats from this position. A requirement of good faith severely limits the actual knowledge standard by imposing a duty to investigate into the rightfulness of entitlement orders. The duty to investigate runs counter to the stated purpose of the U.F.A. in relieving banks and agents from having to make extensive investigatory efforts that slow the transaction process.

At some point, fiduciaries may even be excluded from holding certain types of securities or conducting transactions using certain technologies if banks are bound by a constructive knowledge standard. New technology may make it impossible for banks to allow fiduciaries to use technologies that do not allow effective oversight or sufficient time to perform checks of entitlement orders. Even the current automated trading technologies may not allow banks to adequately investigate orders by fiduciaries. Many transactions now are too highly automated and fast to even allow anything other than a manual, ex post review. A restriction on the fiduciary's choice of funds and transactions means restricting the fiduciary's ability to serve the beneficiary to the best means possible.

The U.F.A. and U.C.C. only relieve banks of an inquiry duty in the absence of suspicion of wrongdoing.\textsuperscript{138} Only minimal reason for suspicion will trigger a duty of inquiry akin to the common law standard.

\textsuperscript{133} Id. at 303 (Professor Scott's views had a direct impact on the drafting of the U.F.A.).
\textsuperscript{134} Id. at 304.
\textsuperscript{135} Id. at 303-04.
\textsuperscript{136} Id. The U.T.P.A. was the last uniform act drafted specifically in this area of the law and also broadens the scope of protection the most from the common law. See also Section IIB.
\textsuperscript{138} See U.C.C.; Unif. Fiduciaries Act §2, 7A U.L.A. 135 (1978) (constructive knowledge and good faith standards require investigation when reasonable because liability can be imposed for willful blindness).
Thus, the protection afforded by the U.F.A., U.A.S.F.S.T., and U.C.C. are somewhat illusory and undercut the underlying purposes of the statutes. On the contrary, the U.T.P.A. only imposes liability on securities intermediaries with actual knowledge of a fiduciary's breach of duty.¹³⁹ Even where a securities intermediary has knowledge of suspicious circumstances, it is under no duty to inquire into the rightfulness of its client fiduciary's powers. This standard parallels and encourages the increasingly efficient market systems.

Recognizing the possibility that courts may narrowly interpret the powers of trustees and fiduciaries, many trust instruments are drafted with broad powers to assure the proper functioning of the trust. In a small part, some legislatures have granted broad powers to fiduciaries through protection of the U.T.P.A. ¹⁴⁰ Under the modern statutes, it is assumed that the powers of fiduciaries are so broad that securities intermediaries do not need to inquire into the scope of the powers to assure that fiduciaries are acting properly.¹⁴¹ For other legislatures adopting the prior standard of inquiry duty, a securities intermediary has to investigate into the proper powers of the fiduciary. Under the U.T.P.A. and similar statutes, the burden of assuring fiduciaries act rightfully is shifted to the drafters of the trust instruments and beneficiaries. Economically, it is good policy for beneficiaries to assure not only that a proper fiduciary is selected, one that can be trusted to act rightfully, but also that the trust powers are not drafted any broader than the beneficiary desires.

Transactions are becoming more automated and trustees are given more freedom (in response to the increasing complexity of trust arrangements and uses). The law, however, continues to retain the decades-old constructive knowledge standard. At the very least, the good faith standard should be read with an understanding that financial transactions are becoming too complex, numerous, and automated to impose a duty to inquire unless there is actual knowledge or egregious circumstances, such as disregard of a missing Power of Attorney.

Given the fact that most states have statutes that favor having intermediaries assume clients are acting properly, intermediaries are exposed to a greater risk of missing the instances when the client has acted beyond his or her powers. To add to this confusion, a constructive knowledge standard adds to the confusion by making the knowledge determination all the more unpredictable. Grant Gilmore, the

¹⁴⁰. See generally Curtis, supra note 13.
¹⁴¹. Id. at 305.
principal architect of the original Article 9 may have described it best by stating that "[t]he presence or absence of 'knowledge' is a subjective question of fact, difficult to prove." Unless there is an overwhelming policy argument in favor of using such a criterion, it is always wise to discard it and to make the decision turn on some easily determinable event.\textsuperscript{142} The drafters of the adopted legislation chose a "knowledge" standard, but an actual knowledge standard is better because it dismisses the question of necessary degree. As is often the case in high-stakes, high-volume transactions, one cannot easily determine what knowledge existed. An actual knowledge standard would at least rest on more concrete circumstances. The constructive knowledge standard only opens the door to our natural predilection to forget the benefits of hindsight and imply the requisite degree of knowledge based on the surrounding external information.

An actual knowledge standard would not be entirely unfair for the beneficiary. A securities intermediary would think and hope that a client holding funds in a fiduciary relationship with a third party would be more trustworthy than other clients.\textsuperscript{143} Given a constructive knowledge standard, these client accounts administered by fiduciaries may need to be watched more closely by the bank than others by virtue of the fact that a third party beneficiary has an interest in these funds.\textsuperscript{144} An actual knowledge standard leaves the balance as it seems to have been intended by the drafters of the various later model statutes.

Where funds directed by a fiduciary become depleted due to the fiduciary's own doing and the fiduciary cannot satisfy judgment, the holding companies will become a natural scapegoat. If the trustor chooses an untrustworthy person to act as the fiduciary, the intermediary will function almost like a default security on the funds. As is often the case, however, beneficiaries know little about the operation

\textsuperscript{142} Grant Gilmore, Security Interests in Personal Property § 34.2, 502 (1965).

\textsuperscript{143} Note that the drafting notes to the U.T.P.A. and other uniform laws indicates that the drafters favored trustee self-regulation over trustor monitoring. The notes do not even mention placing the burden of monitoring on the intermediary carrying out the transaction and holding the funds.

\textsuperscript{144} In the situation where an intermediary holds funds in a nondiscretionary account, the intermediary would not be liable for a loss of funds from particular transactions. Only where advice is given as to investments would the duty of care owed by the intermediary to the client be subjected to a heightened standard. First Am. Disc. Corp. v. Jacobs, 324 Ill. App. 3d 997, 1012 (2001); cf. Commodity Futures Trading Comm'n v. Heritage Capital Advisory Serv., Ltd. 823 F.2d 171, 173 (7th Cir. 1987). Moreover, this article does not discuss the case where the bank itself is acting as trustee, which has been allowed by most courts and the SEC (under the Trust and Fiduciary Activities Exemption).
of the trust and do not even want to know about its operation.\textsuperscript{145} Beneficiaries often are happy simply to receive the proper funds without getting involved in the intricacies of the trust creation and operation.\textsuperscript{146} The duty and/or rational necessity of monitoring trustee-client actions, in addition to other factors like trustee solvency analysis, imposed by a constructive knowledge standard imposes an unduly oppressive burden on the holding banks. Nevertheless, requiring a beneficiary to select a proper trustee does not require involvement in the management of the trust. Given a beneficiary's pecuniary interest, the beneficiary already takes some amount of interest in trustee selection. Moreover, shifting the burden onto the banks does not serve a purpose other than transferring the loss to the entity with the most money.

From an economic standpoint, an actual knowledge standard would be more advantageous for the economy as a whole than a constructive knowledge standard. Financial innovation has led to faster transfers and new forms of money leading to greater economic growth. Without adopting a heightened, actual knowledge standard would economic growth would be slowed. For example, how would a securities intermediary holding funds for a fiduciary determine whether such financial innovations, such as swaps accounts, are appropriate? In general, broadening the protection afforded securities intermediaries in all states would provide an opportunity for explosive financial innovation in the field. Over the last century, financial innovation has been spurred by either new technology or deregulation of markets. Technology in the financial field is exploding as technology inventions starting from the early 1990's are adopted. As e-money becomes more widely adopted, how will securities intermediaries be able to comply with the inquiry duty imposed by a constructive knowledge standard?\textsuperscript{147} Even with the popularity and complex financial instru-

\textsuperscript{145} Where the settlor is also beneficiary, the settlor will be required to relinquish sufficient control to effectuate a “transfer” as required for creation of the trust. Gay v. Gay, 1994 WL 530148, *3 (Conn. Super. Ct. 1994).

\textsuperscript{146} Beneficiaries may prefer to have someone else with financial expertise manage the funds or may simply not want to be burdened with the daily activities of actively managing the funds.

\textsuperscript{147} See Eric Brousseau, \textit{The Governance of Transaction by Commercial Intermediaries: An Analysis of the Re-engineering of Intermediation by Electronic Commerce} (Universite de Paris Pantheon Sorbonne). Third Conference of the International Society for New Institutional Economics (Washington, D.C. Sept. 16-18, 1999) (arguing that the rise of e-commerce will not lead to the substitution of financial intermediaries by electronic networks). In this author's opinion, technology will lead instead to the vast improvements in the existing financial systems. The current infrastructure will not likely be replaced but instead transformed and made more efficient by faster, less costly transactions and the ability to generate more information about the functioning of the market.
ments today, the documentation burden imposed by the constructive knowledge standard hinders the administration of trusts. 148 In short, financial innovation is pushing markets towards efficiency while the safe-harbor laws become more the bain of the industry.

The costs to debt seekers (due to the duty of inquiry imposed by a constructive knowledge standard on banks) in the indirect financing market comes in the form of not just passing off costs but also a shrinking market of competing banks offering the service. If securities intermediaries are forced to incur greater costs when dealing with fiduciaries, some of these costs will be passed on to clients. In other cases, the business of dealing with fiduciaries may not be viable given the added costs and potential liability. With less intermediaries in the market, the problems of asymmetric information, illiquidity, and higher prices become greater. In a market with less liquidity and information, debt seekers are more likely to make costly decisions and pay higher prices. 149

Imposing an inquiry duty would impede the efficient order of markets and further innovation with regard to the way securities intermediaries hold and transfer funds and even the forms of money. 150 Such a duty could quickly make the holding of funds for fiduciary clients cost prohibitive, as financial transactions become more complex and clients become more demanding on banks' ability to execute transactions. As time passes, the highly dynamic financial industry will only be more burdened by a duty of inquiry and risk of liability. Even as the funds themselves begin to change in form and the transaction becomes more automated, the banks will either have to figure out how to integrate new innovation—both technological and financial innovation—with duties imposed by burdensome law or refrain from utilizing innovative products and technologies. Relief of the burden

148. See Curtis, supra note 13 (writing that the chairman of the drafting committee of the U.T.P.A. argued that the constructive knowledge standard inhibits the effective administration of trusts).

149. Imposing costs on securities intermediaries, the primary underpinning of the indirect financing market threatens the indirect financing system itself. See Raghuram G. Rajan, Do We Still Need Commercial Banks?, Nat'l Bureau of Econ. Research, at http://www.nber.net/reporter/fall98/rajan_fall98.html. (Mr. Rajan argues that commercial banks are still of great importance in financial systems. The broader category of securities intermediaries, however, includes firms that offer a wide variety of services of which commercial banking services are only a small part. Additionally, this article focuses on the importance of intermediaries and the indirect financing system and not commercial banking activities.).

150. The types of transactions, forms of money, and market participants have expanded rapidly in the latter part of the 20th century. By referring to innovations, I mean to refer to advances in trading technologies (e.g. web-based technologies and greater automation), new types of financial instruments and securities, and changes in the markets themselves (especially in regards to the globalization of the market).
of a duty to inquire allows the industry to evolve freely rather than directing or restricting its progress.\textsuperscript{151}

Critics of statutes providing higher levels of protection for banks dealing with fiduciaries may also argue that third party beneficiaries are not able to assure that the banks exercise reasonable diligence and care with regard to their funds.\textsuperscript{152} It cannot be concluded that providing more protection to banks with fiduciary clients will necessarily increase the amount of cases where fiduciaries misappropriate beneficiaries' funds. If banks holding funds for third parties are clearly given more protection, the burden will be shifted to the third party beneficiaries to take steps to protect themselves rather than relying blindly on the courts to provide compensation for any resulting losses. It would be less likely for a fiduciary to misappropriate a beneficiary's funds if the beneficiary exercised due diligence in selecting the fiduciary.

The selection of the fiduciary may be the most important step in the process in structuring a trust. It is more efficient to stop the breach of duty at the early stages. It would clearly be unreasonable to give your money to a complete stranger on the street to hold and then complain later when the stranger has used it. Likewise, trustors should not be allowed to dismiss their duty to diligently select proper fiduciaries and later rely on claims against third parties only indirectly involved in the agreements.

If the trustor/drafter is uncomfortable with the fiduciary having broad powers, the trustor could simply add provisions to limit the trustee's powers rather than relying on the bank to oversee the orders of the trustee. The trustor could additionally require communication with the beneficiary, such as accounting provision with more bite or retain particular powers for the settlor and beneficiary. Such provisions might hinder the fiduciary's ability and the flexibility of the trust, but the burden is more fairly placed on the beneficiary and trustor rather than a third party bank with little to gain and no control over the agreement itself. This also allows the trustor to strike the balance of power rather than the court.

\textsuperscript{151} Elimination of regulations and beneficial changes in laws have often been a source of financial innovation. As an example, repeal of Regulation Q and allowance of payment of interest on deposits led to an explosion of new financial products at the end of the last century.

\textsuperscript{152} See generally Curtis, supra note 13.
The news over the course of the last year is a testament to the fact that forcing banks to monitor the actions of clients is often fruitless. It is more effective and efficient for those more intimately involved with the transactions to monitor them than third parties. By this I mean that banks do not have the tools or resources to monitor fiduciary actions as well as beneficiaries. It is true that the bank effectuates the transaction and thus has "knowledge" of the transactions themselves, but in terms of the rightfulness of the transactions, the beneficiaries are in a better position than the banks if the trustor so intended and provided. It is also true that banks have a lot of resources, but they do not have more idle resources. Also, the greater number of transactions makes it harder to police the transactions. The beneficiaries, in contrast, have a direct interest in the funds and should take an interest in the details of the fiduciary's powers and duties.

A further reason for shifting the burden to the beneficiary is to avoid having the courts frustrate the actual intent of beneficiaries. In many circumstances, the trustor intended to give the fiduciary broad power and intended for the beneficiary not to monitor or take part in the administration of the funds from the creation of the trust forward. In other circumstances, the trustor may choose to grant the beneficiary greater oversight and hold limited powers of control (e.g. power of revocation for instances of suspicious fiduciary actions). Thus, with a low standard of protection, the intent of the trustor may be frustrated where the beneficiary intends to grant the fiduciary very broad powers but the law imposes a duty on the holding bank to intervene and investigate transactions directed by the fiduciary.

In the case where the fiduciary is given unlimited powers over large sums of funds and no one monitoring the transactions, the courts should not be involved where the natural consequence of negligent trustee selection by the trustor is heightened risk of conversion of the funds. It is bad policy to promote the use of the courts as a lifeboat for bad commercial practices.

IV. SUMMARY OF THE IMPACT OF AN ACTUAL KNOWLEDGE STANDARD

The economic arguments that follow assume that the relevant markets are operating efficiently. Thus, any added risks or costs will be incorporated into the market price and raise the cost of obtaining cap-

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153. Even when banks and officers can still be held liable for contributory negligence, we have still seen a rash of fraud cases and other corporate malfeasance and a breakdown in monitoring of corporate actions.
ital. As this article argues, the cost savings and lowered risk resulting from adoption of an actual knowledge standard would lead to economic expansion.

Before discussing the economic impact of adoption of the actual knowledge standard, the Efficient Capital Market Theory (ECMT) should first be briefly explained. ECMT states that the price offered in the market represents the best price given all available information.\(^{154}\) The market will swiftly match buyers and sellers and shift the price until it finds equilibrium. Any new information in the market will be instantly incorporated into the price. The market price cannot account for unknown risks, but it will incorporate all information in the marketplace.\(^{155}\) If the market does not work efficiently, the price will no longer represent the best price available. As an example, if the market only consists of a few buyers and sellers, the illiquidity of the market would prevent the price from stabilizing.

A. Above-the-line Benefits

By granting the holding bank greater protection, the fiduciary will clearly be able to effect transactions more efficiently. Without a court-imposed need for the bank to investigate, the transactions can be effectuated faster. Moreover, under a standard that does not generally require a case-by-case determination of the investigative duty, more transactions can be performed automatically, which would allow for a significant efficiency benefit. The banks will be able to assume the fiduciary is acting properly and assume the beneficiary intended such powers.

Such deregulation of transactions by banks for fiduciaries would likely lead to financial innovation giving further benefit to beneficiaries and those involved in the creation and administration of the trusts. In the past few decades, we have already seen a host of new financial instruments and mechanisms for effectuating transactions as a result of deregulation. The same may result from less involvement of the courts.

Under an actual knowledge standard, the intent of the settlor may be carried forward without frustration. A constructive knowledge

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\(^{154}\) "Available information" consists of historical information, public information and all information whether public or available to insiders only.

\(^{155}\) Weak-form efficiency implies that the market cannot be beat using historical data and technical analyses. One might beat the market, however, if inside information is used. Strong-form efficiency implies that the market price is the best price given all public and non-public information. Thus, only through the ability to forecast the future or access to inside information will the buyer know how to beat the market. Assuming the securities markets work efficiently, any known information, including risk information, will be reflected in the market price.
standard requires banks to become involved in the fiduciary's actions whether the settlor intended such a result or not. The benefit to the beneficiary decreases as a result as well.

Given an actual knowledge standard, the fiduciary can order transactions to be processed without hindrance. If the trustor desires greater oversight, the trustor can include appropriate provisions in the trust instrument. Trust instruments can still be drafted with broad powers entrusted to fiduciaries to assure smooth operation of the trust without the necessity of beneficiary involvement. The trustor, however, will still have the burden of initially assuring that the selection of the fiduciary in whom the beneficiary will place his or her reliance is not dismissed as a mere technicality. In essence, in exchange for the ability to grant broad powers to the fiduciary to relieve the beneficiary of responsibility for most aspects of the trust operation, the trustor must not shirk his or her duty to the beneficiary. At minimum, the trustor and beneficiary must assure that a proper person is selected as fiduciary. An actual knowledge standard rightfully holds beneficiaries responsible for negligent selection of fiduciaries.\textsuperscript{156} Under an actual knowledge standard, the level of oversight can be controlled by the trustor rather than as a de facto default standard under the law.

Given the elimination of the duty of inquiry imposed by a constructive knowledge standard, inquiry into the rightfulness of transactions and powers of fiduciary clients can be made on the basis of effectiveness as determined by the market. If a demand truly exists for the settlor to assure that banks retain more oversight over the orders of fiduciaries, the market will create the niche. Moreover, securities intermediaries often compete for assets on the basis of reputation rather than price. Thus they have an incentive to manage the transactions and ensure that clients, especially those serving as fiduciaries, are acting within the proper bounds of their powers and the law. Any association with impropriety can permanently mar the reputation of the bank. The adoption of a U.T.P.A. standard may eliminate a good faith requirement, but no bank will want to be known as a bank that turns a blind eye to wrongful actions.

Some commentators argue that there is little merit in favoring third parties who deliberately shield themselves from the truth over innocent trust beneficiaries.\textsuperscript{157} Unlike the real estate market or other

\textsuperscript{156} U.T.P.A. imposes liability only where there is actual knowledge of fiduciary's breach of duty and does not impose a duty to inquire into the rightfulness of fiduciary's instructions even where suspicious circumstances exist.

\textsuperscript{157} See Curtis, supra note 13 (citing other authorities supporting the argument against the elimination of the constructive knowledge and good faith standards).
physical markets, the great majority of transactions by fiduciaries do not relate to financial instruments in the direct and indirect financing systems. In such markets, it is expensive to monitor the transactions.\textsuperscript{158}

The current problems in the stock market relating to spinning off shares, collusion between stock analysts and investment banking arms, and other similar problems show the difficulty in preventing even the more readily discoverable problems in the markets. In these circumstances, it would make more sense for the beneficiary to limit the powers of the fiduciary rather than a grant broad powers and turning a blind eye to the actions of the fiduciary.

B. Benefits of the Elimination of the Inquiry Duty Entirely

Not only does an actual knowledge standard allow fiduciaries to perform their duties more effectively, as all the uniform acts in this area intended, but the elimination of a duty to inquire would also reap market-wide cost savings.\textsuperscript{159} These cost savings and benefits include (1) not passing on cost to other blameless clients\textsuperscript{160} (2) less litigation (3) decrease in breaches by forcing principals to act\textsuperscript{161} and (4) allowing securities intermediaries more freedom – financial innovation.

C. Benefits of a Uniform Standard

In addition to the benefits of an actual knowledge standard versus a constructive knowledge standard, there are great benefits to a uniform adoption of a single standard. For reasons already stated, securities intermediaries dealing with fiduciaries should be provided a minimum level of protection from liability to third party beneficiaries. The current trend is to afford greater protection to securities intermediaries; however, there is inconsistency in the level of protection provided by the statutes of each state. The inconsistency leads to several problems.

\textsuperscript{158} See Id. at 308-09. Real estate property is used for example only. The U.A.S.F.S.T., U.C.C., and other statutes only extend to transactions involving commercial paper and similar financial instruments determined by the specific statute. For example, the U.A.S.F.S.T. does not extend to Treasury-backed instruments.

\textsuperscript{159} The above sections have already explored the costs of requiring an inquiry into each transaction. This section and subsection D provide analysis of the cost savings from eliminating the current standard.

\textsuperscript{160} Judgments resulting from liability under the constructive knowledge standard will have to be passed off to all clients, meaning that most everyone seeking financing in the indirect financing system, such as banks, will internalize these costs.

\textsuperscript{161} Shifting the burden to trustors will force them to take greater care in selecting fiduciary and thus decrease the chances of the fiduciary breaching his or her duty.
Over the last century, the financial markets have become increas-
ingly more innovative and broader in reach. Due to the complexity of
trust agreements and the number of parties involved, a larger bank is
often selected to hold the funds of the trust. Moreover, it is increas-
ingly rare for a bank to only be located within one state or even to
hold funds pursuant to a trust agreement for parties all located in one
state. Due to the interstate nature of the transactions, it would be
suitable for national protection to be afforded to banks dealing with
fiduciaries to provide predictability. The costs to banks for doing busi-
ness in states with many different laws is obvious and accepted; yet, in
this area of the law, there are added unjustifiable costs. As mentioned
above, in states where the U.T.P.A. has been adopted in addition to
other uniform acts protecting banks holding funds for fiduciaries, the
unpredictability of the outcome adds to the cost of interstate busi-
ness. A predictable, nationwide standard of protection would
therefore offer exponential benefits.

D. Practical Market Problems with a Constructive
Knowledge Standard

Several market-related problems are solved with the elimination of
the constructive knowledge standard. First, securities intermediaries
handle an enormous volume of transactions each and every day. The
complexity associated with these transactions further complicates the
ability to “police” the transfer orders. It is hard to “police” fiduciary
orders now, but this will become even harder in the future. Second,
imposing liability on the entities completing the transfers misaligns in-
centives and deterrents. Principals stand in the best position to ensure
that fiduciaries do not breach their duties yet do not have an incentive
to do so. The current standard instead provides an incentive to securi-
ties intermediaries to provide inferior service in the form of client pri-
vacy intrusion and erecting bureaucratic obstructions to transactions.
Third, the current standard has kept costs artificially high by creating
an unpredictable standard. Fourth, a further savings can be obtained
by realizing greater efficiencies of shifting the burden to principals.
The current standard also creates unnecessary congestion in the
courts.

conflict, courts generally follow the black-letter principle that “effect should always be given to
the latest . . . expression of the legislative will . . . ” and thus the U.C.C. would control over all)
with Wetherill v. Bank IV Kansas, 145 F.3d 1187, 1193 (10th Cir. 1998) (“a fundamental premise
of statutory construction is that a specific statute dealing with a subject controls over the general
statute on the subject, unless it appears the legislature intended the general act to control,” and
thus U.T.P.A. controls over the U.C.C.).
First, securities intermediaries are ill-equipped to "police" all the transfers of securities ordered by fiduciaries. Securities intermediaries transact an exorbitant number of securities transfers each day. These transfers consist of innumerable types and for a variety of types of clients. Under the common law duty of inquiry, banks routinely require extensive documentation for fiduciary transfers to assure themselves that the fiduciaries were acting rightfully in order to protect themselves from liability. As a result, fiduciary transfers were time-consuming, inefficient, and costly. The modern uniform acts have limited liability somewhat, but not enough. The bank must still investigate when it has any suspicion that the fiduciary may be breaching his or her duty.  

Both securities intermediaries and beneficiaries may be in a position to assure the funds are properly applied. Securities intermediaries are conducting the transfers and can easily monitor specific transactions. Settlor-trustors, however, are the ones who have the sole power to select the fiduciaries and assure they that will act properly. It is unfair to place the burden on securities intermediaries to "police" wrongful fiduciaries that were selected by negligent trustors.

Moreover, even though securities intermediaries are effectuating the transfers, they do not have the resources to monitor these transactions nor has this added transaction cost been factored into the charges to clients. In order to properly "police" fiduciary transfers, a method must be in place to flag transfer directives made by fiduciaries. Such a method assumes that the banks at least have knowledge of which clients are serving as fiduciaries. Once the orders are singled-out, they must be evaluated. Under the current standard, banks are effectively required to evaluate the orders on a case-by-case basis against the power assumed by the fiduciaries under the individual trust agreements. It is clear that in order for a bank to avoid liability under the current standard would be clearly cost and time-prohibitive.

Second, imposing liability on the entities completing the transfers misaligns incentives and deterrents. As mentioned above, securities intermediaries are not able to prevent anything more than the most obvious breaches of fiduciary duties. Regardless of the high standard, it can be argued that the statutes have exceeded their level of deterrent utility.

Third, the current standard has kept costs artificially high by creating an unpredictable standard. Under the constructive knowledge standard, securities intermediaries can never be sure if they will be held liable. Due to the complexity of the business, determinations will often require an involved determination case-by-case. As transactions become more complex, the standard of reasonable suspicion will only become more vague and meaningless. Reasonable suspicion also focuses on the action of the fiduciary without taking into account the bank’s available resources.

Fourth, an actual awareness standard would shift the burden of prevention to principals who are in the best position to prevent such losses. It is inefficient to place the burden on securities intermediaries without the resources to commit to policing transactions. Solving a problem is more effective if done at the source: when the settlor selects the fiduciary.

Lastly, the constructive knowledge standard frustrates the underlying purpose of the statutes. In all states where the U.F.A., U.C.C., or similar statutes have been adopted, the legislature intended to afford protection to securities intermediaries dealing with fiduciaries. Beneficiaries can still usurp the protection provided by these statutes simply by arguing that the securities intermediary had knowledge of the fiduciary’s powers or at least knowledge of the trust agreement and failed to request it. The securities intermediary will therefore be charged with knowledge that the fiduciary was acting beyond the scope of its powers. The bank may have knowledge of the trust agreements and powers of attorney in its possession, but it cannot reasonably be expected to hold intimate knowledge of their contents in relation to each and every transaction executed. The prefatory notes to the U.F.A. show that the legislatures did not intend for protection to be determined on the mere basis of whether the bank had knowledge that the client was acting as a fiduciary; yet, such knowledge can be used by the beneficiary to hold the bank liable. An actual knowledge standard would assure conclusively that securities intermediaries may properly assume that entitlement orders from fiduciaries are proper to make administration of the trust more effective.

V. Conclusion

Most states currently have limited the common law duty of inquiry with respect to fiduciary entitlement orders. States have chosen to adopt the variations of the U.F.A. and U.A.S.F.S.T. Most states

164. See the prefatory notes to U.C.C. § 8-115 and U.F.A., supra note 163.
have adopted the U.C.C., however, § 8-115 has not yet been embraced. All of these statutes have a good faith requirement requiring securities intermediaries to make an investigation into fiduciary orders when reasonable suspicion exists. The U.T.P.A., drafted in 1964 and the latest statute dealing specifically with this issue, adopts an actual knowledge standard without requiring a good faith showing.

The U.T.P.A. actual knowledge standard provides several economic and practical benefits over a constructive knowledge or good faith standard. First, an actual knowledge standard shifts the burden onto trustors. As a consequence, a trustor has an incentive to take the selection of a fiduciary more seriously thus decreasing the likelihood of wrongful actions by the fiduciary. Second, banks are relieved of a duty to investigate suspicious circumstances. By relieving banks of exposure to liability and the burden of investigation, more financial efficiencies are likely to result due to the effect on the market. Also, with less involvement by the bank, the fiduciary can administer the trust more effectively without delays due to required documentation and checks by the bank. Eliminating the requirement of involvement by banks also allows the trustor to more effectively carry out their intent. With an actual knowledge standard, the trustor can write into the trust agreement how much the bank and beneficiary should be involved rather than leaving it to a default standard.165 Lastly, by eliminating the duty imposed on the banks holding the funds, cost-savings can be realized and passed on to the beneficiaries.

For all of these reasons, an actual knowledge standard should be adopted by all the states. An actual knowledge standard is essential to ensure that the indirect financing system continues to work efficiently and trust administration is not hindered further.

165. As an example of limiting the level of involvement, the agreement may establish a balance of oversight responsibility between the beneficiary, the fiduciary, and the bank holding the fiduciary’s assets. Under the de facto default standard, i.e. constructive knowledge, suspicious circumstances trigger a duty to investigate on the part of the bank. This is the default, or minimum standard, and creates a tricky problem for the trustor that desires a higher trigger-point before the bank has a duty to investigate.