Mental Capacity to Transact

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Submitted in partial fulfillment of the
requirements for the degree of
Doctor of the Science of Law
in the School of Law

COLUMBIA UNIVERSITY

2019

Chapter 2 published as *Elder Financial Abuse: Fiduciary Law and Economics*, 34 NOTRE DAME JOURNAL OF LAW, ETHICS & PUBLIC POLICY __ (forthcoming 2020)

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ABSTRACT

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Elder financial abuse is an alarming problem in this era of aging population. Baby boomers are entering retirement with a higher life expectancy and more wealth than any generation before them. The combination of mental decline and substantial wealth renders many seniors vulnerable to overreach. Empirical studies suggest that financial abuse against seniors is hard to detect and likely prevalent.

In private suits alleging elder financial abuse, courts often apply the mental capacity doctrine to avoid seemingly exploitative contracts, gifts and many other lifetime transactions. The formal rationales for avoidance are that the elderly party to the impugned transaction lacked mental capacity, and that the transaction was inequitable. Moreover, guardians and attorneys who manage property for the elderly may have perverse incentives to exploit their position. Presuming the worst from the property manager, courts and legislatures typically impose onerous fiduciary duties to minimize conflicts of interest and deter misconduct. Orthodox fiduciary law explicitly aims to overdeter.

This Dissertation first argues that the mental capacity doctrine in prevailing American law is ill-suited for the era of aging population. In theory, the doctrine grants

a mentally-incapable individual a power to choose whether to avoid her transactions. In reality, that power is usually exercised by a claimant who expects to inherit from the incapable individual. Prevailing doctrinal theories overlook the possibility that the claimant may seek to avoid a transaction to increase her expected inheritance rather than to advance the interests of the incapable individual. The mental capacity doctrine thus poses a heighted risk of avoiding transactions that actually benefited potentially incapable seniors and reflected their testamentary intent. This harms the welfare of many seniors by unduly limiting their ability to benefit their close relatives and friends, reward informal caregiving, and recruit their preferred caregivers.

The mental capacity doctrine can nonetheless be reformulated to offer appropriate protection against elder financial abuse without undue intrusion into close families and personal relationships. In particular, when applied to transactions involving close relatives and friends, the doctrine should be narrow, determinate, and respectful of individual will and preferences.

This Dissertation further argues that orthodox fiduciary law is too strict on most guardians and agents who manage property for the elderly. The problem is that mental or physical decline is common among seniors, but a lack of mental capacity typically stultifies the power to authorize a fiduciary to depart from adherence to strict fiduciary duty. By contrast, mentally-capable individuals are free to discharge those aspects of fiduciary law that they find intrusive and undesirable. In other words, while fiduciary

law is mostly a default law when applied to capable individuals, it is a mandatory law when applied to elderly incapable individuals. Harming the welfare of many seniors, mandatory application of fiduciary law tends to stultify the pursuit of valuable other-regarding preferences in close families and personal relationships. Such strict and inflexible application further disregards the presence of intrinsic bonds and informal norms.

To remedy these shortcomings, this Dissertation proposes a substituted-judgment defense to permit those departures from strict fiduciary law that the incapable individual would have authorized if she was mentally-capable. This defense should be made available to close relatives and friends but not to profit-driven professionals. To deter and sanction elder financial abuse by professional guardians and agents, this Dissertation also proposes reforms to harness their reputational concerns.

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ACKNOWLEDGMENTS

I am grateful to Professor Elizabeth S. Scott—the chair of my advisory committee—and Professors Avery W. Katz, Victor P. Goldberg, and Robert E. Scott—the other members of my committee—for their excellent supervision and endless patience.

This dissertation would not have been completed without the assistance of the Office of Graduate Legal Studies staff. I thank Dean Sylvia T. Polo and her team for their support throughout the years.

The idea for this dissertation developed a result of the work that I undertook as Tipstaff to Justice Geoff Lindsay of the Supreme Court of New South Wales. Justice Lindsay's generous advice and suggestions are greatly appreciated.

Finally, I acknowledge the financial support provided by the Herman N. Finkelstein Memorial Fellowship Fund.

For my parents

General Thesis

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INTRODUCTION

Population aging is old news. As baby boomers enter retirement with a higher life expectancy and more wealth than any generation before them, courts and legislatures are increasingly pressed to resolve disputes over the properties of the elderly. Empirical research suggests that elder financial exploitation is hard to detect and likely prevalent. While human rights-oriented scholars and law reformers have devoted much effort to tackle the problem of elder financial abuse, to my best knowledge, economics-oriented scholars have not paid much attention. This Dissertation offers a law-and-economics perspective on the problem of elder financial abuse.

More precisely, I explore the concept of mental capacity and its implications for financial dealings in the era of aging population. Mental capacity is the threshold concept of mental ability to incur legal responsibility for one's own acts.[1] A lack of mental capacity to transact, for instance, can lead to avoidance of contracts, gifts, and many other lifetime transactions.[2]

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[1] *See* PAUL S. APPELBAUM & THOMAS G. GUTHEIL, CLINICAL HANDBOOK OF PSYCHIATRY & THE LAW 181–84 (4th ed., 2007); SUSANNA L. BLUMENTHAL, LAW AND THE MODERN MIND: CONSCIOUSNESS AND RESPONSIBILITY IN AMERICAN LEGAL CULTURE 1–2 (2016).

[2] The transactional capacity doctrine covers contracts in the strict sense of legally-

Focusing on prevailing American law and offering lessons for Anglo-Australian law, the first chapter of my Dissertation examines the transactional capacity doctrine.[3] Moreover, a lack of mental capacity to manage one's property is a legal basis for appointing a surrogate property manager. Covering prevailing American law and Anglo-Australian law, the remaining chapters of my Dissertation study and critique the fiduciary regulation of guardians and agents who manage property for the elderly.[4]

Although elder financial abuse is a global phenomenon, this thesis focuses on American law and Anglo-Australian law due to their common historical origin and their divergent developments since the mid-twentieth century. While the relevant fiduciary and transactional doctrines remain formalist and inflexible in Anglo-Australian jurisdictions, the Realist revolution in the United States has rendered these doctrines more transparent and flexible, but also less determinate. An economic analysis of American doctrine and theory can offer valuable lessons for Anglo-Australian scholars, courts and law reformers, and vice versa.

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enforceable promises, *see* RESTATEMENT (SECOND) OF CONTRACTS § 1 (AM. LAW INST. 1981), irrevocable gifts, *see* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1(c) (AM. LAW INST. 1999), irrevocable trusts made in the settlor's lifetime, *see* RESTATEMENT (THIRD) OF TRUSTS § 11(3) (AM. LAW INST. 2003), and many other types of lifetime transactions, s*ee generally* 5 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 10:1 (4th ed. 1993 & Supp. 1999).

[3] This Dissertation, ch. 1.

[4] This Dissertation, chs. 2, 3.

This Essay summarizes and connects the three substantive chapters of my Dissertation. Parts I and II below highlight the key findings in respect of transactional law and fiduciary law, respectively. The Conclusion underscores the common problems with these areas of law and my proposed reforms.

I. AVOIDANCE OF TRANSACTIONS FOR WANT OF MENTAL CAPACITY

Mental capacity to transact is the threshold concept of mental ability to incur legal responsibility for one's own transactional choices. A mentally-incapable individual (or her representative) has a limited power to avoid her transactions. According to the widely-accepted, *conflicting-policies theory*,[5] granting the individual (or her representative) a power of avoidance has the following benefits and costs. On the one hand, the power can invalidate transactions arising from exploitation of diminished cognitive abilities or other forms of mental weaknesses. In particular, an exercise of the power can hold an elder financial abuser liable to return the ill-gotten gain of exploitation. Moreover, by disgorging ill-gotten gains after the fact, the power of avoidance can disincentivize potential abusers from making

[5] In the United States, this theory was introduced by Professor Milton D. Green in the 1940s. *See generally* this Dissertation, ch. 1, Section II.C.2. British scholars also tend to support this theory. *See, e.g.*, BRENDA HALE ET AL., MENTAL HEALTH LAW 366 (6th ed. Sweet & Maxwell 2017); Eliza Varney, *Redefining Contractual Capacity? The UN Convention on the Rights of Persons with Disabilities and the Incapacity Defence in English Contract Law*, 2017 LEGAL STUDIES 1, 4–5.

exploitative transactions before the fact. On the other hand, a broad power of avoidance can harm the interests of the capable transacting party and the security of transactions. In addition, allowing avoidance after the fact can discourage others from transacting with potentially incapable individuals before the fact. "Legal incapacity is legal disability, and a person who lacks the capacity to undertake a legally binding obligation is foreclosed from participating in transactions that may be advantageous or even vitally necessary."[6]

There are two doctrinal models in American and Anglo-Australian jurisdictions. Both models first ask whether the relevant transacting party lacked mental capacity at the time of making the impugned transaction, and then impose equitable restrictions on any power of avoidance arising from a finding of incapacity. While the initial step of ascertaining mental capacity is not without controversy, the predominance of equitable considerations has long rendered "disparities in mental ability . . . less salient as a matter of law."[7] In modern times, academic and judicial disagreements mainly pertain to the equitable restrictions on the power of avoidance.

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[6] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 33 cmt. c (AM. LAW INST. 2011).

[7] BLUMENTHAL, *supra* note 1, at 17.

A. The Traditional Model

Anglo-Australian jurisdictions and a minority of American jurisdictions adhere to the traditional, narrow conception of transactional incapacity.[8] Mental capacity to transact in this model is a cognitive notion, asking whether the relevant transacting party was unable to understand the nature and consequences of the impugned transaction. A finding of incapacity would only ground a heavily-qualified power to avoid the transaction. The power would be lost if the transaction was made in good faith, the capable transacting party did not have knowledge of the incapacity, did not overreach, and could not be restored to the status quo ante.

B. The Modern Trend

The modern trend among American jurisdictions is to expand the concept of transactional incapacity and the scope of judicial discretion.[9] In addition to the cognitive test, the Restatement (Second) of Contracts adopts a volitional test to deny capacity if the individual was unable to act in a reasonable manner in relation to the transaction.[10] Influenced by the writing

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[8] *See generally* this Dissertation, ch. 1, Section II.A; Simon Whittaker, *Personal Incapacity*, *in* 1 CHITTY ON CONTRACTS 9-077 (H.G. Beale et al eds., 32d ed., 2015) (discussing Hart v. O'Connor [1985] UKPC 17, [1985] AC 1000 (appeal taken from N.Z.)).

[9] *See generally* this Dissertation, ch. 1, Section II.C.2.

[10] RESTATEMENT (SECOND) OF CONTRACTS § 15(1)(b) (AM. LAW INST. 1981). Although this Restatement denies capacity on the volitional basis only if the capable party has "reason to know" the incapacity, *id*., courts often apply the knowledge qualifier to the cognitive basis of incapacity as well, *see generally* this Dissertation, ch. 1, Section II.C.2.

of Professor Milton Green,[11] this Restatement also invites courts to avoid transactions that are *substantively* abnormal, which means deviation from the norm.[12] Inadequacy of consideration is one indicator of substantive abnormality.[13] To Green, abnormality is both "evidence of a disordered mind" and of potential overreach.[14] Moreover, the recently-published Restatement (Third) of Restitution and Unjust Enrichment directs courts to determine capacity disputes "by weighing at each point the value of the protection secured against the cost of securing it."[15] This view eschews general and predictable rules in favor of a substantial judicial discretion to conduct a cost-benefit analysis on a case-by-case basis.

C. An Economic Case for Curtailing the Power of Avoidance

1. Prevalence of Inheritance Disputes

The author's survey of modern transactional capacity cases reveals that they were usually inheritance disputes between litigants who expected to

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[11] *See generally* this Dissertation, ch. 1, Section II.C.2.

[12] Milton D. Green, *Proof of Mental Incompetency and the Unexpressed Major Premise*, 53 YALE L.J. 271, 309 (1944).

[13] *Id.* at 309.

[14] *Id.* at 305. *Contra.* George J. Alexander & Thomas S. Szasz, *From Contract to Status via Psychiatry*, 13 SANTA CLARA LAW. 537, 541 (1973) (arguing that judicial consideration of abnormality deprives the incapable individual of the right to make eccentric contracts, the practical result of which is "punishment for deviancy, not protection against helplessness").

[15] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 33 cmt. c (AM. LAW INST. 2011).

inherit from the potentially incapable individual.[16] Many cases concerned near-death transactions, and the potentially incapable individual usually had passed away by the time of litigation. Figure 1 below depicts the typical procedural posture.

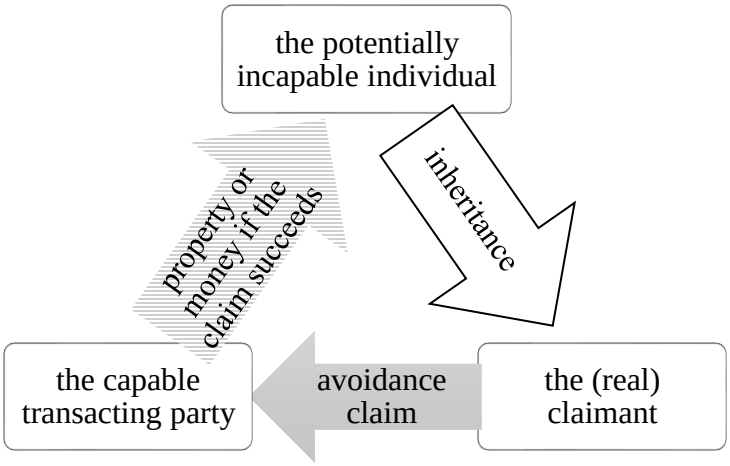

Figure 1: Typical Transactional Capacity Dispute

The prevailing doctrinal theories fail to account for the hallmarks of inheritance disputes. First, the conflicting-policies theory assumes that the act of challenging a transaction for want of capacity indicates that the transaction is disadvantageous to the potentially incapable individual. It is for this reason that the policies of protecting the individual and protecting the security of

[16] *See generally* this Dissertation, ch. 1, Section III.A.1.

transactions are necessarily in conflict.[17] In reality, the claimant who seeks avoidance is typically not the potentially incapable individual herself, but a relative with inheritance expectations;[18] the choice to challenge the transaction is the claimant's rather than the individual's. The conflicting-policies theory fails to make room for the likelihood that the potentially incapable individual might have benefited from the transaction.

Another hallmark of inheritance disputes is the "worst evidence" problem: the testimony of a deceased individual is unavailable.[19] Courts can at best gauge from circumstantial evidence to ascertain the past mental ability of the deceased. If the impugned transaction took place in private, then courts also can only rely on circumstantial evidence to ascertain how the capable transacting party had dealt with the deceased. Such significant evidential deficiency, together with the legal uncertainty arising from the vague standards of mental capacity,[20] give the potential beneficiaries of the deceased's estate an opportunity to avoid transactions that actually benefited

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[17] *See generally* Milton D. Green, *Public Policies Underlying the Law of Mental Incompetency*, 38 MICH. L. REV. 1189, 1214 (1940).

[18] *See generally* this Dissertation, ch. 1, Section III.A.1.

[19] *See generally* ROBERT H. SITKOFF & JESSE DUKEMINIER, WILLS, TRUSTS, AND ESTATES xxxiii, 141, 263–64 (10th ed., 2017); John C.P. Goldberg & Robert H. Sitkoff, *Torts and Estates: Remedying Wrongful Interference with Inheritance*, 65 STANFORD L. REV. 335, 336, 345–46 (2013) (criticizing the tort of interference with inheritance or gift).

[20] *See generally* this Dissertation, ch. 1, Sections II.A, II.C.2.

the deceased. This again challenges the underlying assumption of the conflicting-policies theory.

Moreover, many near-death transactions are *will substitutes*—meaning transfers of wealth at or near death without using the formal probate system.[21] For example, by creating a joint tenancy in her property with a right of survivorship, a potentially incapable individual allows her co-tenant (usually her spouse) to inherit the property when she passes away.[22] Like wills, will substitutes are by their nature one-sided—in favor the party who is expected to inherit—*regardless* of their makers' mental ability. As a result, substantive imbalance is an inherent characteristic of will substitutes. Contrary to the widely-accepted abnormality theory, substantive imbalance is not a good signal of mental deficiency, nor does it raise a red flag of overreach.

The tendency to avoid transactions made in the estate-planning context is particularly problematic in the light of the current shortage of elder caregivers. In American and Anglo-Australian jurisdictions, the burden of caring for the elderly is primarily borne by families rather than the state.[23]

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[21] *See generally* John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV. L. REV. 1108 (1984).

[22] *Id.* at 1112.

[23] NATIONAL ALLIANCE FOR CAREGIVING & AARP PUBLIC POLICY INSTITUTE, CAREGIVING IN THE U.S. 2015 at 12, 66–67 (2015), https://www.caregiving.org/caregiving2015/; *4430.0 – Disability, Ageing and Carers, Australia: Summary of Findings, 2015*, AUST. BUREAU STAT., <http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/4430.0main+features402015 (last accessed Jan. 25, 2018); *Living Longer: Fitting It all in – Working, Caring and Health in*

Unless formally appointed to some fiduciary office,[24] family caregivers typically do not get paid a salary. While caregivers may enjoy the emotional reward of caring for loved ones, they may also expect a reward in the form of inheritance from the care-recipient's estate.[25] Yet the transactional capacity doctrine places undue limits on the ability of many seniors to reward caregiving with inheritance. This harms the welfare of many seniors by limiting their ability to recruit their preferred caregivers. Moreover, many seniors are precluded from pursuing valuable other-regarding preferences to benefit their close relatives and friends.

2. Transactions with Businesses

The transactional capacity doctrine is unduly suspicious of transactions involving close relatives and friends, but it remains suitable for regulating transactions between potentially incapable individuals and businesses. Unlike in the estate-planning context, the abnormality theory correctly regards substantive imbalance in transactions with businesses as a signal of

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Later Life, OFFICE NATL STAT., https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/ageing/articles/livinglongerhowourpopulationischangingandwhyitmatters/fittingitallinworkingcaringandhealthinlaterlife (last accessed Jan. 25, 2018).

[24] *See, e.g.*, UNIF. PROBATE CODE §§ 5-316(a), 5-417 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 120(b) (Unif. Law Comm'n 2017); RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(4) (AM. LAW INST. 2012).

[25] *See generally* Joshua C. Tate, *Caregiving and the Case for Testamentary Freedom*, 42 U.C. DAVIS L. REV. 120 (2008).

mental inability and of potential overreach.[26] While the conflicting-policies theory still ignores the prevalence of avoidance claims driven by inheritance expectations, these claims are unlikely to defeat the testamentary intent of the potentially incapable individual. Thus the flaws of the prevailing doctrinal theories tend *not* to affect consumer contracts and other transactions with businesses.

Moreover, the transactional capacity doctrine offers much-needed safeguards against elderly financial exploitation by businesses. In transacting with businesses, potentially incapable individuals tend to be in a position of significant disadvantage. Aside from having a low bargaining power, individuals—mentally-capable or not—tend to be boundedly-rational in the sense of having cognitive biases, limited willpower, and many other forms of systematic mental limitations.[27] Research in behavioral economics and psychology have shown that businesses can exploit these mental limitations to extract extraordinary profits.[28] In particular, the combination of severe

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[26] *See generally supra* Sections II.A, C.2.

[27] *See, e.g.*, Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99 (1955); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); Richard H. Thaler, *Some Empirical Evidence on Dynamic Inconsistency*, 8 ECON. LETTERS 201 (1981). *See generally* Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 5 STAN. L. REV. 1471, 1476–81; Jonathan Baron & Tess Wilkinson-Ryan, *Conceptual Foundations: a Bird's Eye View*, *in* RESEARCH HANDBOOK ON BEHAVIORAL LAW AND ECONOMICS 25–38 (Joshua C. Teitelbaum & Kathryn Zeiler eds., 2018).

[28] *See generally* RAN SPIEGLER, BOUNDED RATIONALITY AND INDUSTRIAL ORGANIZATION (2011); Botond Köszegi, *Behavioral Contract Theory*, 52 J. ECON.

cognitive limitations and substantial wealth can render many seniors vulnerable to financial exploitation.[29] Moreover, unlike in close families and personal relationships, intrinsic bonds and informal norms do not constrain profit-driven businesses. Thus the need to protect vulnerable seniors from exploitative business practices can justify the continuing application of a rigorous transactional capacity doctrine to transactions with businesses.

3. Modeling Claimant-Incapable Individual Conflicts

Aiming to clarify the role of incentives in typical capacity disputes, I construct a behavioral-contract-theoretic model to capture what the prevailing doctrinal theories fail to recognize:[30] that three players are really involved—the potentially incapable individual, the capable transacting party, and the claimant who decides whether to seek avoidance. The claimant's preferences regarding the impugned transaction can be different from the potentially incapable individual's. For instance, when deciding whether to exercise any power of avoidance, the claimant may disregard the relational bonds and norms between the potentially incapable individual and the

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LITERATURE 1075 (2014); OREN BAR-GILL, SEDUCTION BY CONTRACT: LAW, ECONOMICS, AND PSYCHOLOGY IN CONSUMER MARKETS 2, 42, 248 (2012).

[29] Sumit Agarwal, John C. Driscoll, Xavier Gabaix & David Laibson, *The Age of Reason: Financial Decisions over the Life Cycle and Implications for Regulation*, 2009 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 51, 51–52, 80.

[30] *See generally* this Dissertation, ch. 1, Appendix B.

capable transacting party.

More precisely, in this model, a sophisticated actor may transact with a potentially incapable individual, and may be the subject of a subsequent avoidance claim by the claimant. The sophisticated actor has superior bargaining power and makes choices to maximize her own payoff. This setup "stacks the cards" against me. The model aims to facilitate an analysis of the problem of elderly financial abuse. This problem is most pronounced when the potential abuser—the actor in the model—is assumed to be sophisticated, self-interested and superior in bargaining. Under this assumption, the normative case for a broad power of avoidance is the strongest. This assumption "stack the cards" against me because I will propose to curtail that power.

This model produces equilibrium properties that illustrate several real-life problems. First, without allowing avoidance on the basis of mental incapacity, exploitation may be a problem: the incapable individual may be bound by a transaction that she would not have made if she had capacity. Second, while allowing avoidance may mitigate potential exploitation, it also encourages the claimant to avoid transactions that actually benefited the incapable individual. In some cases, the claimant's temptation to avoid ex post can even discourage transactions with the incapable individual ex ante. The harmful consequences of avoidance are exacerbated if the state of

capacity is not known at the time of making the transaction.

The main insight from the model is that the "true" conflict generated by the power to avoid transactions for want of capacity is often between the incapable individual and the claimant. Allowing avoidance would give the claimant an incentive to avoid transactions that actually benefited the incapable individual. Safeguarding the claimant's interests may therefore harm the welfare of the incapable individual. On the other hand, even with a broad power of avoidance in place, the sophisticated actor typically can safeguard her own interests by choosing not to transact with the incapable individual. Overall, the "true" conflict that animates transactional capacity disputes is often *intertemporal*: the claimant's incentive to seek avoidance ex post may not align with the incapable individual's incentive to transact ex ante. Such conflicts are therefore a source of perverse incentives.

D. Reform Suggestions

An appropriately-formulated transactional capacity doctrine should recognize intertemporal conflicts between claimants and potentially incapable individuals. Such conflicts tend to be severe in relation to transactions involving close relatives and friends (which usually take place in the estate-planning context), but not in relation to transactions with businesses. I therefore offer reform suggestions to limit the extent of

avoidance of transactions involving close relatives and friends.[31]

The main suggestion is to make available a *substituted-judgment defense* to close relatives and friends. This defense removes any power of avoidance in cases where the potentially incapable individual would have entered into the impugned transaction if she had capacity. This suggestion aims to preclude and discourage avoidance of transactions that likely benefitted the incapable individual. By so doing, the interests of the incapable individual are prioritized over the claimant's.

The substituted-judgment defense directs courts to consider the incapable individual's past conduct, transacting patterns, and relational norms when she had capacity.[32] To be sure, transactional capacity cases often concern one-shot transactions that the individual may not have had an opportunity to make in the past. However, most cases concern seniors who have had a life-time of opportunities to make use of estate-planning instruments, such as wills, will substitutes and wish letters. Seniors also tend to have left behind a "memory trail" of informed opinions and value preferences in the minds of their family and friends.[33] Moreover, near-death transactions can be the final

[31] *See generally* this Dissertation, ch. 1, Part IV.

[32] *See generally* this Dissertation, ch. 1, Part IV.A.2.

[33] Terry Carney, *Financial Planning Mechanisms for People with Cognitive Impairment in Australia*, *in* SPECIAL NEEDS FINANCIAL PLANNING: A COMPARATIVE PERSPECTIVE 5–6 (Lusina Ho & Rebecca Lee eds., 2019).

manifestation of property-sharing and gift-giving norms within close families and personal relationships.[34] The substituted-judgment defense directs court to consider the individual's past relational norms and estate plans, in addition to her past conduct and transacting patterns.

II. FIDUCIARY REGULATION OF PROPERTY MANAGERS

While the transactional capacity doctrine may directly avoid transactions that potentially exploit the elderly, fiduciary law often supplies the doctrinal basis for judicial scrutiny. This is because suspicious conduct or transactions often involve guardians and agents who provide property-management services to elderly incapable individuals. A guardian is officially appointed by a court to make decisions on behalf of an incapable individual. A power of attorney is a private instrument through which an individual—the principal—authorizes another person—the agent—to act on behalf of the principal. Modern agency law permits a *durable* agency to commence, or remain valid, upon the principal losing mental capacity.[35]

Like in typical fiduciary relationships, the problem of moral hazard can

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[34] *See generally* Melanie B. Leslie, *Enforcing Family Promises: Reliance, Reciprocity, and Relational Contract*, 77 N.C. L. REV. 551, 564–78 (1999); Alexander M. Meiklejohn, *Contractual and Donative Capacity*, 39 CASE WESTERN RESERVE L. REV. 307, 342, 364–67, 379, 387 (1988-89) (analysis of transactional capacity cases from the 1960s to the 1980s showing that courts tended to uphold transactions made in the course of long-term and close relationships).

[35] *See generally* this Dissertation, ch. 2, Section I.A; this Dissertation, ch. 3, Section II.A.

affect guardianships and durable agency relationships. Guardians and agents typically have a broad discretion over how to take actions affecting the elderly incapable individuals they serve. First, that the incapable individual is unable to take the relevant actions without assistance is the very reason for engaging the guardian or agent. The same reason implies that the individual tends to lack the ability to monitor the guardian or agent to a satisfactory degree.[36] Second, any actual wrongdoing by the guardian or agent is often undetectable; record keeping can be imperfect or poor, and the guardian or agent is easily able to produce evidence favorable to her position. Thus, unless sufficiently constrained, the guardian or agent has the opportunity to exercise her discretion to benefit herself (or a third party) at the expense of the incapable individual. The guardian or agent may be well be tempted to act on that opportunity, which temptation creates a moral hazard problem. A manifestation that problem is elder financial abuse in the course of providing property-management services.

A. Trust Fiduciary Law

Prevailing American law and Anglo-Australian law apply trust fiduciary law to guardians and agents. Trust fiduciary law is prophylactic; it overdeters

[36] *See generally* Elizabeth S. Scott & Robert E. Scott, *Parents as Fiduciaries*, 81 VA. L. REV. 2401, 2419–21(1995); Robert H. Sitkoff, *An Economic Theory of Fiduciary Law*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 197, 199 (Andrew S. Gold & Paul B. Miller eds., 2014).

the fiduciary to mitigate the moral hazard problem.[37] In addition to the duty of care and accounting and reporting duties, guardians and agents owe a duty of *undivided loyalty*: subject to some narrow exceptions,[38] the guardian or agent is prohibited from acting other than in the *sole* interest of the incapable individual. For instance, receiving a gift from the incapable individual typically amounts to a breach of the sole-interest duty of loyalty. A breach makes available a broad range of remedies. These include rescission of the impugned transaction, loss-based remedies to compensate any loss to the incapable individual or her estate, and gain-based remedies to disgorge the errant guardian's or agent's ill-gotten gain.[39]

B. An Economic Case for Limited Fiduciary Regulation

1. Mandatory Fiduciary Law

Fiduciary law is contractarian when applied to a fiduciary who serves a mentally-capable beneficiary; most fiduciary duties are understood as *default* duties to fill in the gaps in the incomplete "contract" between the fiduciary

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[37] RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. b (AM. LAW INST. 2012) ("The rationale [underlying the duty of loyalty] begins with a recognition that it may be difficult for a trustee to resist temptation when personal interests conflict with fiduciary duty."); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 cmts. b, d, h (AM. LAW INST. 2011). *See generally* this Dissertation, ch. 2, Sections I.B–C, I.E (surveying the academic literature on the "default-penalty" theory of fiduciary duty).

[38] *See generally* this Dissertation, ch. 2, Sections I.C, III.A.3; this Dissertation, ch. 3, Section III.C.

[39] *See generally* this Dissertation, ch. 2, Section I.C; this Dissertation, ch. 3, Section III.A.

and the beneficiary. This reflects the prevailing doctrinal position that fiduciary law generally yields to party modification. By modifying the terms of the instrument underlying the fiduciary relationship, the creator may modify the duties of the fiduciary.[40] Similarly, the beneficiary generally can consent to a potential breach of fiduciary duty before it takes place, or ratify it after the fact.

The essentially-default nature of fiduciary law supplies the standard objection to reform proposals to legitimize conflicted conduct or transactions that amount to efficient breaches.[41] If the fiduciary commits an efficient breach without obtaining prior authorization, and is later found in breach, then her personal gain would be disgorged. On the other hand, if the fiduciary seeks authorization from the beneficiary first, then they can negotiate and form an agreement to share the welfare gain arising from the efficient breach; the fiduciary typically would still obtain some of that gain. Thus the fiduciary would be better off acting with the beneficiary's authorization than without. In other words, by simultaneously imposing the sole-interest duty on the

[40] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS §§ 64, 65 (AM. LAW INST. 2012); RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. c (AM. LAW INST. 2006) ("[A]n agent's fiduciary duties to the principal vary depending on the parties' agreement and the scope of the parties' relationship."). The instrument underlying the fiduciary relationship is the power of attorney in the case of an agency, and the order of appointment of the court in the case of a guardianship.

[41] *See generally* this Dissertation, ch. 2, Section I.E; this Dissertation, ch. 3, Sections III.A, V.A.

fiduciary and conferring the power to authorize a breach on the beneficiary, fiduciary law can incentivize the fiduciary to take efficient actions and share the resulting welfare gain with the beneficiary.

Yet, when applied to mentally-incapable individuals, fiduciary law no longer operates as default law. An incapable individual typically has no power to authorize efficient breaches by her guardian or agent. Prevailing American law regards mental capacity as a formal requirement for a valid authorization.[42] While Anglo-Australian law does not formally require mental capacity to validate beneficiary authorization,[43] it can be very costly to "litigation-proof" authorization obtained from an incapable individual. The typical basis of mental incapacity is dementia or a similar degenerative condition, and courts may see the authorization itself as a form of exploitation. To be safe, the guardian or agent may need to incur the substantial cost of engaging a mental health professional to verify and document the quality of consent.

2. Failure to Accommodate Familial Bonds and Norms

Applying with mandatory force, strict fiduciary law tends to harm the welfare of elderly incapable individuals and the welfare of their guardians and agents. A preliminary observation is that fiduciary doctrine does not

[42] *See generally* this Dissertation, ch. 2, Section II.A.1.

[43] *See generally* this Dissertation, ch. 3, Section V.A.1.

formally recognize that there is a broad spectrum of guardians and agents. While some are professionals who charge fees for their services, most are lay persons who are in a close familial or personal relationship with the incapable individual.[44] The incapable individual's spouse/partner or adult child is typically the preferred guardian or agent.

In this light, mandatory application of the sole-interest duty of loyalty tends to generate little benefits in cases concerning close families and personal relationships. In these cases, intrinsic bonds and informal norms can partially alleviate the misalignment of incentives arising from financial conflicts.[45] In the language of economic theory, the fiduciary exploits the moral hazard problem to the extent that her incentives are misaligned with her beneficiary's. As intrinsic bonds and informal norms become more effective in aligning incentives, the fiduciary becomes less likely to exploit her discretion. Extralegal mechanisms thus diminish the need for intrusive regulation by strict fiduciary duty.

At the same time, mandatory application of the sole-interest duty of loyalty can generate large costs in close families and personal relationships.

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[44] *See generally* this Dissertation, ch. 2, Section I.A; this Dissertation, ch. 3, Section II.A.

[45] *See generally* this Dissertation, ch. 2, Section II.B.2 (discussing Elizabeth S. Scott & Robert E. Scott, *Parents as Fiduciaries*, 81 VA. L. REV. 2401 (1995)); this Dissertation, ch. 3, Section V.B.1 (same).

Relative-and-friend guardians and agents usually have financial conflicts arising from joint property ownership, shared residence, or inheritance expectations. Compliance with the sole-interest duty would require the close relative or friend to remove her financial conflicts. The costs of doing so can deter her from taking on the fiduciary office. Thus strict enforcement of the sole-interest duty can narrow the pool of safe and reliable candidates for fiduciary appointment.

Moreover, mandatory application of the sole-interest duty of loyalty can harm welfare by stultifying the pursuit of valuable other-regarding goals and preferences. Experimental research in psychology and behavioral economics shows that individual preferences are often other-regarding, rather than purely self-regarding. In close families and personal relationships, strong other-regarding preferences can manifest in gift-giving norms and property-sharing arrangements. Moreover, many near-death transactions to benefit close relatives and friends can be the final manifestation of reciprocal gift-giving norms. Yet strict enforcement of the sole-interests duty typically leads to a selfish, one-sided distribution of welfare gains—in favor of the incapable individual and no one else. This remains the case even in the absence of harm to the individual. In other words, strict enforcement of the sole-interest duty forces the incapable individual to be selfish, even if she prefers to be other-regarding.

C. Reform Suggestions

When imposed on close relatives and friends, the sole-interest duty of loyalty harms welfare because elderly incapable individuals typically have no power to authorize harmless or mutually-beneficial conflicts. I therefore propose to make available to close relatives and friends a defense that approximates a valid exercise of the power of authorization. More precisely, the guardian or agent should not be held liable for breach of fiduciary duty in cases where the incapable individual would have authorized the conflicted conduct or transaction if she had capacity.[46]

1. A Substituted-judgment Defense for American Jurisdictions

For American jurisdictions, my proposal essentially introduces the well-known doctrine of substituted judgment as a defense for breach-of-fiduciary duty claims. In modern guardianship law and trust law, the doctrine of substituted judgment provides the standard for determining whether to grant *prospective* judicial approval of suspicious conduct. In particular, courts can approve transactions tainted with a conflict of interest, especially if there is evidence showing that such approval would advance the incapable individual's known wishes.[47]

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[46] *See generally* this Dissertation, ch. 2, Part III; this Dissertation, ch. 3, Part V.

[47] *See generally* this Dissertation, ch. 2, Section III.A.2 (discussing evidence of what the incapable individual would have wanted if she had capacity).

If extended to govern *retrospective* judicial scrutiny of fiduciary conduct, the proposed substituted-judgment defense can prevent the sole-interest duty from displacing strong extralegal bonds and other-regarding preferences. A capable individual who wishes to respect these bonds and pursue preferences may exercise her power to authorize a conflict of interest. The proposed defense performs a similar function for an incapable individual. It does so by allowing her guardian or agent to defend a conflict of interest to the extent that the incapable individual would have authorized it if she had capacity. The proposed exemption thus permits the guardian or agent to support the incapable individual to pursue non-selfish goals. This reduces the welfare costs arising from the mandatory application of strict fiduciary law.

2. A Best-interest Defense for Anglo-Australian Jurisdictions

For Anglo-Australian jurisdictions, I argue that close relatives and friends should be afforded a two-prong *best-interest* defense. This defense permits a conflict of interest in cases where (1) the incapable person would have authorized the conflict if she had capacity (the subjective prong); and (2) the conflicted conduct or transaction does not amount to evasion of the applicable family provision statute (the objective prong).[48] The following explains why Anglo-Australian jurisdictions should adopt the best-interest standard while

[48] *See generally* this Dissertation, ch. 3, Section V.C (discussing family provision statutes in Anglo-Australian jurisdictions).

American jurisdictions should reject it.

A preliminary observation is that in England and New South Wales, the best-interest standard is largely the same as the substituted-judgment standard in American law. While Anglo-Australian statutes tend to leave "best interests" undefined, English and New South Wales courts give centrality to one factor: what the incapable individual would have wanted if she had capacity.[49] The subjective prong of my proposed best-interest defense captures the centrality of that factor. Moreover, New South Wales courts follow the same historical Chancery judgment that American courts used to develop the doctrine of substituted judgment.[50] Support from Anglo-Australian doctrine also comes with "best-interests" label.

The author's proposal to adopt an objective prong in the Anglo-Australian best-interests defense, but not in the American substituted-judgment defense, reflects substantial differences between American and Anglo-Australian inheritance law and policy. The typical breach-of-fiduciary duty claim is part and parcel of an inheritance dispute. While Anglo-Australian law heavily regulates testamentary freedom, prevailing American law imposes few

[49] this Dissertation, ch. 3, Section V.A.

[50] *Ex parte Whitbread* (1816) 35 Eng. Rep. 878, 879 (Eng.). *See generally* RESTATEMENT (THIRD) OF TRUSTS § 11 cmt. f, note to cmt. f, re. subsection (5) (AM. LAW INST. 2003); this Dissertation, ch. 3, Section V.A.2.

restrictions (such as a spouse's optional share in the deceased's estate).[51] For example, Anglo-Australian family provision statutes qualify an individual's freedom of testation with a duty to provide for her dependent children (including adult children), but prevailing American law imposes no such duty.[52] Moreover, the qualifications of testamentary freedom tend to be rules in prevailing American law but standards in Anglo-Australian law. For example, Anglo-Australian family provision statutes grant a substantial judicial discretion to decide whether a claimant for family provision relief is a 'dependent', and if so, how much provision from the deceased's estate should be made.[53] In contrast, showing a strong preference for rules, American legislatures have consistently rejected proposals to introduce family provision statutes.[54]

Aside from being incompatible with American inheritance law and policy, the best-interests standard would generate unwanted indeterminacy if adopted in American fiduciary law. The objective best-interest factors—factors other than what the incapable person would have wanted—are usually

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[51] *See generally* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 10.1 cmts. a, c (AM. LAW INST. 1999); SITKOFF & DUKEMINIER, *supra* note 19, 1–2, ch. 8.

[52] *See generally* SITKOFF & DUKEMINIER, *supra* note 19, at 564–65.

[53] *See generally* CROUCHER & VINE, *supra* note 53, paras. 2.35–36; ROSS MARTYN ET AL., *supra* note 50, paras. 11–049, 11–068.

[54] *See generally* SITKOFF & DUKEMINIER, *supra* note 19, at 569–70.

incommensurable, and there is no guidance on how to weigh or rank them.[55] Family life is also largely private; courts often have no access to much of the evidence needed to apply many best-interest factors.[56] The resulting indeterminacy can generate substantial adjudication costs to courts, as well as compliance and litigation costs to private individuals.[57] Adopting an objective best-interest standard in American jurisdictions would therefore introduce unwanted indeterminacy in the estate-planning context.[58]

On the other hand, the typical Anglo-Australian inheritance dispute already exhibits a high degree of indeterminacy. Guardians and agents who are in a close familial or personal relationship with the incapable individual have a strong case for family provision relief. When an inheritance dispute is viewed as a whole, introducing a best-interest analysis adds little to the high degree of indeterminacy already arising from family provision statute.[59] Hence the vices of indeterminacy should not stop Anglo-Australian fiduciary law from adopting the proposed best-interests defense.

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[55] *See, e.g.*, Elizabeth S. Scott & Robert E. Emery, *Gender Politics and Child Custody: Puzzling Persistence of the Best-Interests Standard*, 77 LAW & CONTEMPORARY PROBLEMS 69, 75 (2014).

[56] *Id.* at 74.

[57] *See generally* Louis Kaplow, *Rules versus Standards: an Economic Analysis*, 42 DUKE L.J. 557 (1992).

[58] *See generally* this Dissertation, ch. 2, Sections I.F, III.B.1.

[59] *See generally* this Dissertation, ch. 3, Section V.D.1.

CONCLUSION

A. Inappropriate Response to Potential Conflicts of Interest

When applied to resolve mental capacity disputes involving the elderly, prevailing fiduciary law and transactional law fail properly to respond to potential conflicts of interest. First, prevailing law underreacts to potential conflicts between an elderly incapable individual and a claimant who expects to inherit from the individual. It is the claimant who really decides whether to avoid a transaction for want of capacity or bring a breach-of-fiduciary duty claim; she may make that decision to increase her own expected inheritance, rather than to advance the interests of the incapable individual. Failing to account for such potential conflicts, prevailing transactional law mistakenly assumes that every attempt to avoid a transaction indicates the potentially incapable individual would have found the transaction disadvantageous. Similarly, prevailing fiduciary law ignores potential conflicts between an elderly incapable individual and a claimant who seeks to recover expected inheritance from a well-intended guardian or agent.

Second, prevailing law overreacts to potential conflicts of interest between an elderly incapable individual and her close relative or friend. Prevailing fiduciary law explicitly requires guardians and agents to avoid conflicts between their personal interests and their duties. Such inflexible prohibition ignores the fact that conflicts are ubiquitous in close familial and

personal relationships. Moreover, extralegal bonds and norms can partially alleviate the moral hazard problem that triggers legal intervention. Similarly, prevailing transactional law disregards intrinsic bonds and informal norms in close familial and personal relationships. Garden-variety estate-planning transactions are regarded with great suspicion.

While a failure to recognize the claimant-incapable individual conflict matters little in the consumer or business context, such failure tends to harm welfare in the family and estate-planning context. Directly or through their guardians and agents, seniors may wish to benefit their close relatives and friends and reward their caregivers. Yet prevailing law tends to stultify the pursuit of these valuable goals and preferences.

B. Reform Suggestions

Prevailing fiduciary law and transactional law are unduly suspicious of potential conflicts between an elderly incapable individual and her close relative or friend. Prevailing law fails to recognize potential conflicts between the individual and a claimant who is driven by inheritance expectations. To remedy these shortcomings, I propose to make available to close relatives and friends a defense that enshrines what the elderly incapable individual would have wanted if she had capacity. This proposal aims to help the elderly pursue their non-selfish goals, respect their familial bonds, and reward their caregivers. The problem of elder financial abuse ought to be resolved in a

way that advances the welfare of the elderly, as defined by their own will and preferences.

Chapter 1: Mental Capacity in American Transactional Law

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INTRODUCTION

Consider the following hypothetical based on *Daughton v. Parson*:[1] for decades, Cecil lived with his parents, Ollie and Thomas, and assisted them

[1] 423 N.W.2d 894 (Iowa Ct. App. 1988).

with operating their farm. In their old age, Ollie and Thomas orally promised to pass the farm on to Cecil, but no one acted upon that promise until Thomas passed away. Having fallen in her health and moved to a nursing home, Ollie executed deeds to transfer the farm to Cecil for no consideration. Ollie's other children, who expect to inherit a share of her estate when she dies, now seek to avoid the transfer deeds and recover the farm from Cecil. They argue that Cecil took advantage of Ollie's *mental incapacity*.[2] This Chapter addresses the question of who should succeed in this and similar cases.[3]

Disputes over the properties of the elderly arise against the background of population aging and the likely prevalence of elder financial abuse.[4] Mental and physical decline is common among seniors. The combination of severe cognitive limitations and substantial wealth renders many seniors vulnerable to financial exploitation. The late Brooke Astor, who had dementia after a lifetime of philanthropy, had tens of millions of dollars stolen from her by her son and family lawyer while she was left to live in

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[2] Mental *incapacity* is a functional concept in law, *see generally infra* Section I.A, and is distinct from the medical concept of mental *disorder*. A mental disorder refers to "a syndrome characterized by clinically significant disturbance in an individual's cognition, emotion regulation, or behavior[.]" AM. PSYCHIATRIC ASS'N, DIAGNOSTIC AND STATISTICAL MANUAL OF MENTAL DISORDERS at 20 (5th ed., 2013). Having a mental disorder is neither sufficient nor necessary for an individual to lack mental capacity to transact in the eyes of the law. *See generally infra* Sections II.A, II.C.

[3] The Iowa court ruled against Cecil. Daughton v. Parson, 423 N.W.2d 894, 898 (Iowa Ct. App. 1988).

[4] *See generally infra* Section I.A.2.

squalor in her final years of life.[5] The famed artist Peter Max, who suffers from advanced dementia, has to witness his family, friends and business associates "trading lurid courtroom allegations of kidnapping, hired goons, attempted murder . . . and schemes to wring . . . money out of" his profitable art franchise.[6] The alleged business manager and caretaker of Stan Lee is now facing multiple counts of financial and physical abuse against the late comic book legend.[7]

In private suits alleging elder financial abuse, courts often apply the *mental capacity doctrine* to determine whether to avoid seemingly exploitative contracts, gifts and other lifetime transactions.[8] The doctrine is meant to protect individuals who lack sufficient mental ability to incur legal responsibility for their own transactional choices.[9] Yet allowing avoidance of transactions tainted with incapacity can discourage others from transacting

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[5] *See* Russ Buettner, *Appeals Exhausted, Astor Case Ends as Son Is Sent to Jail*, N.Y. TIMES, Jun. 21, 2013; John Eligon, *Settlement in Battle over Astor Estate Is Reached*, N.Y. TIMES, Mar. 28, 2012.

[6] Amy Chozick, *Dementia Stopped Peter Max from Painting. For Some, That Spelled a Lucrative Opportunity.*, N.Y. TIMES, May 28, 2019.

[7] *See, e.g.*, *Stan Lee: Ex-manager of Comic Book Legend Charged with Elder Abuse*, BBC NEWS (May 14, 2019), https://www.bbc.com/news/entertainment-arts-48265450.

[8] *See generally infra* note 57 and accompanying text; this Dissertation, Appendix A (surveying modern transactional capacity cases).

[9] *See generally infra* Sections I.A, II.A.

with potentially incapable individuals ex ante.[10] To resolve this dilemma, the widely-accepted *conflicting-policies theory* directs courts to balance the conflicting policies of protecting incapable individuals and protecting the security of transactions on a case-by-case basis.[11] A related *abnormality theory* holds that courts should be suspicious of transactions exhibiting substantive or procedural imbalance, or any other factor indicating deviation from the norm.[12] Producing great indeterminacy, these theories direct courts to "weigh[] at each point the value of the protection secured against the cost of securing it."[13]

Against the weight of two modern Restatements,[14] I argue that the mental

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[10] *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 33 cmt. c (AM. LAW INST. 2011) ("Legal incapacity is legal disability, and a person who lacks the capacity to undertake a legally binding obligation is foreclosed from participating in transactions that may be advantageous or even vitally necessary."). *See generally infra* Section III.A.3.

[11] *See generally infra* Sections II.A, II.C.2.

[12] *See generally infra* Sections II.A, II.C.2. Professor Milton D. Green introduced the conflicting-policies theory and abnormality theory. *See generally* Milton D. Green, *Public Policies Underlying the Law of Mental Incompetency*, 38 MICH. L. REV. 1189 (1940) [hereinafter Green, *Public Policies*]; Milton D. Green, *Judicial Tests of Mental Incompetency*, 6 MO. L. REV. 141 (1941) [hereinafter Green, *Judicial Tests*]; Milton D. Green, *The Operative Effect of Mental Incompetency on Agreements and Wills*, 21 TEX. L. REV. 554 (1943) [hereinafter Green, *Operative Effect*]; Milton D. Green, *Fraud, Undue Influence and Mental Incompetency: A Study in Related Concepts*, 43 COLUM. L. REV. 176 (1943); Milton D. Green, *Proof of Mental Incompetency and the Unexpressed Major Premise*, 53 YALE L.J. 271 (1944) [hereinafter Green, *Major Premise*].

[13] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 33 cmt. c (AM. LAW INST. 2011).

[14] *See infra* Section III.A (arguing against the formulation of the mental capacity doctrine in RESTATEMENT (SECOND) OF CONTRACTS (AM. LAW INST. 1981) and

capacity doctrine in prevailing American law is ill-suited for the era of aging population. The previous hypothetical based on *Daughton v. Parson* can illustrate the main problem.[15] While the Iowa court applied contractual doctrines, the case had the hallmarks of a dispute over inheritance. Ollie executed the suspicious deeds in her final years of life, in order to pass the family farm on to Cecil—the child who had labored on it for decades. Ollie's other children challenged those deeds to increase their expected inheritance. Ollie's mental decline rendered it difficult for her to give evidence regarding her true intentions.[16] In theory, the mental capacity doctrine granted Ollie the power to choose whether to avoid her deeds.[17] In reality, that power was exercised by those children who did not want Cecil alone to inherit the family farm. The critical flaw of the prevailing theories is their failure to recognize that the claimant who seeks avoidance may do so against the interest of the incapable individual.[18]

Taking a law-and-economics approach, I propose to reformulate the

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RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (AM. LAW INST. 2011)).

[15] 423 N.W.2d 894 (Iowa Ct. App. 1988).

[16] In typical transactional capacity cases, the potentially incapable individual is unable to testify because she has passed way. *See generally infra* Sections III.A.1–2.

[17] RESTATEMENT (SECOND) OF CONTRACTS §§ 7 cmt. b, 12 cmt. a (AM. LAW INST. 1981).

[18] *See infra* Section III.A.1.

mental capacity doctrine to promote the welfare of seniors who may lack mental capacity. Many transactions between seniors and their close relatives and friends are *estate-planning* instruments made to pursue valuable other-regarding preferences and reward informal caregiving. The mental capacity doctrine ought to offer safeguards against elder financial exploitation without undue intrusion into close families and personal relationships. The main normative claim is that when applied to transactions involving close relatives and friends, the doctrine ought to be narrow, determinate, and respectful of individual will and preferences.[19]

The types of transactions that fall within the scope of this Chapter are those to which courts habitually apply the doctrine governing mental capacity to *contract*.[20] These types of transactions include contracts in the strict sense of legally-enforceable promises,[21] deeds and conveyances,[22] irrevocable gifts,[23] and irrevocable trusts made in their makers' lifetime.[24] For simplicity,

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[19] *See generally infra* Part IV.

[20] *See generally infra* this Dissertation, Appendix A (surveying modern cases in which courts applied the doctrine governing mental capacity to contract).

[21] *See* RESTATEMENT (SECOND) OF CONTRACTS § 1 (AM. LAW INST. 1981).

[22] *See* 5 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 10:1 (4th ed. 1993 & Supp. 1999).

[23] *See* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1(c) (AM. LAW INST. 1999).

[24] *See* RESTATEMENT (THIRD) OF TRUSTS § 11(3) (AM. LAW INST. 2003).

the author labels all these as "transactions" without regard to their doctrinal distinctions, and highlights the exact doctrinal category (for example, contract, gift) when relevant. This Chapter does not cover transactions between incapable individuals and their guardians, agents or other fiduciaries. While the doctrine governing mental capacity to transact is broad and indeterminate, the doctrine that regulates the fiduciaries of elderly incapable individuals is strict and inflexible. The author has written separately on mental capacity in fiduciary law.[25]

This Chapter contributes to the theoretical and doctrinal literature on contract law, property law, remedies, and the law of inheritance. While there is a small literature on transactional capacity disputes predating the era of aging population,[26] recent scholarship focuses on capacity to make a will.[27] Similarly, the closely-related scholarship on undue influence focuses on

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[25] *See generally* this Dissertation, ch. 2 (discussing mental capacity in American fiduciary law).

[26] *See, e.g.*, SUSANNA L. BLUMENTHAL, LAW AND THE MODERN MIND: CONSCIOUSNESS AND RESPONSIBILITY IN AMERICAN LEGAL CULTURE chs. 5–7 (2016); Alexander M. Meiklejohn, *Contractual and Donative Capacity*, 39 CASE WESTERN RESERVE L. REV. 307, 342 (1988-89); Melvin A. Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 763 (1982); *supra* note 12.

[27] *See, e.g.*, Mark Glover, *Rethinking the Testamentary Capacity of Minors*, 79 MISS. L. REV. 69 (2014); Stephen R. Alton, *The Strange Case of Dr. Jekyll's Will: A Tale of Testamentary Capacity*, 52 TULSA L. REV. 263 (2017); Adam J. Hirsch, *Testation and Mind*, 74 WASH. & LEE L. REV. 259, 264 (2017); Joshua C. Tate, *Personal Reality: Delusion in Law and Science*, 49 CONN. L. REV. 891 (2017). *See also* BLUMENTHAL, *supra* note 26, ch. 4 (discussing testamentary capacity cases in the nineteenth century).

wills.[28] With some exceptions,[29] mental capacity to transact also escapes the attention of disability-rights scholars and reformers. Moreover, economically-minded scholars have not considered the interesting dynamics of transactional capacity disputes. This Chapter shows that these disputes deserve scholarly attention, and offers guidance on how best to resolve them.

Part I below introduces the concept of mental capacity to transact and explains its importance in the era of aging population. Part II elaborates upon the mental capacity doctrine in prevailing American law. Part III argues that the prevailing formulation of the doctrine is ill-suited for resolving typical capacity disputes. Part IV offers reform suggestions to promote welfare. Appendix A of this Dissertation provides a survey of modern cases to substantiate the positive claims to be advanced. Appendix B constructs an economic model to highlight the crucial role of incentives in transactional capacity disputes.

I. MENTAL CAPACITY TO TRANSACT: THEORY AND CONTEXT

This Part will introduce the conceptual foundations of mental capacity to

[28] *See, e.g.*, Melanie B. Leslie, *The Myth of Testamentary Freedom*, 38 ARIZ. L. REV. 235 (1996); Ray D. Madoff, *Unmasking Undue Influence*, 81 MINN. L. REV. 571 (1997); Susanna L. Blumenthal, *The Deviance of the Will: Policing the Bounds of Testamentary Freedom in Nineteenth-Century America*, 119 HARV. L. REV. 959 (2006).

[29] *See, e.g.*, George J. Alexander & Thomas S. Szasz, *From Contract to Status via Psychiatry*, 13 SANTA CLARA LAW. 537 (1973) (arguing for abolition of the mental capacity doctrine); David P. Weber, *Restricting the Freedom of Contract: a Fundamental Prohibition*, 16 YALE HUM. RTS. & DEV. L.J. 51, 67–68 (2013) (defending the mental capacity doctrine).

transact and explain its practical importance in the era of aging population. The goal here is to make a prima facie case for operationalizing an appropriately-formulated doctrine of mental capacity to combat elder financial abuse. Parts II and III below will examine whether the mental capacity doctrine in prevailing American law is appropriately formulated.

A. Theoretical Foundations

Mental capacity to transact is the threshold concept of mental ability to incur legal responsibility for one's chosen transactions, such as contracts and transfers of property.[30] A threshold concept of mental ability is present in all major theories of contract law and in theories of property law that enshrine donative intent.[31] In particular, economic theories of contract law have a threshold concept of mental ability to determine whether an individual is sufficiently rational to choose contracts that benefit herself.[32] If she is not

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[30] *See* PAUL S. APPELBAUM & THOMAS G. GUTHEIL, CLINICAL HANDBOOK OF PSYCHIATRY & THE LAW 181–84 (4th ed., 2007).; BLUMENTHAL, *supra* note 26, at 1–2. *Cf.* Eisenberg, *supra* note 26, at 763 (defining "transactional incapacity" as lacking "the attitude, experience, or judgmental ability to make a deliberative and well-informed judgment concerning the desirability of entering into a given complex contraction"). Compared with the notion of mental incapacity to transact in prevailing American law, *see infra* Section II.A, Professor Eisenberg's notion of "transactional incapacity" covers a much broader class of individuals and attracts less drastic legal consequences. *See generally* Eisenberg, *supra* note 26, at 765–66.

[31] *See, e.g.*, RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 10.1 cmts. a, c (Am. Law Inst. 1999).

[32] *See generally* ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 465–66 (5th ed., 2013).

sufficiently rational, then her chosen contract may not advance her individual welfare or the joint welfare of the contracting parties.[33] Autonomy theories of contract law also have a threshold concept of mental ability to determine whether, in the contractual sphere, an individual can be the author of her own goals and relationships.[34] Moreover, whether a contract or transfer of property is likely to advance welfare or autonomy partially depends on the transacting parties' mental abilities. Hence pluralist theories also have some threshold concept of mental ability to assign value to welfare or autonomy, and compare it with the protection of the vulnerable, anti-discrimination, and other relevant values.[35]

B. Deterrence and Sanction of Elder Financial Abuse

How best to formulate and operationalize a doctrine of mental capacity to transact is an important and controversial question in the era of aging

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[33] *See generally* Avery W. Katz, *Economic Foundations of Contract Law*, *in* PHILOSOPHICAL FOUNDATIONS OF CONTRACT LAW 175–80 (Gregory Klass, George Letsas & Prince Saprai eds., 2014) (discussing different modes of argument using contractual surplus); Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 13–17 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (comparing economic and noneconomic theories of contract law).

[34] *See, e.g.*, JOSEPH RAZ, THE MORALITY OF FREEDOM 372–73 (1988) ("If a person is to be maker or author of his own life then he must have the mental abilities to form intentions of a sufficiently complex kind, and plan their execution. These include minimum rationality, the ability to comprehend the means required to realize his goals, the mental faculties necessary to plan actions, etc."); MICHAEL HELLER & HANOCH DAGAN, THE CHOICE THEORY OF CONTRACTS 86 (2017); SCOTT & KRAUS, *supra* note 24, at 465–66.

[35] *See, e.g.*, SCOTT & KRAUS, *supra* note 24, at 28–29.

population. Since the last century, the percentage of Americans age sixty-five or over [hereinafter, seniors] has tripled. The population of seniors is estimated at 43.1 million in 2016 (15.2 percent of the population), and is projected to reach ninety-six million by 2060.[36] Physical and mental decline is common among seniors. In particular, recent studies estimate that Alzheimer's dementia affects about 5.5 million (one in ten) seniors.[37] "[One in three] seniors dies with Alzheimer's or another dementia. It kills more than breast cancer and prostate cancer combined."[38]

Mental and physical decline can make it difficult or impractical for many seniors to safeguard their own financial interests. Empirical studies suggest that elder abuse and neglect are likely prevalent. One nationwide survey reveals that every year, about 5.2 percent of Americans age sixty years or over potentially experience financial mistreatment by a family member.[39]

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[36] U.S. ADMIN. COMMUNITY LIVING, 2017 PROFILE OF OLDER AMERICANS 1–2 (2018) https://acl.gov/sites/default/files/Aging%20and%20Disability%20in%20America/2017OlderAmericansProfile.pdf.

[37] *Facts and Figures*, ALZHEIMER'S ASS'N, https://www.alz.org/alzheimers-dementia/facts-figures (last visited Dec. 8, 2018).

[38] *Id*.

[39] Ron Aciero et al., *Prevalence and Correlates of Emotional, Physical, Sexual, and Financial Abuse and Potential Neglect in the United States: The National Elder Mistreatment Study*, 100 AM. J. PUBLIC HEALTH 292, 292, 296 (2010). These authors broadly defined "financial mistreatment by family member" to mean family member "spent money", "did not make good decisions", "did not give copies", "forged signature", "forced respondent to sign a document" or "stole money". *Id.* at 294. *See also id*. at 292 (summarizing similar results from earlier surveys).

Financial abuse is often found to be the most common form of elder abuse.[40] Moreover, family members are not the only abusers. A survey restricted to Arizona and Florida suggests that every year, nearly sixty percent of residents age sixty or over were the target of consumer fraud.[41] Studies often attribute the prevalence of elder financial abuse to large net worth, diminished cognitive abilities, as well as dementia and other brain diseases.[42]

If appropriately formulated and applied, a doctrine of mental capacity to transact can contribute to efforts to deter and sanction elder financial abuse. The doctrine grants a power to avoid transactions arising from the exploitation of diminished cognitive abilities or other forms of mental weaknesses.[43] An exercise of the power of avoidance can hold the financial abuser liable to return her ill-gotten gain. Thus the doctrine can partially remedy financial exploitation after the fact. By so doing, the doctrine may

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[40] *Id.* at 296. *See also* LIFESPAN OF GREATER ROCHESTER, WEILL CORNELL MEDICAL CENTER OF CORNELL UNIVERSITY & NEW YORK CITY DEPARTMENT FOR THE AGING, UNDER THE RADER: NEW YORK STATE ELDER ABUSE PREVALENCE STUDY 17, 35 (May 2011), http://ocfs.ny.gov/main/reports/Under%20the%20Radar%2005%2012%2011%20final%20report.pdf (survey of seniors residing in New York reporting that financial abuse is the most common form of elder abuse, and that spouses/partners and adult children are the most likely abusers).

[41] KRISTY HOLTFRETER, MICHAEL D. REISIG, DANIEL P. MEARS & SCOTT E. WOLFE, FINANCIAL EXPLOITATION OF THE ELDERLY IN A CONSUMER CONTEXT 2, 128 (March 2014), https://www.nij.gov/publications/pages/publication-detail.aspx?ncjnumber=245388. *See also id.* at 21–26 (summarizing similar results from earlier surveys).

[42] *Id.* at 2–3, 32.

[43] *See infra* Section II.A.

also disincentivize potential abusers from committing financial abuse in the first place.[44]

A numerical example can illustrate this point. Suppose a potential abuser may overreach to purchase a house for a cheap price from a senior who lacks mental capacity.[45] The potential abuser is sophisticated and self-interested. Her expected gain from committing the abuse is $G million; this is her profit from purchasing the house cheaply. If effectively enforced, a doctrine of mental capacity can avoid the sale of the house and disgorge the ill-gotten gain—$G million. More precisely, an exercise of the power of avoidance can attract remedies that effectuate the return of the house to the senior and, at the same time, the return of the purchase price to the abuser.[46] This would eliminate the abuser's profit, leaving her with $0. She would no longer be incentivized to commit the abuse because her expected gain from doing so would be removed.

C. Supplementing Tort Law and Criminal Law

Recent legislative efforts to tackle elder financial abuse tend to make use of criminal law and tort law rather than the law of capacity. Many states have

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[44] *See also infra* this Dissertation, Appendix B (constructing a formal economic model to illustrate the deterrence effects of the power of avoidance).

[45] This example is a stylized modification of Farnum v. Silvano, 540 N.E.2d 202 (Mass. Ct. App. 1989) (discussed in text accompanying *infra* notes 64–68).

[46] *See generally infra* Sections II.A, IV.B.

introduced criminal sanctions for financial exploitation of seniors and people with mental disorders; "financial exploitation" is typically defined as undue influence[47]—a functionally-similar concept to mental incapacity.[48] A growing number of states have also adopted statutes to disinherit abusers who commit undue influence against seniors and people with mental disorders.[49] In addition, many states have introduced a tort of interference with inheritance or gift.[50]

The law of capacity offers safeguards that are different from, but can supplement, the safeguards provided by tort law and criminal law. Criminal and tort statutes may deter and sanction a financial abuser, but she may still have an incentive to engage in misconduct if her ill-gotten gain exceeds her

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[47] *See generally* Lori Stiegel & Ellen Klem, Am. Bar Ass'n Comm'n Law & Aging, *Types of Abuse: Comparison Chart of Provisions in Adult Protective Services Laws, by State*, AM. BAR ASS'N, https://www.americanbar.org/content/dam/aba/administrative/law_aging/Abuse_Types_by_State_and_Category_Chart.authcheckdam.pdf (last visited Dec. 8, 2018); Lori Stiegel & Ellen Klem, Am. Bar Ass'n Comm'n Law & Aging, *Undue Influence: Context, Provisions, and Citations in Adult Protective Services Laws, By State*, AM. BAR ASS'N, http://www.americanbar.org/content/dam/aba/administrative/law_aging/Undue_Influence_Context_Provisions_and_Citations_Chart.authcheckdam.pdf (last visited Dec. 8, 2018). *See also* Nina A. Kohn, *Elder (In)Justice: A Critique of the Criminalization of Elder Abuse*, 49 AM. CRIM. L. REV. 1 (2012) (criticizing statutes that criminalize elder financial abuse).

[48] *See infra* Section II.B.

[49] *See generally* Jennifer Piel, *Expanding Slayer Rule to Elder Abuse*, 43 J. AM. ACAD. PSYCHIATRY LAW 369 (2015).

[50] *See generally* RESTATEMENT (SECOND) OF TORTS § 774B (AM. LAW INST. 1979); John C.P. Goldberg & Robert H. Sitkoff, *Torts and Estates: Remedying Wrongful Interference with Inheritance*, 65 STAN. L. REV. 335 (2013) (criticizing the tort of interference with inheritance or gift).

expected tortious or criminal liability. An appropriately-formulated doctrine of mental capacity provides a different kind of remedy: disgorgement of the ill-gotten gain.[51] This remedy can deter and sanction the abuser by taking away what motivated her to engage in misconduct in the first place.

A modification of the numerical example introduced in Section I.B can illustrate the finer differences between the disgorgement remedy and tort or criminal liability.[52] Suppose the potential abuser—who may overreach to purchase a house cheaply from an incapable senior—would be exposed to tortious liability if she were to so overreach. Her expected tortious liability is $1 million, while her expected gain $G million. If effectively enforced, then tort law deters the potential abuser from committing the abuse if $1 million > $G million; she is not incentivized to commit the abuse because her expected cost in terms of tortious liability is greater than her expected gain. However, if $1 million < $G million, her expected gain exceeds her expected tortious liability, so she still has an incentive to commit the abuse. On the other hand, by avoiding any sale of the house and disgorging any ill-gotten gain, an appropriately-formulated doctrine of mental capacity can deter the potential abuser even in cases where $1 million < $G million. Such

[51] *See generally* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 16, 33 (AM. LAW INST. 2011).

[52] *See supra* notes 45–46 and accompanying text.

disgorgement of her ill-gotten gain would leave her with $0. She is no longer incentivized to commit the abuse because her motivation for doing so would be removed.

II. MENTAL CAPACITY TO TRANSACT IN AMERICAN LAW

Part I has laid out the theoretical basis for using an appropriately-formulated doctrine of mental capacity to deter and sanction elder financial exploitation. This Part explains how such a doctrine is formulated in prevailing American law. Part III below will argue that the prevailing formulation is ill-suited for resolving typical capacity disputes in the era of aging population.

A. Prevailing Formulation

In prevailing American law, the mental capacity doctrine balances the conflicting policies of protecting incapable individuals and protecting the security of transactions.[53] To determine whether to avoid an impugned transaction, the doctrine directs the court to take two steps:

(1) ascertain whether the relevant transacting party lacked mental capacity at the time of making the transaction;

(2) consider any imbalance in the substantive and procedural aspects of the transaction.

[53] *See infra* Section II.C.2.

There are several tests for answering the first question of whether a transacting party lacked mental capacity. The traditional test is *cognitive*, asking whether a mental disorder or defect results in an inability to understand in a reasonable manner the nature and consequences of the transaction.[54] To cover non-cognitive forms of mental inability, the Restatement (Second) of Contracts adopts an additional *volitional* test: whether a mental disorder or defect results in an inability to act in a reasonable manner in relation to the transaction.[55] The modern Restatements on property and trusts do not support the volitional test.[56] In the last twenty years, the majority rule among American courts supports application of the volitional test (in addition to the cognitive test) to contracts, gifts of property,

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[54] RESTATEMENT (SECOND) OF CONTRACTS § 15(1)(a), cmt. a (AM. LAW INST. 1981); RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1(c), cmt. d, reporter's note 4 (AM. LAW INST. 1999). *See, e.g.*, Shoals Ford, Inc. v. Clardy, 588 So.2d 879 (Ala. 1991); Pappert v. Sargent, 847 P.2d 66 (Alaska 1993); Board of Regents v. Davis, 74 Cal.App.3d 862 (Cal. Ct. App. 1977); Davis v. Colorado Kenworth Corp., 396 P.2d 958 (Colo. 1964); Humble Oil & Refining Co. v. DeLoache, 297 F.Supp. 647 (D.S.C. 1969); McPheters v. Hapke, 497 P.2d 1045 (Idaho 1972); Gallagher v. Central Indiana Bank, N.A., 448 N.E.2d 304 (Ind. Ct. App. 1983); Costello v. Costello, 186 N.W.2d 651 (Iowa 1971); DeBauge Bros., Inc. v. Whitsitt, 512 P.2d 487 (Kansas 1973); Ridings v. Ridings, 286 S.E.2d 614 (N.C. Ct. App. 1982); Matthews v. Acacia Mut. Life Ins. Co., 392 P.2d 369 (Okla. 1964); *In re* Marriage of Davis, 193 89 P.3d 1206 (Or. Ct. App. 2004); Estate of McGovern v. Com. State Employees' Retirement Board, 517 A.2d 523 (Pa. 1986); Brown v. Resort Developments, 385 S.E.2d 575 (Ba. 1989); Harris v. Rivard, 390 P.2d 1004 (Wash. 1964); Hauer v. Union State Bank of Wautoma, 532 N.W.2d 456 (Wis. Ct. App. 1995).

[55] RESTATEMENT (SECOND) OF CONTRACTS § 15(1)(b) (AM. LAW INST. 1981). Intoxication amounts to incapacity if it satisfies the cognitive or volitional test. *Id.* § 16.

[56] *See* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1(c), reporter's note 3 (AM. LAW INST. 1999) (on mental capacity to make irrevocable gifts); RESTATEMENT (THIRD) OF TRUSTS § 11(3) (AM. LAW INST. 2003) (on mental capacity to make irrevocable lifetime trusts).

and many other forms of lifetime transactions.[57] Another form of mental incapacity arises from the need to engage a guardian to manage one's personal or financial affairs.[58]

A finding of mental incapacity gives rise to a prima facie power to avoid the impugned transaction, and only the incapable transacting party or her representative may exercise that power.[59] However, the power of avoidance is subject to equitable qualifications. The second step in applying the mental capacity doctrine requires the court to consider any imbalance in the

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[57] *See, e.g.*, Sparrow v. Demonico, 960 N.E.2d 296 (Mass. 2012); Biggs v. Eaglewood Mortg., LLC, 582 F.Supp.2d 707 (D. Md. 2008); Hernandez v. Banks, 65 A.3d 59 (D.C. Ct. App. 2013); *In re* Estate of Marquis, 822 A.2d 1153 (Me. 2003); LaBarbera v. Wynn Las Vegas, LLC, 422 P.3d 138 (Nev. 2018); Rawlings v. John Hancock Mut. Life Ins. Co., 78 S.W.3d 291 (Tenn. 2001); Edward D. Jones & Co. v. Fletcher, 975 S.W.2d 539 (Tex. 1998). *See also* Gore v. Gadd, 522 P.2d 212 (Or. 1974). *Contra*. Dillin v. Alexander Dillin v. Alexander, 576 P.2d 1248 (Or. 1978); *In re* Marriage of Davis, 193 89 P.3d 1206, 1207 (Or. Ct. App. 2004) ("[I]n some cases, Oregon courts may have applied certain aspects of the [volitional] test in determining competency. Nevertheless, the cognitive test appears to be the law of this state[.]").

[58] RESTATEMENT (SECOND) OF CONTRACTS § 13 cmt. a (AM. LAW INST. 1981) (explaining that the public is deemed to have constructive notice of the guardianship proceedings, and that the guardian's control of the incapable person's property and the court's supervisory role should not be impaired or avoided); RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1 cmt. h (AM. LAW INST. 1999) (Appointment of a guardian raises a rebuttable presumption of incapacity to make an irrevocable gift.).

A *guardian* is a person who is officially appointed to make decisions on behalf of another person. An alternative name for guardian is conservator. *See, e.g.*, UNIF. PROBATE CODE § 5-401 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 401 (Unif. Law Comm'n 2017). *See also* APPELBAUM & GUTHEIL, *supra* note 30, at 181–82 (discussing clinical evaluation of disorders giving rise to guardianship); Ralph C. Brashier, *Conservatorships, Capacity, and Crystal Balls*, 87 TEMP. L. REV. 1, 14–15 (2014) ("A conservatorship order that limits the decedent's ability to contract is very common[.]").

[59] RESTATEMENT (SECOND) OF CONTRACTS §§ 7 cmt. b, 12 cmt. a (AM. LAW INST. 1981).

substance of the transaction and in the conduct of the parties. The court may limit or deny the power of avoidance if the capable transacting party did not know the incapacity, had acted in good faith, and could not be restored to the status quo ante.[60] In some jurisdictions, a lack of knowledge of the incapacity would qualify the power of avoidance arising from a volitional basis of incapacity, but not from a cognitive basis.[61] An unreasonable delay in attempting to avoid the transaction also may prevent its avoidance or limit the resulting remedy.[62] Moreover, courts tend to limit or deny avoidance of contracts for necessities of life, such as food, clothing and housing.[63]

Farnum v. Silvano can illustrate how the mental capacity doctrine operates in practice.[64] In that case, Viola—a ninety-year-old woman who suffered from dementia and seizure disorder—sold her house for about half of its fair market value to Joseph—a twenty-four-year-old friend who mowed

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[60] *Id.* § 15 cmt. f; RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 cmts. e, g, reporter's note e (AM. LAW INST. 2011)

[61] These are the jurisdictions that follow RESTATEMENT (SECOND) OF CONTRACTS § 15(1)(b) (AM. LAW INST. 1981). *See supra* note 57 and accompanying text. Even in cases concerning cognitive incapacity, courts may still frame the remedy to account for a lack of knowledge of the incapacity. *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 cmt. e, reporter's note e (AM. LAW INST. 2011).

[62] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 cmt. e, reporter's note e (AM. LAW INST. 2011).

[63] *Id.* § 16 cmt. a; RESTATEMENT (SECOND) OF CONTRACTS § 15 cmt. e (AM. LAW INST. 1981).

[64] 540 N.E.2d 202 (Mass. Ct. App. 1989).

her lawn. Viola "trusted and had confidence in [Joseph]",[65] even though he "was not a member of her family or someone who had cared for her for long duration."[66] Viola was hospitalized several times around the time of the sale. Joseph selected and paid for Viola's lawyer in connection to the sale. Viola's nephew, who was also her guardian, challenged the sale on grounds of mental incapacity, fraud, undue influence and constructive trust.[67] The Massachusetts court ruled against Joseph on the mental incapacity ground without resolving the other grounds. The court found that Viola lacked mental capacity according to the cognitive test, and considered Joseph's knowledge of her incapacity a "decisive factor".[68]

B. Similarities with the Doctrine of Undue Influence

Claimants who seek to avoid transactions for want of mental capacity usually also rely on the doctrine of undue influence.[69] In most jurisdictions, a presumption of undue influence arises if the following two questions are answered in the affirmative:[70]

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[65] *Id.* at 203.

[66] *Id.* at 205.

[67] *Id.* at 203–05.

[68] *Id.* at 205.

[69] *See infra* notes 149–50 (discussing the author's survey of modern transactional capacity cases).

[70] RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.3, cmt. f,

(1) Whether there were suspicious circumstances in the formation of the transaction, for example, a transacting party had a "mental weakness";[71]

(2) Whether the transaction took place in a relationship of domination or confidence, for example, a relationship "between a hired caregiver and an ill or feeble donor or between an adult child and an ill or feeble parent."[72]

If arisen, then the presumption of undue influence would render the transaction voidable, and place the burden on the stronger transacting party to prove her good faith and the weaker party's free will and voluntariness.[73]

When applied to in cases alleging elder financial abuse, the undue influence doctrine is functionally-indistinguishable from the mental capacity doctrine.[74] In theory, mental capacity is a concept of mental ability to incur

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reporter's note f (AM. LAW INST. 1999) (citations omitted); ROBERT H. SITKOFF & JESSE DUKEMINIER, WILLS, TRUSTS, AND ESTATES 289–90 (10th ed., 2017).

[71] RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.3, cmt. e (AM. LAW INST. 1999). *See, e.g.*, Starr v. Starr, 116 Cal.Rptr.3d 813 (Ca. Ct. App. 2010) ("[Undue influence's] hallmark is high pressure that works on mental, moral, or emotional weakness[.]").

[72] RESTATEMENT (SECOND) OF CONTRACTS § 177 cmt. a (AM. LAW INST. 1981); RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.3 cmt. g (AM. LAW INST. 1999).

[73] RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.3 cmt. f (AM. LAW INST. 1999).

[74] *See, e.g.*, Noland v. Noland, 956 S.W.2d 173, 179 (Ark. 1997).

The undue influence doctrine also covers transactions not involving a "mentally weak" party. *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 177 (AM. LAW INST. 1981); RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.3 (AM. LAW INST. 1999).

legal responsibility, while undue influence a concept of unfair conduct. In practice, these two doctrines raise essentially the same issues: whether the elderly transacting party lacked sufficient mental ability, and whether equitable considerations justify avoidance. Moreover, both doctrines employ vague standards of mental inability and inequitable conduct.

Hence how the mental capacity doctrine operates in practice is a good proxy for how the undue influence doctrine is applied to "mentally weak" seniors. In this light, this Chapter will make arguments regarding the mental capacity doctrine, noting that the same arguments also apply to the undue influence doctrine in elder-financial-abuse cases.[75]

C. Gradual Expansion of Scope and Judicial Discretion

Section II.B above shows that the mental capacity doctrine is formulated in terms of vague standards rather than sharp rules. As a result, courts have a substantial discretion to determine whether the relevant transacting party lacked mental capacity, and whether to avoid the impugned transaction. Moreover, upon successful avoidance, the parties become liable to return to each other any benefits that they have already received pursuant to the

[75] The mental capacity doctrine also informs the development of several other private-law concepts, such as consent, *see, e.g.*, Jennifer A. Drobac & Oliver R. Goodenough, *Medical Myths: Exploring Effectiveness, Misinformation and Scientific Rigor*, 12 IND. HEALTH L. REV. 471, 473 (2015), and unconscionability, *see, e.g.*, Eisenberg, *supra* note 26, at 799–800; Richard A. Epstein, *Unconscionability: a Critical Reappraisal*, 18 J. L. & ECON. 293, 294–95, 300–01, 303 (1975).

avoided transaction.[76] Vague equitable standards continue to guide judicial formulation of the exact remedies.[77] In sum, the mental capacity doctrine employs vague standards to resolve three issues:

(1) whether a transacting party lacked mental capacity;

(2) whether to limit or deny the power to avoid the impugned transaction; and

(3) the remedial consequences of successful avoidance.

This Chapter will not object to the existing tests of mental capacity, which tests apply to resolve the first issue. The vagueness of these tests reflects the reality that promulgating rules ex ante would have been too complex and too costly.[78] First, the social and medical conceptions of mental disorders have evolved significantly in the last two centuries.[79] It would have been too complex and too costly to promulgate rule-like legal tests to determine which

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[76] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 15(2), 16(1), 33(1) (AM. LAW INST. 2011).

[77] *Id*. *See also id.* §§ 49(3), 50, 52 (different measures of restitutionary liability depending on whether the recipient is "innocent" or a "conscious wrongdoer").

[78] *See generally* Louis Kaplow, *Rules Versus Standards: an Economic Analysis*, 42 DUKE L.J. 557 (1992). *See also* Alan Schwartz & Robert E. Scott, *The Common Law of Contract and the Default Rule Project*, 102 VA. L. REV. 1523 (2016) (arguing against efforts to create substantive default rules that are transcontextual).

[79] *See generally* CAROL S. NORTH & SEAN H. YUTZY, GOODWIN AND GUZE'S PSYCHIATRIC DIAGNOSIS 1-8 (6th ed., 2010) (discussing the history of psychiatric diagnosis); BLUMENTHAL, *supra* note 26, ch. 2; Christian Perring, *Mental Illness*, THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Feb. 22, 2010), https://plato.stanford.edu/entries/mental-illness/.

subset of the large, diverse and growing set of mental disorders should lead to avoidance of transaction.[80] Second, in the modern economy, the stereotype that seniors are "frail, out of touch, burdensome or dependent" is inaccurate and outdated.[81] Seniors approaching traditional retirement age often do not want to retire notwithstanding any physical or mental decline. Many start their own businesses or work part-time. Advances in transportation and communication technologies also have eased the physical obstacles to utilizing knowledge, skills and financial flexibility.[82] Hence there is no obvious age cutoff that can objectively determine a senior's mental capacity to transact.

However, a finding of mental incapacity does not necessarily justify avoidance of the impugned transaction. This Chapter will challenge the prevailing doctrinal theories that govern the second and third issues identified above: the limitations on the power of avoidance and the remedial consequences of successful avoidance. The rest of this Part will show that over the centuries, the mental capacity doctrine has steadily expanded in

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[80] *See* AM. PSYCHIATRIC ASS'N, *supra* note 2, at xiii–xl (a standard list of mental disorders). Equating mental capacity in the legal sense with mental disorder in the psychiatric sense may offend international human rights law. *See generally* Eliza Varney, *Redefining Contractual Capacity? The UN Convention on the Rights of Persons with Disabilities and the Incapacity Defence in English Contract Law*, 2017 LEGAL STUDIES 1.

[81] WORLD HEALTH ORG., WORLD REPORT ON AGEING AND HEALTH 10 (2015), http://apps.who.int/iris/bitstream/10665/186463/1/9789240694811_eng.pdf.

[82] *Id.* at 12.

scope and become less determinate in application. As a result, there is a substantial judicial discretion to decide transactional capacity disputes, and the theoretical underpinnings of the doctrine are meant to guide the exercise of that discretion. Part III will challenge these theoretical underpinnings.

1. Historical Origins

Compared with its modern form, the mental capacity doctrine was significantly narrower in medieval English law.[83] Early common law denied transactional capacity to individuals who were *non compotes mentis*—a term of art meaning "unsound mind". Writing in the first half of the seventeenth century, Sir Edward Coke divided individuals with an unsound mind into four categories: idiots; lunatics who lost their memory and understanding by accidents such as sickness or grief; lunatics with lucid intervals; and drunkards.[84] Idiots were born with an inability to read, count, tell her age, or name her parents, while lunatics had had understanding.[85] The process of establishing idiocy or lunacy commenced with a petition for the appointment

[83] Mental incapacity appears in one of the oldest treatises on English common law. *See* 2 BRACTON ON THE LAWS AND CUSTOMS OF ENGLAND vol. 2 at 134–35, vol. 3 at 28, vol. 4 at 308 (Samuel E. Thorne trans., Belknap Press 1968), http://bracton.law.harvard.edu/Unframed/English/.

[84] 2 EDWARD COKE, A COMMENTARY UPON LITTLETON § 246.a. (Robert H. Small ed., 1853); 1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE, AS ADMINISTERED IN ENGLAND AND AMERICA § 230 (5th ed. 1849).

[85] LEONARD SHELFORD, A PRACTICAL TREATISE ON THE LAW CONCERNING LUNATICS, IDIOTS AND PERSONS OF UNSOUND MIND 2–4 (1833) (citations omitted).

of a commission to engage in a fact-finding mission.[86] A finding that the individual was an idiot or a lunatic at the time of making the impugned transaction provided a basis to avoid it.[87] The formal rationale for avoidance was a lack of rational and deliberate consent.[88]

In medieval common law, the mental capacity doctrine aimed not to further the interests of the incapable individual but the interests of his expectant heir and family. First, a finding of idiocy or lunacy could result in the appointment of a guardian to take control of the individual and his property; the guardian was typically a relative.[89] Second, there was a fundamental maxim that a person could *not* plead his own unsoundness of mind. The original rationale for that "absurd and mischievous" maxim was the person could not remember what he did when he was mentally unsound.[90] Instead, it was up to his guardian, expectant heir, executor or administrator of his estate to plead his unsoundness of mind.[91]

Dissatisfied with the narrow definitions of idiocy and lunacy and with the

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[86] *Id.* at 82–83 (citations omitted).

[87] SHELFORD, *supra* note 85, at 266; 1 STORY, *supra* note 84, §§ 223–24.

[88] 1 STORY, *supra* note 84, § 223.

[89] SHELFORD, *supra* note 85, at 130–33.

[90] 1 STORY, *supra* note 84, § 225.

[91] SHELFORD, *supra* note 85, 409–11; 1 STORY, *supra* note 84, § 225.

slow and costly fact-finding commission, common law courts in the long eighteenth century began to avoid transactions upon a jury's finding of cognitive deficiency. *Ball v. Mannin* was a leading case.[92] That case concerned a John Shinton Ball—an heir of land who was of "weak capacity" from minority but had not been found an idiot or a lunatic.[93] As soon as he reached majority, John executed a deed to create a family trust with his inheritance. The trust conferred substantial benefits on his mother and father-in-law at the expense of his brothers from his mother's previous marriage with his deceased father.[94] After John passed away and a failed attempt to set aside the trust deed for fraud, his nephew sought avoidance on the basis of incapacity.[95] Rather than applied the narrow definition of idiocy, the trial judge instructed the jury to decide "whether [John] was capable of understanding what he did by executing the deed in question, when its general purport was fully explained to him."[96] The final appellate court upheld this jury instruction.[97]

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[92] (1829) 4 Eng. Rep. 1241; 3 Bligh N.S. 1 (H.L.) (appeal taken from Ir.).

[93] *Id.* Eng. Rep. at 1248; Bligh N.S. at 19.

[94] *Id.* Eng. Rep. at 1241; Bligh N.S. at 1.

[95] *Id.* Eng. Rep. at 1242; Bligh N.S. at 2–3.

[96] *Id.* Eng. Rep. at 1241, 1248; Bligh N.S. at 1, 3, 21.

[97] *Id.* Eng. Rep. at 1242, 1248–49; Bligh N.S. at 3, 21–23.

While courts of common law saw mental capacity as a threshold concept of mental ability, courts of equity were more concerned with the fairness of the impugned transaction.[98] In addition to idiocy, lunacy and cognitive deficiency, equity courts avoided transactions on the basis of a "weakness of mind"—a vague standard covering "temporary illness, general mental imbecility, the natural incapacity of early infancy, the infirmity of extreme old age, or those accidental depressions, which result from sudden fear, or constitutional despondency, or overwhelming calamities."[99] Moreover, equity courts avoided the transactions of individuals experiencing "excess drunkenness".[100] However, that a transacting party was mentally weak (or excessively drunk) only gave rise to an inference of fraud, imposition or undue influence; the other party could rebut that inference.[101] These equity cases would gradually develop into the "mental weakness" strand of the modern doctrine of undue influence.[102]

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[98] In this Part, "common law courts" refer to the Court of Queen's Bench or King's Bench, the Court of Common Pleas and the common law side of the Exchequer; and "equity courts" refer to the Court of Chancery and the equity side of the Exchequer.

[99] 1 STORY, *supra* note 84, § 234.

[100] *Id.* § 253.

[101] *Id.* § 235. Even when idiocy or lunacy was found, courts of equity took into account whether the transaction was made in good faith, whether the capable transacting party had knowledge of the incapacity, whether she had overreached, and whether she could be restored to the status quo ante. *See* 1 STORY, *supra* note 84, § 231.

[102] *See generally supra* Section II.B; BLUMENTHAL, *supra* note 26, at 180–81.

In the nineteenth century, Anglo-American courts clearly felt the impact of new developments in psychiatry and medical jurisprudence.[103] As Professor Susanna Blumenthal wrote, judges were "generally receptive to the teachings of the new medical psychology but found it difficult to apply them in the courtroom."[104] Judges also often found it desirable to protect the interests of the *capable* transacting party and the security of transactions.[105] As a result, judges began to apply equitable principles to uphold transactions that were considered fair, even if a transacting party was mentally-incapable.[106] Diminishing the role of medical evidence, this "pragmatic" approach rendered "disparities in mental ability . . . less salient as a matter of law."[107]

The "pragmatic" approach taken by nineteenth-century courts produced a majority rule that heavily relied on equitable considerations to limit or deny the power to avoid transactions on the basis of mental incapacity.[108] Under

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[103] *See generally* BLUMENTHAL, *supra* note 26, at 78–79.

[104] *Id.* at 178.

[105] *Id.* at 183–84, 193–95.

[106] *Id.* at 178–79, 184. *See also* 2 JOHN NORTON POMEROY, POMEROY'S EQUITY JURISPRUDENCE §§ 928, 948 (3d ed. 1905).

[107] BLUMENTHAL, *supra* note 26, at 17.

[108] *Id.* at 184. The minority rule at the time held that mental incapacity rendered the transaction void, rather than merely voidable at the option of the incapable individual (or her representative). *Id.* at 184.

the majority rule, a finding that a transacting party lacked mental capacity would only ground a qualified power to avoid the transaction. This power would generally be lost if the capable transacting party "proceeded in good faith and in nonnegligent ignorance of the incapacity, unless the parties could be placed in *status quo*."[109] These restrictions on the power of avoidance were primarily concerned with the conduct giving rise to the transaction and the remedial consequences of avoidance. The initial finding of mental incapacity was merely a pretext for a judicial inquiry into the equities of the transaction.

In exercising their substantial discretion to resolve transactional capacity disputes, nineteenth-century judges were generally more willing to uphold transactions in the business sphere than in the family sphere. As Professor Blumenthal observed, while judicial opinions on mental capacity and neighboring principles were not uniform,[110] judges tended to protect strangers who had no reason to suspect incapacity.[111] At the same time, judges were generally reluctant to uphold contracts and lifetime transfers of property in a broad range of family relationships that were considered confidential or fiduciary in nature.[112] Business and family were "separate doctrinal realms

[109] *Id.* at 184. *See also*1 STORY, *supra* note 84, § 231.

[110] BLUMENTHAL, *supra* note 26, at 184, 181, 230.

[111] *Id.* at 181, 184.

[112] *Id.* at 179–80,199–200.

that many nineteenth-century judges envisioned and tried to maintained, concerned as they were with insulating intimate relations from those of the market."[113] In particular, judges were strongly suspicious of formal caregiving agreements in families, in which "services and support were supposed to be offered freely, without expectation of return."[114]

2. The Realist Revolution

In the light of the judicial tendency to search for inequitable conduct, Realist legal scholars in the early twentieth century reformulated the mental capacity doctrine. Most influential was Professor Milton Green's critique in the 1940s. The formalists at the time offered a lack of subjective "meeting of the minds" to justify avoidance of a transaction for want of mental capacity.[115] Professor Green disagreed, arguing that it is impossible to ascertain a person's subjective state of mind.[116] In reality, courts examined the behaviors of the person, and only paid lip service to the cognitive test of incapacity.[117] Also common was equally-qualified psychiatrists reaching

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[113] *Id.* at 199.

[114] *Id.* at 221 (citation omitted).

[115] *See, e.g.*, Dexter v. Hall, 82 U.S. 9, 20 (1872) (discussed in Green, *Operative Effect*, *supra* note 9, at 558).

[116] Green, *Judicial Tests*, *supra* note 12, at 160–161.

[117] *Id.* at 161, 163; Green, *Major Premise*, *supra* note 12, at 306. Searching for a subjective "meeting of the minds" was also inconsistent with the then-emerging, objective theory of contract law that "scrutiniz[es] the conduct of the promisor from an objective

opposite conclusions regarding mental ability, leading courts to disregard expert opinions all together.[118]

Professor Green offered two alternative theories. First, his *conflicting-policies theory* articulated the public policies at stake: protecting the mentally-incapable individual and her family, and protecting the security of transactions.[119] To Green, these policies were necessarily in conflict because the incapable individual's (or her representative's) choice of challenging the transaction indicated that it was disadvantageous to her.[120] Moreover, Green offered the *abnormality theory*: judicial decisions depended on an implicit but dominant consideration pertaining to the objective abnormality of the impugned transaction. Abnormality manifested "in a transaction which is obviously out of line with the institutional pattern of similar transactions" in the light of "all of the circumstances" and "what a reasonably competent [person] might have made."[121] Fraud or gross inadequacy of consideration

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viewpoint to see if it was of such a character as to arouse reasonable expectations." Green, *Judicial Tests*, *supra* note 12, at 162. *See also* Green, *Operative Effect*, *supra* note 12, at 4.

[118] Green, *Major Premise*, *supra* note 12, 285–86; Faber v. Sweet Style Mfg. Corp., 242 N.Y.S.2d 763, 768 (N.Y. Sup. Ct. 1963).

[119] Green, *Public Policies*, *supra* note 12, at 1214.

[120] *Id.* at 1214. *Contra. infra* Section III.A.1 (arguing that this is the critical flaw of Green's theories).

[121] Green, *Major Premise*, *supra* note 12, at 309.

were factors showing abnormality.[122] Courts were more likely to avoid a transaction if some abnormal factor was present.[123] To Green, abnormality was both "evidence of a disordered mind" and of potential overreach.[124] To promote a scientific study of the law and greater predictability in future cases, he advocated for explicit consideration of abnormality.[125]

In addition to adopting Green's theories, the Restatement (Second) of Contracts responded to new developments in psychiatry.[126] To supplement the cognitive test of incapacity,[127] this Restatement introduced a *qualified* volitional test; this new test denies contractual capacity if due to a mental disorder or defect, the relevant transacting party is unable to act in a reasonable manner in relation to the transaction, *and* the other party has "reason to know".[128] In a treatise, the reporter explained that imposing a

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[122] *Id.* at 304–05, 307.

[123] *Id.* at 305–06.

[124] *Id.* at 305. *Contra.* Alexander & Szasz, *supra* note 29, at 541 (arguing that judicial consideration of abnormality deprives the incapable individual of the right to make eccentric transactions, the practical result of which is "punishment for deviancy, not protection against helplessness[]").

[125] Green, *Major Premise*, at 309–11.

[126] RESTATEMENT (SECOND) OF CONTRACTS § 15 cmts. a, b (AM. LAW INST. 1981).

[127] *Id.* § 15(1)(a).

[128] *Id.* § 15(1)(b), reporter's note (citing, inter alia, Note, *Mental Illness and the Law of Contracts*, 57 MICH. L. REV. 1020, 1033–36 (1959) (arguing in favor of expanding the mental capacity doctrine to cover non-cognitive mental disorders); Note, *Contracts-Competency to Contract of Mentally Ill Person Who Fully Understands Transaction But Is Unable to Control Conduct*, 16 WAYNE L. REV. 1188, 1195 (1970) (arguing psychiatric

knowledge qualifier on the volitional test, but *not* on the traditional cognitive test, was a compromised position between not adding a volitional test at all and adding it without qualification.[129] However, the modern Restatements on property and trusts were unwillingness to adopt the volitional test.[130]

Ortelere v. Teachers' Retirement Board of New York was one of the very first cases to adopt Green's theories.[131] In that case, the widower of a retired school teacher sought to avoid an irrevocable election of retirement benefits that the school teacher made while she was under treatment for "involuntary melancholiac in depression" (a form of clinical depression).[132] The election increased her allowance during her lifetime but upon her death, nothing would be payable to her designated beneficiary—her widower. She died shortly after making the election, so in hindsight, it turned out to be a poor financial choice for her family.[133] The evidence revealed that she had "complete cognitive judgment and awareness" at the time of making the

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experts should be allowed to opine on incapacity without regard to legal categories)). *Contra*. Alexander & Szasz, *supra* note 29, at 542–55 (opposing the adoption of the volitional test).

[129] E. ALLAN FARNSWORTH, CONTRACTS § 4.6 at 229–30 (4th ed. 2004).

[130] RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1(c), reporter's note 3 (AM. LAW INST. 1999); RESTATEMENT (THIRD) OF TRUSTS § 11(3) (AM. LAW INST. 2003).

[131] 250 N.E.2d 460 (N.Y. 1969).

[132] *Id.* at 462.

[133] *Id.* at 462–63.

election,[134] and the administrators of the retirement system were aware that she was seeing a psychiatrist.[135] The New York Court of Appeals reversed the lower court's dismissal of her widower's claim for avoidance. The Court found the cognitive test out-of-step with psychiatric learning; it failed to account for people who could not control their conduct due to a mental disorder even though there was no impairment of their cognitive ability. The Court went on to adopt the qualified volitional test and Green's theories.[136]

Recent developments continue the steady march to make the mental capacity doctrine broad and indeterminate. Further rendering "disparities in mental ability . . . less salient as a matter of law[,]"[137] the practical differences between the cognitive and volitional tests of incapacity are gradually disappearing. The recently-published Restatement (Third) of Restitution and Unjust Enrichment applies the same equitable considerations—including any knowledge of the incapacity—to qualify the power of avoidance arising from

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[134] *Id.* at 462.

[135] *Id.* at 465–66.

[136] *Id.* at 464–65. An earlier New York case adopted the volitional test without the knowledge qualifier. *See* Faber v. Sweet Style Mfg. Corp., 242 N.Y.S.2d 763, 765, 768–69 (N.Y. Sup. Ct. 1963).

[137] BLUMENTHAL, *supra* note 26, at 17. *See generally* Meiklejohn, *supra* note 26, at 342, 387 (analysis of transactional capacity cases from the 1960s to the 1980s showing that courts tend to give more weight to lay testimony than to expert testimony, which tendency indicates courts' reluctance to unduly defer to psychiatry).

any form of incapacity.[138] This departs from the earlier view that insofar as contracts are concerned, the knowledge qualifier should only apply to the volitional test of incapacity, but not to the cognitive test.[139] Moreover, the new Restatement takes the view that "the contours of legal responsibility [in transactional capacity cases] are determined, not by measuring 'capacity to contract' against some *a priori* standard, but by weighing at each point the value of the protection secured against the cost of securing it."[140] This view not only reaffirms Green's theories, it also eschews general and predictable rules in favor of granting a substantial judicial discretion to conduct a cost-benefit analysis on a case-by-case basis.

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Centuries of gradual expansion has made the mental capacity doctrine in prevailing American law broad in scope and indeterminate in application.

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[138] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 cmt. e, cmt. g, reporter's note e (AM. LAW INST. 2011). A jurisdiction's failure to adopt the volitional test also does not prevent volitional mental disorders from satisfying the cognitive test of incapacity. For example, manic depressive disorder—the mental disorder that led to New York's early adoption of a version of the volitional test in Faber v. Sweet Style Mfg. Corp., 242 N.Y.S.2d 763, 766 (N.Y. Sup. Ct. 1963)—has successfully satisfied the cognitive test in other jurisdictions. *See, e.g.*, Shoals Ford, Inc. v. Clardy, 588 So.2d 879, 882-83 (Ala. 1991). The modern name for manic depressive disorder is bipolar disorder. NORTH & YUTZY, *supra* note 79, at 12.

[139] *See* RESTATEMENT (SECOND) OF CONTRACTS § 15(1)(b) (AM. LAW INST. 1981).

[140] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 33 cmt. c (AM. LAW INST. 2011). *See also* Meiklejohn, *supra* note 26, at 352–53, 355 (analysis of transactional capacity cases from the 1960s to the 1980s showing that substantive imbalance as an abnormality factor is relevant to, but not determinative of, the issue of capacity).

Perhaps for this reason, the doctrine is considered "one of the great controversies in American legal history[,]"[141] and "more tenuous or spectral" than other branches of jurisprudence.[142] The doctrine now grants a substantial judicial discretion to balance the conflicting policies of protecting incapable individuals and protecting the security of transactions. A finding of mental incapacity is merely a pretext for a case-by-case assessment of the costs and benefits of protection. Theoretical and normative considerations now guide the exercise of judicial discretion to avoid transactions and to determine the remedial consequences of successful avoidance.[143]

III. VARIETIES OF TRANSACTIONS IN THE ERA OF AGING POPULATION

While nineteenth-century courts tended to treat business and family as separate doctrinal spheres,[144] both the Restatement (Second) of Contracts and the Restatement (Third) of Restitution and Unjust Enrichment direct modern courts to apply the same, *transcontextual* standards to govern transactions with businesses and transactions involving relatives and friends.[145] Such

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[141] Hirsch, *supra* note 27, at 264.

[142] Waggoner v. Atkins, 162 S.W.2d 55, 58 (Ark. 1942) (dismissing an incapacity challenge to a sale of interest in land by a seller who drank excessively, used narcotics, and brought the challenge three years after restoration of his mental faculties).

[143] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 33(3) (AM. LAW INST. 2011).

[144] *See supra* notes 110–14 and accompanying text.

[145] *See especially* RESTATEMENT (SECOND) OF CONTRACTS § 15 illus. 2–7 (AM. LAW

transcontextual standards leave courts to determine the exact legal criteria to be applied in particular cases, with the benefit of hindsight.[146] Hence, in modern times, whether business transactions and family-and-friend transactions should be treated differently is a matter of judicial discretion.

In this light, the author will argue that courts should loosen regulation of transactions involving close relatives and friends, but rigorously protect potentially incapable individuals from exploitative business practices. In modern times, most transactions covered by the mental capacity doctrine involve relatives and friends;[147] Section III.A below will examine these transactions. Section III.B will consider transactions between potentially incapable individuals and businesses. The overarching claim to be advanced is that the prevailing doctrinal theories are unduly suspicious of transactions that take place in close families and personal relationships.[148] However, these

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INST. 1981); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 illus. 2, 4, 7–8 (AM. LAW INST. 2011). *See also* Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PENN. L. REV. 595, 597–98 (1995) (explaining private legislatures' incentives to produce standards that delegate substantive discretion to courts); Schwartz & Scott, *supra* note 78 (criticizing efforts to create transcontextual default standards).

[146] *See, e.g.*, Kaplow, *supra* note 78.

[147] *See infra* notes 149–50 and accompanying text.

[148] This Chapter uses "close family" as a shorthand for a familial relationship that satisfies the "core qualities [of] a demonstrated, long-term commitment and the assumption of mutual care and financial responsibility[.]" Elizabeth S. Scott & Robert E. Scott, *From Contract to Status: Collaboration and the Evolution of Novel Family Relationships*, 115 COLUM. L. REV. 293, 306 (2016) (footnote omitted) [hereinafter, Scott & Scott, *From Contract to Status*]. *See generally id.* at 305 (explaining the key attributes of a contemporary family that is based on adult relationships). Rather than based on formal marriage or

doctrinal theories remain suitable for regulating transactions with businesses.

A. Transactions involving Relatives and Friends

The author's survey of modern transactional capacity cases shows the prevalence of claims by relatives who expect to inherit from the potentially incapable individual.[149] As Figure 2 shows, in more than half of the cases surveyed, the person who sought avoidance was a relative of the potentially incapable individual's.[150] Figure 3 further shows that about half of the cases surveyed concerned a transaction between the potentially incapable individual and a relative or friend. Moreover, Figure 4 shows that the impugned transaction was frequently made in the potentially incapable individual's final years of life. These observations suggest that avoidance claims were usually sought by a relative to pursue a personal benefit: to

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biological relationship, *id.* at 305, a close family is a family of "affection and dependence". LAWRENCE M. FRIEDMAN, DEAD HANDS: A SOCIAL HISTORY OF WILLS, TRUSTS, AND INHERITANCE LAW 11 (2009).

[149] This survey covers cases decided in 2013-18 that are listed under Westlaw's West Key Number System, k-92. *See infra* this Dissertation, Appendix A. The survey excludes cases that did not reach issues regarding mental capacity; and cases concerning a breach of fiduciary duty. Fiduciary cases raise different issues. *See generally* this Dissertation, chs. 2, 3. There are thirty cases in the survey if arbitration agreements are included, and twenty-two if arbitration agreements are included. Arbitration agreements raise federal-law issues. *See infra* notes 220–26 and accompanying text.

[150] The sample size of the Westlaw survey is small (thirty). *See id*. As a robustness check, Diagram 1 also compares the results of the Westlaw survey with the results of a sample of fifty-five cases decided after 1963 that appear in the case citations supplement to RESTATEMENT (SECOND) OF CONTRACTS § 15 (AM. LAW INST. 1981) and in the footnotes of 5 WILLISTON & LORD, *supra* note 22, § 10:8. 1963 was the year in which the New York judiciary first adopted a volitional test of mental capacity. *See* Faber v. Sweet Style Mfg. Corp., 242 N.Y.S.2d 763, 768 (N.Y. Sup. Ct. 1963).

increase her expected inheritance from the potentially incapable individual.

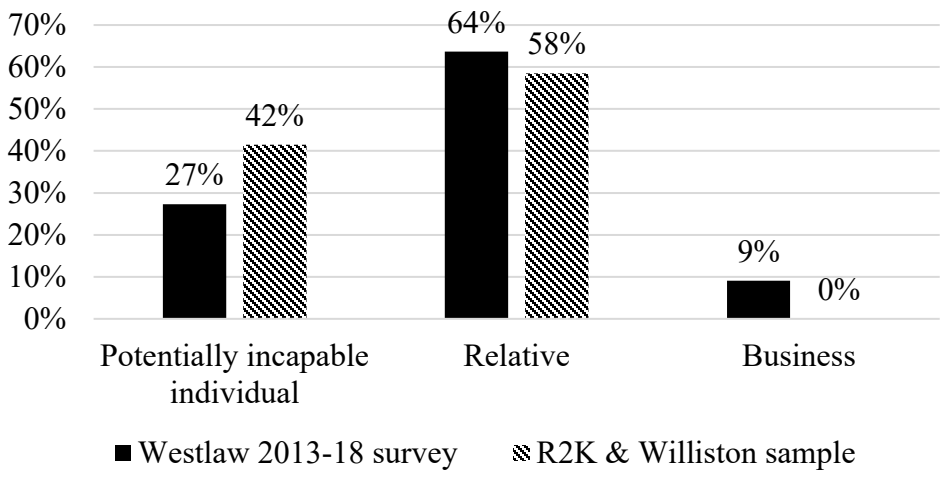

Figure 2: Identity of the Claimant (Excl. Arbitration Agreements)

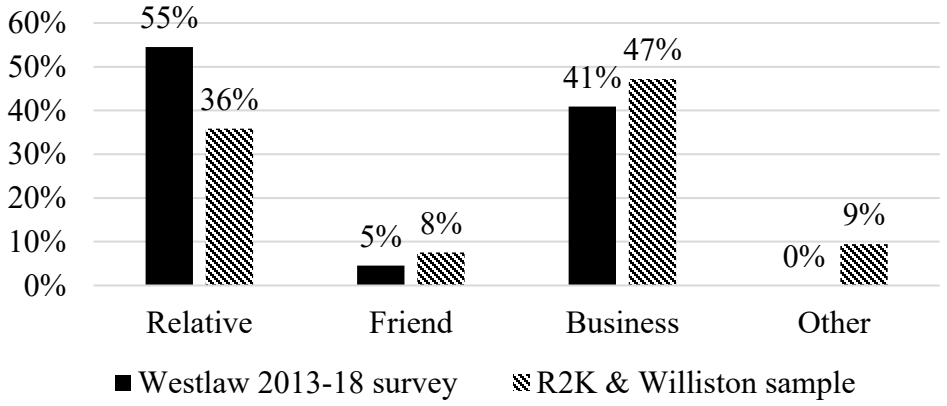

Figure 3: Identity of the Capable Transacting Party (Excl. Arbitration Agreements)

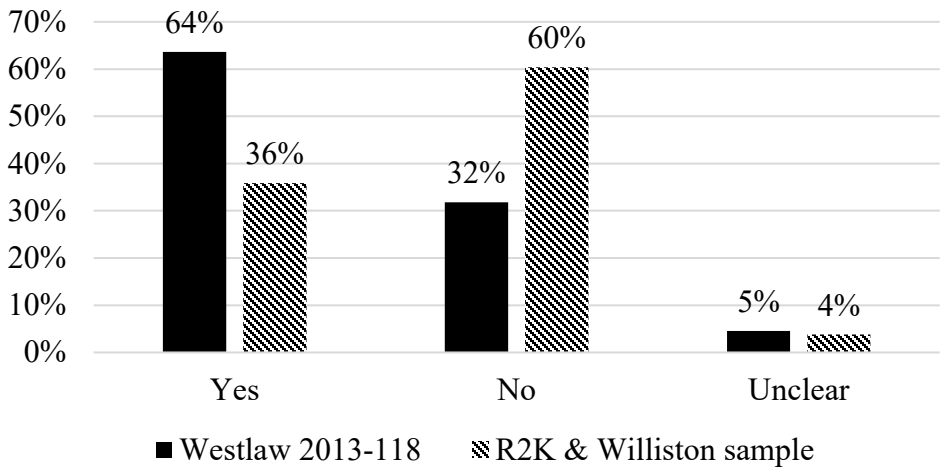

Figure 4: Impugned Transaction Made in Old Age (Excl. Arbitration Agreements)

1. Claims Driven by Inheritance Expectations

The survey of modern cases reveals the hidden role of inheritance expectations in transactional capacity disputes. Figure 5 below depicts the typical procedural posture. The potentially incapable individual is typically inactive due to incapacity or death. The size and composition of her estate at death depend on the outcome of the avoidance claim against the capable transacting party. A successful claim tends to enlarge the estate of the incapable individual, and thereby benefits the claimant (who expects to inherit some or all of such estate). Thus the mental capacity doctrine can potentially impact upon potentially incapable individuals *and* potential claimants who have inheritance expectations.

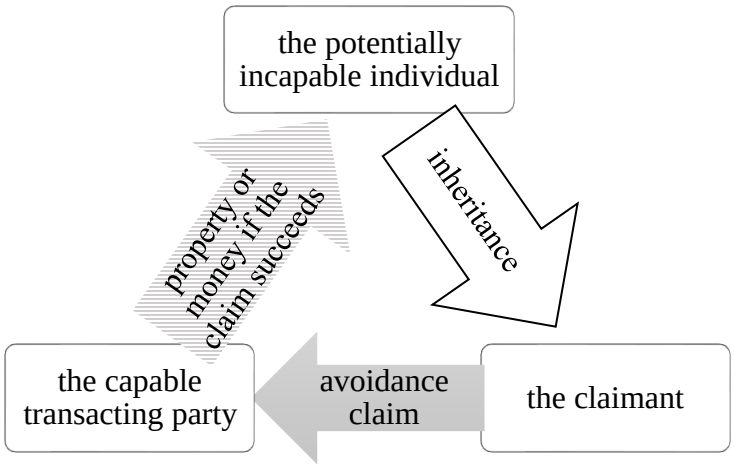

Figure 5: Typical Transactional Capacity Dispute

The prevailing doctrinal theories fail to recognize the role of inheritance expectations. The conflicting-policies theory critically depends on the assumption the potentially incapable individual finds the impugned transaction subjectively disadvantageous; it is for this reason that the policies of protecting the individual and protecting the security of transactions are necessarily in conflict.[151] However, in typical cases, the true claimant is not the potentially incapable individual herself; the claimant's interest may or may not be aligned with the individual's. In cases involving misalignment of interest, the individual may actually find the transaction beneficial rather than disadvantageous.[152] In these cases, the conflicting-policies theory is wrong.

[151] *See supra* note 120 and accompanying text.

[152] *See also* Kohn, *supra* note 47, at 2, 20–24 (criticizing statutes that criminalize elder

Moreover, a hallmark of inheritance disputes is the "worst evidence" problem: the testimony of a deceased individual is unavailable.[153] The court can at best gauge from circumstantial evidence to ascertain the past mental state or intention of the deceased. If the impugned transaction took place in private, then the court also can only rely on circumstantial evidence to ascertain how the capable transacting party had dealt with the deceased. Such significant evidential deficiency, together with the legal uncertainty arising from the vague standards of mental capacity,[154] give the potential beneficiaries of the deceased's estate an opportunity to avoid transactions that actually *advance* the deceased's testamentary intent. This again challenges the conflicting-policies theory.

2. Estate Planning

Section III.A.1 has shown that the prevailing, conflicting-policies theory wrongly assumes the potentially incapable individual necessarily finds the impugned transaction disadvantageous. This Section will argue that the widely-accepted abnormality theory is also often wrong; it ignores the fact that many near-death transactions are estate-planning instruments.

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financial abuse for allowing the state to act without the active participation of victims).

[153] *See generally* SITKOFF & DUKEMINIER, *supra* note 70, at xxxiii, 141, 263–64. *See also* Goldberg & Sitkoff, *supra* note 50, at 336, 344–46, 365, 376–77 (criticizing the tort of interference with inheritance for failing to address the "worst evidence" problem).

[154] *See supra* Sections II.A, II.B, II.C.2.

Many near-death transactions captured by the mental capacity doctrine are in substance *will substitutes*—meaning transactions to effectuate transfers of wealth at or near death without going through the formal probate system.[155] For example, by creating a joint tenancy in her property with a right of survivorship, a potentially incapable individual allows her co-tenant to inherit the property when she passes away.[156] Professor John Langbein showed that over the course of the twentieth century, will substitutes became popular estate-planning instruments in the United States.[157] As a result, Professor Langbein and other scholars called for regulation of will substitutes as estate-planning instruments rather than as contracts or lifetime gifts.[158] Nonetheless,

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[155] *See generally* John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV. L. REV. 1108 (1984).

To be sure, near-death contracts and gifts are often "imperfect" will substitutes; unlike wills, they cannot be revoked by their makers before death, and they also take effect before death. *Id.* at 1114–15. Perhaps for this reason, prevailing American law applies the test for contractual capacity, rather than testamentary capacity, to irrevocable gifts. *See* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1(c), cmt. d, reporter's note 4 (AM. LAW INST. 1999). However, if the maker of an irrevocable will substitute lacks capacity, then the will substitute become prima facie revocable. The maker (or her representative) may exercise the power to avoid the will substitute for want of capacity before she dies. *See supra* note 59 and accompanying text. In other words, mental incapacity can render formally irrevocable will substitutes practically revocable.

[156] Langbein, *supra* note 155, at 1112. *See, e.g.*, Dubree v. Blackwell, 67 S.W.3d (Tex. Ct. App. 2001) (discussed in *infra* notes 259–62 and accompanying text).

[157] Langbein, *supra* note 155.

[158] *See especially id.*; RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS §§ 7.1, 7.2 (AM. LAW INST. 1999).

like their counterparts in the nineteenth century,[159] modern American courts tend to apply contractual doctrines to resolve capacity disputes over will substitutes.[160]

Engaging the abnormality theory, judicial application of contractual doctrines to will substitutes ignores the inherit differences between estate-planning instruments and true contracts. First, abnormality means deviation from the "norm", and what may be "normal" in truly contractual dealings is different from what may be "normal" in estate-planning. In particular, contracts are usually beneficial to both sides, but will substitutes are by their nature one-sided—in favor the party who is expected to inherit. Like wills, but unlike contracts, will substitutes inherently exhibit substantive imbalance *regardless* of their makers' mental ability. As a result, substantive imbalance is *not* a reliable indication of poor mental ability. Thus the abnormality theory wrongly asserts that substantive imbalance is a sign of mental incapacity.[161] The same problem affects other factors that amount to deviation from the contractual "norm" but are consistent with the estate-planning "norm".

Second, the abnormality theory assumes the existence of a "norm" the deviation from which is suspect, but ascertaining what is "normal" in estate

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[159] *See generally* BLUMENTHAL, *supra* note 26, at 179–80, 199–200.

[160] *See generally* this Dissertation, Appendix A.

[161] *See generally supra* notes 121–24 and accompanying text.

planning is notoriously hard. Since the mid-twentieth century, families based on formal marriage and bloodline are in decline, while unmarried cohabiting partnerships, blended families, and other nontraditional family forms are becoming more prevalent.[162] The task of ascertaining the probable estate plan of a typical person must be carried out in the light of the great diversity of modern family forms. That task, as Professor Robert Sitkoff and the late Professor Jesse Dukeminier wrote in the context of intestate rules, "often involves substantial guesswork, as people's preferences differ, and it is hard to know what most people … would want."[163]

Moreover, the abnormality theory is overly cynical in asserting that substantive imbalance is a sign of overreach by the capable transacting party.[164] Will substitutes are typically made to transfer wealth to their makers'

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[162] *See generally* Scott & Scott, *From Contract to Status*, *supra* note 148, at 302–03; SITKOFF & DUKEMINIER, *supra* note 70, at 74–75, 90, 108–10; RALPH C. BRASHIER, INHERITANCE LAW AND THE EVOLVING FAMILY 1–4 (2004); Thomas P. Gallanis, *The Flexible Family in Three Dimension*, 28 L. & INEQ. 291, 57–59 (2010); Kathrine M. Arango, *Trial and Heirs: Antemortem Probate for the Changing American Family*, 81 BROOK. L. REV. 779, 782–87 (2016) (recent survey of Census statistics and empirical studies on American families).

[163] SITKOFF & DUKEMINIER, *supra* note 70, at 63. Intestate rules are majoritarian default rules governing distribution of the probate property of persons who die without a will. *Id.* at 63. *See also* Susan N. Gary, *The Probate Definition of Family: a Proposal for Guided Discretion in Intestacy*, 45 U. MICH. J.L. REFORM 787 (2012) (arguing that fixed intestacy rules fail to adapt to diverse family structures and proposing guided judicial discretion as an alternative); Frances H. Foster, *The Family Paradigm of Inheritance Law*, 80 N.C. L. REV. 199 (2001) (arguing against the family paradigm in American inheritance law and proposing potential reforms outside that paradigm).

[164] *See generally supra* notes 121–24 and accompanying text.

close relatives and friends. In a close familial or personal relationship, biological and affective bonds can partially deter misconduct, so can social and moral norms.[165] Whether these extralegal mechanisms are strong enough depends on the nature of the relationship. For instance, Professors Elizabeth Scott and Robert Scott argued that intrinsic bonds and informal norms are typically sufficient to deter misconduct in close parent-minor child relationships.[166] More recently, Professor Elizabeth Scott and the author argued that extralegal mechanisms can also partially deter misconduct when a spouse/partner or an adult child serves as guardian to an elderly incapable person.[167] However, affective bonds tend to be less effective in such a guardianship than in a close parent-minor child relationship. The point is that substantive imbalance may or may not be a reliable signal of misconduct by the capable transacting party; such signal must be interpreted in the light of the presence of intrinsic bonds and informal norms as well as the strength of such extralegal mechanisms. It is often wrong for the abnormality theory to treat substantive imbalance as evidence of potential overreach.

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[165] *See generally* Elizabeth S. Scott & Robert E. Scott, *Parents as Fiduciaries*, 81 VA. L. REV. 2401, 2430, 2433 (1995) [hereinafter, Scott & Scott, *Parents*].

[166] *Id.*

[167] Elizabeth S. Scott & Ben Chen, *Fiduciary Principles in Family Law*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW ch. 12 (Evan J. Criddle, Paul B. Miller, Robert H. Sitkoff eds., 2019).

It must be clarified that the presence and strength of intrinsic bonds and social norms in the relationship between a potentially incapable individual and the capable transacting party depend littles on the individual's relationship with the claimant. This clarification matters because in many disputed cases, the active litigants all are related to the potentially incapable individual, for example, her relations from different marriages.[168] The relationship between the claimant and the capable transacting party is typically acrimonious. However, what matter for deterring misconduct are the extralegal mechanisms that regulate the capable transacting party's relationship with the potentially incapable individual, not with the claimant. Thus the fact that the disputed cases usually involve litigants who are related to each other does not weaken the argument that strong intrinsic bonds and social norms can partially deter misconduct in the relationship between the potentially incapable individual and her close relative or friend.

Empirical findings regarding elder abuse in families therefore must be cautiously interpreted. Surveys from American jurisdictions consistently report that alleged perpetrators of elder abuse are usually related to the victim.[169] While the exact figures vary, adult children and spouses/partners

[168] *See, e.g.*, Kinsel v. Lindsey, 526 S.W.3d 411 (Tex. 2017) (claims brought by the potentially incapable individual's step-children and step-grandchildren against her niece, nephew and others).

[169] *See supra* notes 39–40.

are typically reported as the largest groups of alleged perpetrators.[170] Yet these findings should not be interpreted to suggest that spouses/partners, adult children, or other family members are prone to commit elder abuse. Saying elder abusers are likely to be family members is not the same as saying family members are likely to be elder abusers.[171] That family members are well-represented in elder abuser statistics may well be driven by the prevalence of transactions between seniors and their family members (especially in the estate-planning context), rather than by any strong tendency of family members to commit elder abuse.[172] The author is unaware of any empirical finding showing such a tendency.

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[170] *See, e.g.*, LIFESPAN OF GREATER ROCHESTER, WEILL CORNELL MEDICAL CENTER OF CORNELL UNIVERSITY & NEW YORK CITY DEPARTMENT FOR THE AGING, *supra* note 40, at 17, 35.

[171] More formally, let Ω denote the set of transactions involving seniors. Let A denote the subset of Ω that constitute abuse, and F the subset of Ω that involve a family member. In general, $P(F|A) \neq P(A|F)$, where $P(F|A)$ is the conditional probability that a given abusive transaction involves a family member, and $P(A|F)$ the conditional probability that a given transaction with a family member constitutes abuse. Existing empirical studies consistently show a high $P(F|A)$, *see supra* notes 168–69 and accompanying text, but stop short of revealing $P(A|F)$.

To be sure, Bayes' theorem implies $P(A|F)=P(F|A)P(A) \div P(F)$, where $P(A)$ is the (unconditional) probability that a transaction constitutes abuse, and $P(F)$ the (unconditional) probability that a transaction involves a family member. In principle, one can derive $P(A|F)$ from $P(F|A)$, $P(A)$, and $P(F)$. Yet the hidden nature of elder abuse seems to prevent empirical researchers from ascertaining $P(A)$. *See, e.g.*, LIFESPAN OF GREATER ROCHESTER, WEILL CORNELL MEDICAL CENTER OF CORNELL UNIVERSITY & NEW YORK CITY DEPARTMENT FOR THE AGING, *supra* note 40, at 7.

[172] More formally, Bayes' theorem implies $P(F|A)=P(A|F)P(F) \div P(A)$, where these probabilities are described in *supra* note 170. A high $P(F|A)$ can be explained by a high $P(F)$, (or a low $P(A)$), rather than by a high $P(A|F)$.

Showing undue suspicion of substantive imbalance in transactions involving close relatives and friends, the abnormality theory can harm the welfare of incapable individuals. Experimental research in psychology and behavioral economics shows that individual preferences are often other-regarding, rather than purely self-regarding. In addition to altruism, a common form of other-regarding preferences is *reciprocity fairness*—returning kindness for another's kindness but unkindness for another's unkindness.[173] Wills can be the final manifestation of strong other-regarding preferences in close and long-term relationships.[174] Similarly, one-sided contracts, irrevocable gifts, and many other forms of will substitutes can be the manifestation of strong other-regarding preferences. Yet the mental capacity doctrine tends to regard these transactions with great suspicion; it harms the welfare of the incapable individual by rendering her less able to pursue valuable other-regarding goals and preferences.

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[173] *See generally* SANJIT DHAMI, THE FOUNDATIONS OF BEHAVIORAL ECONOMIC ANALYSIS chs. 5.2, 5.3, 6.7 (2016) (surveying experimental research on other-regarding preferences). *See, e.g.*, Ernest Fehr & Klaus M. Schmidt, *A Theory of Fairness, Competition, and Cooperation*, 114 Q. J. ECON. 817 (1999); Gary E. Bolton & Axel Ockenfels, *ERC: A Theory of Equity, Reciprocity, and Competition*, 90 AM. ECON. REV. 166 (2000); Gary Charness & Matthew Rabin, *Understanding Social Preferences with Simple Tests*, 117 Q. J. ECON. 817 (2002). *See also* DHAMI, ch. 5.5 (discussing external validity of experimental research); Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1646, 1685–90 (2003) (Preferences for reciprocal fairness provide a source of self-enforcement in deliberately incomplete contracts).

[174] *See generally* Melanie B. Leslie, *Enforcing Family Promises: Reliance, Reciprocity, and Relational Contract*, 77 N.C. L. REV. 551, 564–78 (1999) [hereinafter Leslie, *Enforcing Family Promises*].

To be sure, there is preliminary evidence that courts tend to exercise their substantial discretion to uphold transactions made in close families and personal relationships. Based on a doctrinal analysis of transactional capacity cases decided in the 1960s to the 1980s, Professor Alexander Meiklejohn found that courts were generally willing to consider relational factors and tended to uphold transactions made in the course of long-term and close relationships that benefited the potentially incapable individual.[175] For this and other reasons, he concluded that the prevailing doctrinal theories are "fundamentally sound".[176] However, neither Professor Meiklejohn's sample of cases nor mine is large enough to generate statistically significant results,[177] especially in the light of the numerous abnormality factors and other variables that may affect judicial decisionmaking.[178] To the extent that courts indeed tended to uphold transactions involving close relatives and friends, they reached the right results for the wrong reasons. Part IV below

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[175] Meiklejohn, *supra* note 26, at 364–67, 379, 387.

[176] *Id.* at 310. The other reasons for Professor Meiklejohn's conclusion were that courts tended to give more weight to lay testimony than to expert testimony, showing their avoidance of undue deference to psychiatry, *see id.* at 342, 387; that substantive imbalance was relevant to, but not determinative of, the issue of capacity, *see id.* at 352–53, 355; and the undesirable consequences of guardianship might be mitigated by the widespread legislative adoption of durable powers of attorney and limited guardianship, each of which preserved transactional capacity, *see id.* at 379–86.

[177] *See id.* at 311 note 17, 366–67 note 285; *supra* notes 149–50 (discussing the author's survey).

[178] *See generally supra* notes 121–24 and accompanying text.

will offer reform suggestions to maximize the likelihood that the right results are reached, for the right reasons.

3. Reward for Informal Caregiving

In the present era of aging population, the '[e]conomic and social costs both to society and to potential caregivers [are] increasing, while the tax base and the pool of family caregivers, especially women, [are] shrinking.'[179] In the United States, the burden of providing care to the elderly is primarily borne by families rather than by the state. A recent empirical study estimates that about 34.2 million Americans provide unpaid care to an adult, with nearly half of the care recipients being seventy-five years or older.[180] Caregivers typically provide four years of unpaid care to an aged parent or spouse/partner.[181] Caregiving is burdensome and time-consuming; it generally takes 24.4 hours per week on average, and increases to 44.6 hours

[179] Ann M. Soden Ad. E., *Family Matters: Some Emerging Legal Issues in Intergenerational and Generational Relations*, *in* BEYOND ELDER LAW: NEW DIRECTIONS IN LAW AND AGING 119 (Israel Dorn & Ann M Soden eds., 2012). *See generally* NATIONAL ALLIANCE FOR CAREGIVING & AARP PUBLIC POLICY INSTITUTE, CAREGIVING IN THE U.S. 2015 at 12, 66–67 (2015), https://www.caregiving.org/caregiving2015/; Joshua C. Tate, *Caregiving and the Case for Testamentary Freedom*, 42 U.C. DAVIS L. REV. 120, 134–35 (2008) [hereinafter Tate, *Caregiving*]; Alison Barnes, *The Virtues of Corporate and Professional Guardians*, 31 STETSON L. REV. 941, 947 (2002) [hereinafter Barnes, *Corporate and Professional Guardians*].

[180] NATIONAL ALLIANCE FOR CAREGIVING & AARP PUBLIC POLICY INSTITUTE, *supra* note 179, at 17–18.

[181] *Id.* at 20–21.

per week on average when the care-recipient is a spouse/partner.[182] To provide care, family caregivers often have to reduce their work hours, sacrifice their careers or tap into their retirement savings.[183]

In this light, the prevailing doctrinal theories can harm the welfare of many seniors by unduly limiting their ability to reward caregiving. Unless formally appointed to some fiduciary office,[184] family caregivers typically do not get paid a salary for providing valuable care. Instead, family caregivers may enjoy the emotional reward of caring for loved ones.[185] Another common form of reward for caregiving is inheritance from the care-recipient's estate.[186] Yet the prevailing doctrinal theories pose a heightened risk of avoiding will substitutes that truly reflect the testamentary intent of their

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[182] *Id.* at 34.

[183] *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-19-382, RETIREMENT SECURITY: SOME PARENTAL AND SPOUSAL CAREGIVERS FACE FINANCIAL RISKS 23–25 (2019).

[184] *See, e.g.*, UNIF. PROBATE CODE §§ 5-316(a), 5-417 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 120(b) (Unif. Law Comm'n 2017); RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(4) (AM. LAW INST. 2012).

[185] *See generally* Scott & Scott, *Parents*, *supra* note 165, at 2430–33.

[186] *See generally* Tate, *Caregiving*, *supra* note 179 (Testamentary freedom allows the elderly to reward caregivers.). *See, e.g.*, Vig v. Swenson, 904 N.W.2d 489, 493 (N.D. 2017). *See also* Thomas P. Gallanis & Josephine Gittler, *Family Caregiving and the Law of Succession: a Proposal*, 45 U. MICH. J. LAW REFORM 761 (2012) (proposing to give an elective share in the decedent's estate to family caregivers who have provided substantial uncompensated care to the decedent in a family residence).

makers.[187] As a result, potentially incapable seniors are less able to reward caregiving with inheritance. This stultifies the pursuit of valuable other-regarding preferences.

Moreover, a limited ability to reward caregiving with inheritance may prevent many seniors from securing the services of their preferred family-and-friend caregivers. Close relatives and friends are not fungible.[188] While professional caregivers and nursing homes have incentives to develop transferable skills and expertise,[189] close relatives and friends have an intimate relationship with the care-recipient and tend to be empathetic of her subjective needs and wishes.[190] The marginal benefit of receiving care from closes relatives and friends rather than from professional caregivers or nursing homes can be significant. A limited ability to reward caregiving with inheritance therefore may deprive potentially incapable seniors of the services of their preferred family-and-friend caregivers.

To be sure, care-recipients may use wills rather than will substitutes to

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[187] *See supra* Section III.A.2.

[188] *See generally* Scott & Scott, *Parents*, *supra* note 165, at 2415, 2430, 2445.

[189] *See* Barnes, *Corporate and Professional Guardians*, *supra* note 179, at 954–55; Linda S. Whitton & Lawrence A. Frolik, *Surrogate Decision-making Standards for Guardians: Theory and Reality*, 3 UTAH L. REV. 1491, 1508 (2012) [hereinafter, Whitton & Frolik, *Theory and Reality*]. *See generally infra* Section III.B.2.

[190] APPELBAUM & GUTHEIL, *supra* note 30, at 205–06.

leave inheritance to their caregivers.[191] Before a care-recipient loses mental capacity to make a lifetime transaction, she may make a will to reward her caregiver. Prevailing American law formally sets a lower threshold for testamentary capacity than for capacity to make contracts, irrevocable gifts and other lifetime transactions. The test of testamentary capacity enquires into cognitive ability,[192] but is easier to satisfy than the traditional cognitive test of capacity to make lifetime transactions. In theory at least, an individual can lack capacity to make lifetime transactions and yet has capacity to make a will.[193] Thus some care-recipients who lack capacity to make lifetime transactions can still make valid wills to reward their caregivers. However, the administration of wills invokes the formal probate system, which can be "slow, cumbersome and expensive".[194] Moreover, the subtle differences between testamentary capacity and capacity to make lifetime transactions

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[191] *See generally* Tate, *Caregiving*, *supra* note 179.

[192] The prevailing test of testamentary capacity is:

> [T]he testator or donor must be capable of knowing and understanding in a general way the nature and extent of his or her property, the natural objects of his or her bounty, and the disposition that he or she is making of that property, and must also be capable of relating these elements to one another and forming an orderly desire regarding the disposition of the property.

RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1(b) (AM. LAW INST. 1999).

[193] SITKOFF & DUKEMINIER, *supra* note 70, at 268–69.

[194] *Id.* at 444.

have practical significance only in borderline cases,[195] which are rare. In typical cases, individuals who lack capacity to make lifetime transactions would likely fail the test of testamentary capacity as well.

B. Transactions with Businesses

Section III.A above has argued that the prevailing theories underlying the mental capacity doctrine are ill-suited for resolving disputes over transactions involving close relatives and friends. Turning now to transactions between potentially incapable individuals and businesses,[196] this Section will argue for continuing application of the prevailing theories.

1. Need for Heightened Protection Remains

Unlike transactions involving close relatives and friends, transactions between potentially incapable individuals and businesses do not typically take place in the estate-planning context. In particular, the author's survey of modern cases suggests that consumer contracts are the most common type of transactions with businesses.[197] Unlike in the estate-planning context, the abnormality theory correctly regards substantive imbalance in transactions

[195] The formal differences between testamentary capacity and transactional capacity also seem not to affect the cognitive factors that psychiatric experts examine to form an opinion regarding mental ability. *See* APPELBAUM & GUTHEIL, *supra* note 30, at 181–82.

[196] For simplicity, this Chapter uses the term "business" to describe a company or a natural person who transacts with potential incapable individuals with a view to profit.

[197] *See generally* this Dissertation, Appendix A.

with businesses as a signal of mental inability and of overreach.[198] However, the conflicting-policies theory still ignores inheritance expectations and mistakenly assumes that claimants necessarily seek avoidance to advance the interests of the potentially incapable individual. There are nonetheless good reasons for continuing application of the prevailing theories *notwithstanding* that mistaken assumption.[199]

In transacting with businesses, potentially incapable individuals tend to be in a position of significant disadvantage. Aside from having a low bargaining power, individuals—mentally-capable or not—tend to be boundedly-rational in the sense of having cognitive biases, limited willpower, and many other forms of systematic mental limitations.[200] Research in behavioral economics and psychology have shown that businesses can exploit these mental limitations to extract extraordinary profits.[201] In cases

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[198] *See generally supra* Sections II.A, II.C.2.

[199] *Contra.* Alexander & Szasz, *supra* note 29, at 547 (arguing for abolition of the mental capacity doctrine).

[200] *See, e.g.*, Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99 (1955); Daniel Kahneman & Amos Tversky, *Prospect Theory: an Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); Richard H. Thaler, *Some Empirical Evidence on Dynamic Inconsistency*, 8 ECON. LETTERS 201 (1981). *See generally* Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 5 STAN. L. REV. 1471, 1476–81; Jonathan Baron & Tess Wilkinson-Ryan, *Conceptual Foundations: a Bird's Eye View*, *in* RESEARCH HANDBOOK ON BEHAVIORAL LAW AND ECONOMICS 25–38 (Joshua C. Teitelbaum & Kathryn Zeiler eds., 2018).

[201] *See generally* RAN SPIEGLER, BOUNDED RATIONALITY AND INDUSTRIAL ORGANIZATION (2011); Botond Köszegi, *Behavioral Contract Theory*, 52 J. ECON. LITERATURE 1075 (2014); OREN BAR-GILL, SEDUCTION BY CONTRACT: LAW, ECONOMICS,

concerning elderly incapable individuals, the concerns raised by these research are particularly pronounced. As Professors Sumit Agarwal, John Driscoll, Xavier Gabaix and David Laibson wrote in an influential paper, the combination of severe cognitive limitations and substantial wealth can render many seniors particularly vulnerable to financial exploitation.[202] These learned authors further highlighted that market forces and competition are inadequate for protecting vulnerable seniors from exploitative business practices.[203] Moreover, unlike in close families and personal relationships, intrinsic bonds and informal norms do not constrain profit-driven businesses. Thus the need to protect vulnerable seniors from exploitative business practices can justify continuing application of a rigorous mental capacity doctrine.[204]

2. Example: Contracts with Nursing Homes

To illustrate how the mental capacity doctrine may operate in the consumer context, this Section considers contracts with nursing homes.

AND PSYCHOLOGY IN CONSUMER MARKETS 2, 42, 248 (2012).

[202] Sumit Agarwal, John C. Driscoll, Xavier Gabaix & David Laibson, *The Age of Reason: Financial Decisions over the Life Cycle and Implications for Regulation*, 2009 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 51, 51–52, 80.

[203] *Id.* at 80–81. *See also* BAR-GILL, *supra* note 201, at 2, 26–32; EYAL ZAMIR & DORON TEICHMAN, BEHAVIORAL LAW AND ECONOMICS 282–83, 285 (2018).

[204] *See generally supra* Section I.B (discussing how the mental capacity doctrine deters and sanctions financial misconduct).

About one-third of the modern cases surveyed by the author concerned contracts for admitting a senior to a nursing home.[205] Contracts with nursing homes disproportionately affect seniors who may lack mental capacity, given their likely need for professional care in their final years of life. Unlike most family caregivers, nursing homes tend to be sophisticated institutions that are paid to provide their services. An analysis of contracts with nursing homes can therefore offer insights on how the mental capacity doctrine can protect elderly incapable individuals from potentially exploitative business practices.

Elder abuse and low-quality care in nursing homes are alarming problems. Nursing-home residents and their families tend to lack the ability to assess and monitor the provision of services and quality of care.[206] Advocates of regulation, and even nursing homes themselves, accept that market forces are insufficient to assure quality of care and deter abuse.[207] During years 1999 and 2000, "[o]ver thirty percent of the nursing homes in the United States—5,283 nursing homes—were cited for an abuse violation" that potentially cause harm to nursing-home residents.[208] Surveys done in the

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[205] *See infra* this Dissertation, Appendix A.

[206] David G. Stevenson, *The Future of Nursing Home Regulation: Time For A Conversation?*, HEALTH FAIRS, Aug. 23, 2018.

[207] *Id.*

[208] U.S. H.R., COMM. ON GOVERNMENT REFORM, SPECIAL INVESTIGATIONS DIVISION, MINORITY STAFF, ABUSE OF RESIDENTS IS A MAJOR PROBLEM IN U.S. NURSING HOMES 4–5

United States (and other countries) reported that over half of nursing-home staff admitted to committing abuse, and almost ninety percent of residents or their proxies reported neglect.[209] While federal law regulates nursing homes through setting forth rights and standards and other mechanisms,[210] oversight and enforcement efforts have failed to achieve long-lasting improvements.[211]

A rigorous mental capacity doctrine can partially deter and sanction elder abuse and poor quality of services in nursing homes. First, the doctrine enables private suits by potentially incapable individuals or their representatives.[212] Private suits are especially valuable for holding nursing homes accountable when the state takes a lax attitude toward regulation.[213] The author's survey of modern cases shows that potentially incapable individuals who contracted with nursing home typically had passed away by

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(2001), http://canhr.org/reports/2001/abusemajorproblem.pdf.

[209] Yongjie Yon et al., *The Prevalence of Elder Abuse in Institutional Settings: a Systematic Review and Meta-analysis*, 29 EUR. J. PUB. HEALTH 58, 61 (2018) (citations omitted).

[210] *See generally* Richard Weinmeyer, *Health Law: Statutes to Combat Elder Abuse in Nursing Homes*, 16 AM. MED. ASS'N J. ETHICS 359 (2014).

[211] *See* Jordan Rau, *Poor Patient Care at Many Nursing Homes Despite Stricter Oversight*, N.Y. TIMES, Jul. 5, 2017; Robert Gebelhoff, Opinion, *The Hidden Victims of Trump's Deregulatory Agenda: Nursing Home Residents*, WASH. POST Mar. 25, 2019.

[212] *See supra* note 59 and accompanying text.

[213] *See* Gebelhoff, *supra* note 211.

the time of litigation.[214] Like in cases concerning relatives and friends, claimants who brought posthumous avoidance claims against nursing homes were usually relatives with inheritance expectations; a successful claim would tend to increase the size of the claimant's expected inheritance from the elderly individual's estate. However, unlike in the estate-planning context,[215] avoidance claims against nursing homes tend not to contradict the testamentary intent of the elderly individual; people typically do not intend to leave inheritance to their nursing homes. Thus, in cases concerning contracts with nursing homes, inheritance expectations can motivate private suits that are unlikely to be inconsistent with the interests of the potentially incapable individual.

Second, the abnormality theory—that sanctions deviation from the norm—tends to lead to contract avoidance when the nursing home in dispute charged more than what typical nursing homes would charge. Upon contract avoidance, the nursing home would be obliged to repay the contract price to the resident (or her estate), and would become entitle to recover a reasonable price commensurate with the services actually provided; such reasonable price could match the market price or the costs of the services actually

[214] *See generally infra* this Dissertation, Appendix A.

[215] *See generally supra* Section III.A.2.

provided.[216] Thus poor services would attract a low reasonable price. Any conscious wrongdoing by the nursing home would also reduce the reasonable price that it would receive.[217] Moreover, successful avoidance of a contract for want of capacity would vitiate any exclusion-of-liability clause therein;[218] the capable contracting party would therefore be prevented from invoking any exclusion-of-liability clause to resist subsequent tort actions.[219]

To be sure, like many other consumer contracts in the United States,[220] nursing-home contracts tend to contain mandatory arbitration clauses that oblige parties to refer their disputes to an arbitral tribunal rather than a

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[216] *See generally* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 cmt. a, cmt. e, §§ 49, 54 (AM. LAW INST. 2011).

To be sure, the mental capacity doctrine alone is insufficient to induce socially-optimal levels of nursing-home services. For instance, setting the reasonable price for nursing-home services to equal the market price would not induce efficient outcomes, because the market price is not an efficient price. The usual obstacles to efficient bargaining—information asymmetry, cognitive biases, limited willpower and the like—are present in the nursing-home market. *See generally supra* Section III.B.1; Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, *in* HANDBOOK OF LAW AND ECONOMICS vol. 1 at 30–46 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (discussing the obstacles to efficient contracting).

[217] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 54(4)(a) (AM. LAW INST. 2011).

[218] *See, e.g.*, Del Santo v. Bristol County Stadium, Inc., 273 F.2d 605 (1st Cir. 1960).

[219] *See, e.g.*, *id*.

[220] *See, e.g.*, Theodore Eisenberg, Geoffrey P. Miller & Emily Sherwin, *Arbitration's Summer Soldiers: an Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH J. L. REFORM 871, 883 (2008).

court.[221] About one-third of the cases I surveyed concerned an arbitration clause that formed part of a nursing-home contract.[222] Lacking salience, mandatory arbitration clauses can affect consumers regardless of their state of capacity.[223] Subject to some narrow exceptions, courts are obliged to refer to arbitration disputes within the scope of a facially-valid mandatory arbitration clause. Disputes concerning mental capacity may or may not be one of these exceptions; the Supreme Court has left open the issue of whether mental capacity is a matter for a court or an arbitral tribunal to decide in the

[221] *See also* Gebelhoff, *supra* note 211 (discussing recent efforts to lift a previous ban on mandatory arbitration clauses in nursing-home contracts).

[222] *See, e.g.*, John Knox Billage of Tampa Bay, Inc. v. Perry, 94 So.3d 715 (Fa. Ct. App. 2012) (remanded for evidential hearing to ascertain mental capacity to enter into arbitration agreement); Liberty Health & Rehab of Indianola, LLC v. Howarth, 11 F.Supp.3d 684 (N.D. Miss. 2014) (denied motion to compel arbitration); Pikeville Medical Center, Inc. v. Bevins, 2014 WL 5420002 (Ky. Ct. App. 2014); Maynard v. Golden Living, 56 N.E.3d 1232 (Ind. Ct. App. 2016) (referred to arbitration); Kindred Nursing Centers Limited Partnership v. Chrzanowski, 791 S.E.2d 601 (Ga. Ct. App. 2016) (remanded for evidential hearing to ascertain mental capacity to enter into arbitration agreement); Dalon v. Ruleville Nursing and Rehabilitation Center, LLC, 161 F.Supp.3d 406 (N.D. Miss. 2016) (remanded for evidential hearing to ascertain mental capacity to enter into arbitration agreement); Cardinal v. Kindred Healthcare, Inc., 155 A.3d 46 (Penn. 2017) (referred to arbitration); Richmond Health Facilities-Madison, L.P. v. Shearer, 2017 WL 3273381 (E.D. Ky. 2017) (referring to arbitration all but claims personal to claimant); Stephan v. Millennium Nursing and Rehab Center, Inc., No. 1170524, 2018 WL 4846501 Ala. Oct. 5, 2018) (denied motion to compel arbitration).

[223] *See generally* J. Maria Glover, *Disappearing Claims and the Erosion of Substantive Law*, 124 YALE L.J. 3052 (2015); Oren Bar-Gill, *Consumer Transactions*, *in* THE OXFORD HANDBOOK OF BEHAVIORAL ECONOMICS AND THE LAW 472–73 (Michael Szenberg & Lall Ramrattan eds., 2014) (Arbitration clauses form part of those non-salient aspects of consumer contracts that consumers typically do not read.).

first instance.[224] Lower courts are divided on this issue.[225] The prevailing academic view is that mental incapacity is similar to unconscionability and other usual defenses to contract enforcement, which are typically referred to arbitration.[226]

The prevalence of mandatory arbitration clauses in nursing-home contracts at most partially undermines the protective function of the mental capacity doctrine. Unless and until the Supreme Court rules otherwise, many lower courts can continue to resolve disputes over mental capacity rather than refer such disputes to arbitration. Claimants can also invoke the mental capacity doctrine before an arbitral tribunal. To be sure, *class-action* arbitration waivers can stultify consumer rights by making it too expensive to litigate individually,[227] but this problem is mitigated in cases where a successful claim would recover a sufficiently large sum of money to the

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[224] Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 444 footnote 1 (2006).

[225] *See supra* note 222.

[226] George A. Bermann, *The "Gateway" Problem in International Commercial Arbitration*, 37 YALE J. INT'L L. 1, 34–35 (2012) (arguing an arbitral tribunal should decide a mental-incapacity challenge to an arbitration agreement). *Contra*. Autumn Smith, *You Can't Judge Me: Mental Capacity Challenges to Arbitration*, 56 BAYLOR L. REV. 1051 (2004) (arguing a court should decide a mental-incapacity challenge to an arbitration agreement).

[227] *See generally* Glover, *supra* note 223, at 3066–68. *See, e.g.*, AT&T Mobility LLC v. Concepcion, 563 U.S. 333 (2011) (Federal law preempts state law that invalidates class-action-arbitration waivers in consumer contracts.); Kindred Nursing Centers Limited Partnership v Clark, 137 S Ct 1421 (2017); Epic Systems Corp v Lewis, 138 S Ct 1612 (2018).

claimant. Thus, at least in high-stake cases, the mental capacity doctrine can partially deter and sanction abuse and poor services in nursing homes.

3. Example: Annuities

Annuities are another example of transactions with businesses that disproportionately affect seniors who may lack mental capacity. Primary a retirement-planning product, an annuity is an insurance contract under which the insured pays premiums in exchange for a stream of income from the insurer.[228] For example, a life annuity provides guaranteed periodic payments for the remainder of the insured's lifetime. A common reason for buying an annuity is to obtain insurance against the *longevity risk* of the insured living longer than expected and being unable to support her consumption. Another common reason is to qualify the insured for Medicaid, which can pay for her medical and nursing-home costs. By making a large lump-sum premium to the insurer and meeting other criteria, the insured impoverishes herself to meet Medicaid's asset limits.[229]

Individuals often make suboptimal decisions regarding annuities. Research in behavioral finance and psychology suggest that due to mental

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[228] *See generally Fast Answers: Annuities*, U.S. SEC. & EX. COMM'N, https://www.sec.gov/fast-answers/answersannuityhtm.html (last visted Jun. 11, 2019).

[229] *See generally* Am. Council on Aging, *How Purchasing a Medicaid Compliant Annuity Impacts One's Eligibility for Medicaid Long-Term Care*, MEDICAID PLANNING ASSISTANCE, https://www.medicaidplanningassistance.org/eligibility-by-annuity (last updated Jan. 14, 2019).

accounting, loss aversion and framing effects, individuals can incorrectly perceive annuities as risky gambles rather than insurance products.[230] Yet common types of annuities, especially fixed annuities that provide guaranteed streams of income, are not regulated by the Securities and Exchange Commission.[231] Moreover, commission-driven salespersons may sell annuities that are not in the buyer's best interests without violation of strict fiduciary duty.[232] In fact, several insurers recently reported booming annuities sales and partially attributed the boom to recent weakening of fiduciary regulation.[233]

If carefully applied, the mental capacity doctrine can partially fill in a gap in regulatory protection in the annuities market. Like in cases concerning

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[230] Wei-Yin Hu & Jason S. Scott, *Behavioral Obstacles in the Annuity Market*, 63 FIN. ANALYSTS J. 71 (2007); Jeffrey R. Brown et al., *Why Don't People Insure Late-Life Consumption? A Framing Explanation of the under-Annuitization Puzzle*, 98 AM. ECON. REV.: PAPERS & PROC. 304 (2008).

[231] *See generally Fast Answers: Annuities*, U.S. SEC. & EX. COMM'N, https://www.sec.gov/fast-answers/answersannuityhtm.html (last visted Jun. 11, 2019).

[232] Agarwal et al., *supra* note 202, at 84–85. *See* Chamber of Commerce of U.S.A. v. U.S. Department of Labor, 885 F.3d 360 (5th Cir. 2018) (invalidating the Fiduciary Rule which the Department of Labor proposed to impose ERISA fiduciary duties on a broad range of financial services brokers and advisers); Gregory F. Jacob, Opinion, *Is the Fiduciary Rule Dead?*, REG. REV. (Apr. 10, 2019) https://www.theregreview.org/2019/04/10/jacob-is-fiduciary-rule-dead/ (discussing the state of the Fiduciary Rule). *But see* Market Synergy Group, Inc. v. U.S. Department of Labor, 885 F.3d 676 (10th Cir. 2018) (upholding the Fiduciary Rule).

[233] *See* Suzanne Barlyn, *U.S. Annuities Sales Boom after Fiduciary Rule Kicks the Bucket*, REUTERS, Nov. 14, 2018.

nursing-home contracts,[234] the doctrine facilitates private suits, including those driven by inheritance expectations. Sanctioning deviation from the norm, the abnormality theory tends to avoid overpriced annuities. Upon avoidance, the insurer would be obliged to repay the incapable individual (or her estate) the prepaid premium, and would become entitle to recover a reasonable price commensurate with the value of the insurance coverage.[235] The court, however, must be mindful that the value of the insurance coverage is *not* the same as the sum of income payments already received by the incapable individual.[236] Such sum does not account for the fact that the individual had benefited from passing on longevity risk to the insurer. What the insurer is entitled to recover should reflect its assumption of the longevity risk.[237]

4. Availability of Ex-ante Judicial Approval

A further reason for treating transactions involving relatives and friends differently from transactions with businesses is the availability of a process

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[234] *See supra* Section III.B.2.

[235] *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 illus. 14, § 54 illus. 24 (AM. LAW INST. 2011).

[236] *But see Ortelere v. Teachers' Retirement Board of New York*, 250 N.E.2d 460 (N.Y. 1969) (discussed in *supra* text accompanying notes 131–36).

[237] *See also* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 54(6), cmt. k (AM. LAW INST. 2011) (limiting remedies in cases of prejudicial or speculative delay in asserting a right of rescission).

to obtain *ex-ante* judicial approval. The discussions so far concern judicial scrutiny after the fact, that is, judicial scrutiny of a previously-made transaction the subject of a claim for avoidance. To minimize the risk of avoidance after the fact, a transacting party can petition a state court for approval of the transaction before the fact.[238] This Section describes the process for obtaining ex-ante judicial approval and argues that the availability of this process partially justifies heightened regulation of transactions with businesses.

The process for engaging ex-ante judicial scrutiny is part and parcel of a state's *guardianship* system. To create a guardianship over a potentially incapable individual, prevailing American law requires the relevant state court (typically the probate court) to be satisfied that the individual lacks mental capacity to manage some aspect of her life or property.[239] Once the individual is found incapable, the court has a discretion to appoint a substitute decision-maker—the guardian—to make decisions on behalf of the individual. The court can also make a decision on its own. The guardianship process has enabled capable transacting parties to obtain ex-ante judicial

[238] *See, e.g.*, UNIF. PROBATE CODE § 5-411 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 414 (Unif. Law Comm'n 2017).

[239] *See, e.g.*, UNIF. PROBATE CODE § 5-401 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 401(b) (Unif. Law Comm'n 2017).

approval of transactions that would otherwise be vitiated by mental incapacity.[240]

Both the procedural and substantive aspects of ex-ante judicial scrutiny provide safeguards against financial misconduct. The petitioner is typically required to give notice to the potentially incapable individual and any interested parties, and disclose any conflict of interest.[241] This procedure gives the court and any interested parties an opportunity to evaluate the pros and cons of the proposed transaction.[242] In some cases, independent legal representation can also be afforded to the potentially incapable individual.[243] The equitable doctrine of substituted judgment (or its statutory adoption) provides the substantive standard for determining whether to grant ex-ante judicial approval. This standard typically requires the court to give effect to

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[240] *See, e.g.*, *In re* Keri, 853 A.2d 909 (N.J.) (ex-ante judicial approval of large gifts to the sons of the incapable individual). *See also* Lisa S. Whitton, *Durable Powers as an Alternative to Guardianship: Lessons We Have Learned*, 37 STETSON L. REV. 7, 38–39 (2007) (bank and financial institutions asking for invocation of guardianship proceedings to confirm authority to transact large properties of incapable individuals).

[241] *See, e.g.*, UNIF. PROBATE CODE § 5-411(a) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 414(a) (Unif. Law Comm'n 2017).

[242] *In re* Castner, 661 A.2d 344, 348 (N.J. Super. Ct. 1995).

[243] *See, e.g.*, *In re Keri*, 853 A.2d 909 (N.J.). *See generally* Am. Bar Ass'n Comm'n Law & Aging, *Representation and Investigation in Guardianship Proceedings*, AM. BAR ASS'N, http://www.americanbar.org/content/dam/aba/administrative/law_aging/chartrepresentationandinvestigation.authcheckdam.pdf (last visited Dec. 8, 2018) (surveying right to counsel in American guardianship statutes).

what the incapable individual would have wanted if she was capable.[244] If her wishes are not known, or if giving effect to her wishes would unreasonably harm or endanger her, then the court rules according to what is in her best interest.[245]

Hence, at least in high-stake cases, businesses that wish to transact with potentially incapable individuals without bearing the risk of subsequent avoidance can take advantage of the process for obtaining ex-ante judicial approval. On the other hand, unless advised by lawyers who are familiar with guardianship law, lay relatives and friends are unlikely to be sufficiently sophisticated and well-informed to invite ex-ante judicial scrutiny. The availability of ex-ante judicial scrutiny thus provides a reason for regulating transactions with businesses more strictly than transactions with relatives and friends.

C. Summary of Shortcomings

This Part has argued that the mental capacity doctrine in prevailing

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[244] *See generally infra* Section IV.A. *See, e.g.*, UNIF. POWER OF ATTORNEY ACT § 217(c) cmt. (Unif. Law Comm'n 2006) (gifting by agent); UNIF. PROBATE CODE §§ 5-411(a), 5-411 (c), 5-427(b) (amended 2010) (gifting by guardian); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 414(c) (Unif. Law Comm'n 2017); RESTATEMENT (THIRD) OF TRUSTS § 11 cmt. f, note to cmt. f, re: subsection (5) (AM. LAW INST. 2003).

[245] UNIF. PROBATE CODE §§ 5-314(a), 5-418(b) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 418(c) (Unif. Law Comm'n 2017).

American law is ill-suited for the era of aging population. Transactional capacity disputes typically concern inheritance. Yet the conflicting-policies theory fails to recognize that claims to avoid transactions involving relatives and friends are usually made to increase the claimant's expected inheritance, rather than to advance the interests of the potentially incapable individual. Moreover, the abnormality theory fails to recognize that substantive imbalance is an inherent characteristic of estate-planning instruments; it is not indicative of mental incapacity or of overreach. Thus the prevailing doctrinal theories tend to be overly suspicious of transactions made in the estate-planning context.

On the other hand, these shortcomings of the prevailing doctrinal theories do not affect typical transactions between potentially incapable individuals and profit-driven businesses. In the business context, claims driven by inheritance expectations are unlikely to contradict the testamentary intent of the potentially incapable individual. Substantive imbalance in transactions with businesses is also a signal of overcharge, if not overreach. Given the prevalence of elder financial abuse by businesses, courts should rigorously apply the mental capacity doctrine to avoid seemingly exploitative transactions and disgorge the ill-gotten gains of exploitation.[246]

[246] *See generally supra* Section I.B. *Contra* Alexander & Szasz, *supra* note 29, at 558–59 (arguing for abolition of the mental capacity doctrine notwithstanding the survival of "unfortunate contracts").

IV. LIMITING AVOIDANCE OF TRANSACTIONS WITHIN CLOSE FAMILIES AND PERSONAL RELATIONSHIPS

Guided by Part III, this Part makes reform proposals to loosen regulation of transactions between potentially incapable individuals and their close relatives or friends. Section IV.A below will elaborate upon a reform proposal to limit the power to avoid transactions for want of capacity. Section IV.B will make further reform suggestions regarding the consequences of successful avoidance.

A. Adoption of a Substituted-judgment Defense

The main reform proposal is to make available to close relatives and friends a *substituted-judgment defense*: the power to avoid a transaction for want of capacity is lost if the capable transacting party can prove (by the usual civil standard of preponderance of evidence) that the incapable individual would have made the transaction in a state of capacity. The proposed defense is an additional hurtle to successful avoidance; after the claimant successfully proves a lack of mental capacity, the capable transacting party can resist avoidance by establishing the proposed defense.

The proposed substituted-judgment defense originates from guardianship law and the law of trusts.[247] In guardianship and trust cases, when a court is

[247] *See generally* UNIF. PROBATE CODE §§ 5-314(a), 5-418(b) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 414 cmt. (Unif. Law Comm'n 2017); RESTATEMENT (THIRD) OF TRUSTS § 11 cmt. f, note to cmt. f, re. subsection (5) (AM. LAW INST. 2003). *See generally* Lawrence A. Forlik & Linda S.

petitioned to make a decision on behalf of an incapable individual, the equitable doctrine of substituted judgment (or its statutory adoption) typically supplies the decisionmaking standard. As Section III.B.4 has explained, this doctrine directs the court to make a decision that the individual would have made herself if she had mental capacity. The proposed defense essentially imports the doctrine of substituted judgment into cases concerning contracts, irrevocable gifts and other lifetime transactions.

1. Economic Intuition

A stylized example can illustrate the economic intuition behind my proposal to adopt the substituted-judgment defense.[248] Suppose that pursuant to a hypothetical transaction, an incapable individual transferred P to the

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Whitton, *The UPC Substituted Judgment/Best Interest Standard for Guardian Decisions: A Proposal for Reform*, 45 U. MICH. J. L. REFORM 739, 742–43 (2012) (surveying financial decision-making standards in American guardianship statutes) [hereinafter, Forlik & Whitton, *A Proposal for Reform*].

[248] This example is a special case of the behavioral-contract-theoretic model that *infra* this Dissertation, Appendix B formally sets up and analyzes. Recent research has developed a behavioral contract theory to incorporate well-documented psychological phenomena into classical contract-theoretic topics, such as moral hazard, adverse selection and incomplete contracts. *See generally* SPIEGLER, *supra* note 201; Köszegi, *supra* note 201. The model developed in *infra* this Dissertation, Appendix B belongs to the class of multi-selves models, which have been widely applied to study a variety of legal issues. *See, e.g.*, Elizabeth S. Scott, *Rational Decisionmaking about Marriage and Divorce*, 76 BA. L. REV. 9, 59–62 (1990) (multi-selves and precommitment mechanisms in marriages); RICHARD A. POSNER, AGING AND OLD AGE 84–95 (1995) (multi-selves and aging); Agnieszka Jaworska, *Advance Directives and Substitute Decision-Making*, THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY § 3 (Mar. 24, 2009), https://plato.stanford.edu/entries/advance-directives/ (multi-selves and surrogate decisionmaking); Jennifer Radden, *Multiple Selves*, *in* THE OXFORD HANDBOOK OF THE SHELF (Shaun Gallagher ed., 2011) (multi-selves and dissociative identity disorder).

capable party. The value of P is the maximum that the individual was willing to transfer in a state of incapacity.[249] If the individual had capacity, then her valuation would be B. For instance, the value of B may reflect the individual's benefit arising from leaving inheritance to a close relative or friend, or from rewarding her caregiver.[250] After the individual passed way, the claimant decides whether to seek avoidance of the transaction.[251] In the event of successful avoidance, the claimant recovers P from the capable transacting party and pays a reasonable price R for what the individual had received pursuant to the avoided transaction. For simplicity, suppose that P and R are sufficiently large so that it would be worthwhile for the parties to incur the litigation costs (or transaction costs, in the case of a settlement) to resolve any capacity dispute.

In this stylized example, if the claimant's power to avoid transactions for want of capacity is unrestricted, then she has an incentive to seek avoidance

[249] This specification captures the scenario of a sophisticated capable transacting party acting to maximize her own payoff with the knowledge that she is transacting with an incapable individual and with superior bargaining power relative to the incapable individual. While this scenario may seem unrealistic and cynical, it captures the problem of elder financial abuse. This problem is most pronounced when the potential abuser—the capable transacting party—is sophisticated, self-interested, well-informed and superior in bargaining. In this scenario, the normative case for maintaining a broad mental capacity doctrine is the strongest. Because I propose to narrow the doctrine, I choose to analyze this scenario to "stack the cards" against me.

[250] *See generally* Sections III.A.2–3.

[251] *See generally* Section III.A.1.

whenever $P > R$. Her marginal benefit of seeking avoidance is $P - R$, which is positive whenever $P > R$. Notice that her incentive to seek avoidance does *not* depend on B—the "true" benefit of the transaction to the incapable individual. In particular, in cases of $B \geq P > R$, the claimant is incentivized to seek avoidance notwithstanding that the individual had benefited from the transaction. In these cases, allowing avoidance tends to generate no benefit, but can give rise to the error costs of avoiding a transaction that advanced the welfare of the incapable individual. Further costs include litigation costs or the transaction costs of reaching a settlement.

This stylized example captures the dynamics of capacity disputes involving relatives and friends. Section III.A has shown that inheritance expectations can drive claimants to seek avoidance of transactions that actually benefitted the incapable individual. The stylized example captures this possibility by specifying $B \geq P > R$: the claimant is incentivized to seek avoidance ($P > R$), even in cases where the transaction was beneficial to the incapable individual ($B \geq P$). The prevailing doctrinal theories mistakenly assumes $P > B$, which inequality means that the transaction was necessarily disadvantageous to the incapable individual.[252] This mistaken assumption can lead to avoidance of transactions that meet the description of $B \geq P$.

[252] *See generally supra* note 120 and *infra* this Dissertation, Appendix B.

The economic intuition behind the proposed substituted-judgment defense is to preclude avoidance in cases where $B \geq P$. In these cases, any claim for avoidance does not reflect the "true" benefit of the transaction to the incapable individual; in notation, $B \geq P$ and $P > R$ together imply $B > R$. Recognizing that avoidance in these cases harms the welfare of the incapable individual, the proposed defense imposes a restriction on the claimant's power of avoidance. Such restriction thus prioritizes the interests of the incapable individual to the extent inconsistent with the claimant's.

2. Verification of Subjective Will and Preferences

The analysis in Section IV.A.1 depends on having sufficient information to ascertain whether the facts and circumstances of a particular case meets the description of $B \geq P$ or $B < P$. Denoting what the incapable individual had transacted to the capable party, P is usually readily observable and verifiable. However, B—the incapable individual's valuation if she had capacity—can be hard to verify. To be sure, there is no need to ascertain the *exact* value of B; one only need to ascertain whether B is smaller than P or not. This Section discusses how the proposed substituted-judgment defense may elicit information regarding B relative to P in practice.

An individual's own choices made in a mentally-capable state are evidence of her subjective will and preferences.[253] To elicit such evidence,

[253] *See generally* Jaworska, *supra* note 248, § 1; RONALD DWORKIN, LIFE'S DOMINION:

the proposed substitute-judgment defense typically looks to the incapable individual's past conduct, transacting patterns, and relational norms.[254] To be sure, capacity disputes often concern one-off transactions that the individual may not have had an opportunity to make in the past.[255] However, most cases concern seniors who have had a life-time of opportunities to make use of estate-planning instruments, such as wills, will substitutes and wish letters.[256] Seniors also tend to have left behind a "memory trail" of informed opinions and value preferences in the minds of their family and friends.[257] Moreover, transactions made in the final years an individual's life may be the final manifestation of property-sharing and gift-giving norms within a close familial or personal relationship.[258] The substituted-judgment defense directs courts to consider the incapable individual's past relational norms and estate plan, in addition to her past conduct and transacting patterns.

AN ARGUMENT ABOUT ABORTION, EUTHANASIA, AND INDIVIDUAL FREEDOM 222–29 (1993) (discussing how the substituted-judgment standard promotes individual autonomy); B. Douglas Bernheim, *Behavioral Welfare Economics*, 7 J. EUR. ECON. ASSO'N 267, 290–93 (2009).

[254] *See, e.g.*, *In re* Brice's Guardianship, 8 N.W.2d 576, 578 (Iowa 1943).

[255] *See, e.g.*, Dubree v. Blackwell, 67 S.W.3d 286 (Tex. Ct. App. 2001).

[256] *See, e.g.*, *In re* Miller, 935 N.E.2d 729, 733–34 (Ind. Ct. App. 2010).

[257] Terry Carney, *Financial Planning Mechanisms for People with Cognitive Impairment in Australia*, *in* SPECIAL NEEDS FINANCIAL PLANNING: A COMPARATIVE PERSPECTIVE 5–6 (Lusina Ho & Rebecca Lee eds., 2019).

[258] *See generally* Leslie, *Enforcing Family Promises*, *supra* note 174, at 564–78.

Dubree v. Blackwell can illustrate how the proposed defense can be applied to limit or deny the power of avoidance.[259] In that case, Lillie—an elderly woman—transferred her house to Edward—her lifelong friend and caregiver—a few months before she died. Lillie also changed her bank account to a joint account with Edward with a right of survivorship. After Lillie passed away, her nephew—who was entitled to inherit her estate—sought to avoid these transactions on grounds of mental incapacity and undue influence.[260] Medical experts and lay witnesses gave conflicting testimonies regarding her mental ability at the time of making the transactions.[261] Refusing to allow avoidance, the Texas court gave significant weight to a long history of property sharing and a close personal relationship between Lillie and Edward.[262] The court practically applied the substituted-judgment defense: Lillie's past dealings with Edward and their relational norms indicated that she would have make the transactions if she had capacity.

To be sure, there are cases involving conflicting evidence of what the

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[259] 67 S.W.3d 286, 288 (Tex. Ct. App. 2001).

[260] *Id.* at 288, 290–91. Within the scope of cases concerning "mentally weak" individuals, the doctrine of undue influence is functionally-equivalent to the mental capacity doctrine. *See supra* Section II.B.

[261] 67 S.W.3d 286, 290–91 (Tex. Ct. App. 2001).

[262] *Id.* at 288.

incapable individual would have wanted if she had capacity.[263] In these cases, there should be a rebuttable presumption in favor of upholding her testamentary intent expressed in any properly-executed will or will substitute. Prevailing American law requires that a valid will (or will substitute) be executed in a mentally-capable state.[264] There are also formality requirements to be satisfied. For example, an attested will needs to be in writing, signed by the individual and attested by several witnesses.[265] Similarly, to create a revocable trust of interest in land—a form of will substitute—the individual needs to put the instrument in writing and sign it.[266] Estate-planning instruments that satisfy formality requirements are solid evidence of the individual's wishes. Formality requirements are also imposed to caution the individual against making ill-considered choices. Moreover, formality requirements may protect the individual from fraud and imposition. Finally, formality requirements function to facilitate standardization, so that testamentary intent expressed in wills (or will substitutes) can be

[263] *See generally* Whitton & Frolik, *Theory and Reality*, *supra* note 189, at 1492–93.

[264] RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1 (AM. LAW INST. 1999).

[265] *See generally id.* § 3.1. Courts may excuse some harmless errors in executing a will. *See generally* § 3.3.

[266] *See generally* RESTATEMENT (THIRD) OF TRUSTS §§ 23, 24 cmt. a (AM. LAW INST. 2003).

distinguished from other expressions of intent.[267] Thus properly-executed wills and will substitutes should be afforded special evidential weight in the application of the proposed substituted-judgment defense.

A variation of the facts in *Farnum v. Silvano* can illustrate the practical operation of the proposed presumption.[268] Recall that in that case, an elderly incapable woman—Viola—sold her house for about half of its fair market value to her young friend—Joseph—in whom she had trust and confidence.[269] Suppose that under her validly-executed will, her nephew Harry was entitled to inherit her house. Harry brought the avoidance claim to recover his expected inheritance. The proposed substituted-judgment defense would enshrine what Viola would have wanted if she had capacity. In cases of conflicting evidence, the proposed presumption would operate to uphold Viola's testamentary intent expressed in her validly-executed will: to gift her house to Harry. The result would be avoidance of the sale to Joseph.

The proposed presumption in favor of upholding testamentary intent expressed in valid wills and will substitutes should nonetheless be rebuttable.

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[267] *See generally* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 3.3 cmt. a (AM. LAW INST. 1999); RESTATEMENT (SECOND) OF CONTRACTS § 72 cmt. c. (AM. LAW INST. 1981); Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941); John H. Langbein, *Substantial Compliance with the Wills Act*, 88 HARV. L. REV. 489, 492–97 (1975).

[268] 540 N.E.2d 202 (Mass. Ct. App. 1989).

[269] *Id.* at 203.

As Professor Adam Hirsch observed, estate-planning instruments made in the past can be obsolete.[270] These "stale" instruments are practically "frozen" upon their makers losing mental capacity.[271] For instance, a will made long before the loss of capacity may fail to provide for a caregiver who primarily gives care to the incapable individual in her final years of life. Yet a desire to reward caregiving may well be consistent with the individual's past transactional preferences before she lost capacity.[272] The will is "stale"; circumstances have changed such that the incapable individual would likely update her estate plan if she had capacity.[273] Thus clear and convincing evidence of "staleness" of the relevant will or will substitute should rebut the proposed presumption. The heightened standard of proof reflects the consideration that due evidential weight should be afforded to testamentary instruments that comply with formality requirements.

Adopting the substituted-judgment defense would not undermine the role of psychiatric evidence. The defense merely adds an additional qualification on the power to avoid transactions for want of capacity; there continues to be

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[270] Adam J. Hirsch, *Text and Time: A Theory of Testamentary Obsolescence*, 86 WASH. U. L. REV. 609 (2009) [hereinafter Hirsch, *Text and Time*].

[271] *Id.* at 615–16.

[272] *See, e.g.*, Dubree v. Blackwell, 67 S.W.3d 286 (Tex. Ct. App. 2001).

[273] *See generally* Hirsch, *Text and Time*, *supra* note 270, at 615–17.

a need to ask the threshold question of whether the individual lacked sufficient mental ability at the time of making the impugned transaction.[274] In other words, the substituted-judgment defense would become a second obstacle to successful avoidance; the threshold question of mental ability remains the first obstacle. After the adoption of the substituted-judgment defense, psychiatric experts may continue to shed light on mental ability.

However, adoption of the substituted-judgment defense would preclude judicial consideration of whether the impugned transaction is abnormal (in the sense of deviating from the transactions of reasonably competent people).[275] What a particular individual would have done if she had capacity depends little on what other people tend to do. In the notation of the stylized example, whether $B \geq P$ or $B < P$ is specific to the individual; B does not depend on other people's preferences and choices. What the individual would have done may well be deviant or eccentric.[276] Unlike evidence of the individual's own conduct, transacting patterns and relational norms, evidence of what other people tend to do has little bearing on whether $B \geq P$ or $B < P$. In other words, evidence of abnormality is largely noise. Hence, contrary to

[274] *See supra* notes 54–58 and accompanying text.

[275] Green, *Major Premise*, *supra* note 12, at 309.

[276] *See generally* Alexander & Szasz, *supra* note 29 at 541, 559 (criticizing considerations of substantive abnormality because they potentially deprive personal autonomy and punish people with mental disorders for deviancy or eccentricity).

prevailing doctrinal theories,[277] introducing the substituted-judgment defense would preclude consideration of abnormality factors.

3. Comparison with the Best-Interest Standard

As an alternative to the substituted-judgment standard, guardianship law and the law of trusts sometimes apply the *best-interest standard* to make a decision on behalf of an incapable individual. This standard directs courts to do what is objectively best for a reasonable or rational person in like circumstances.[278] This standard is highly sensitive to context. While the individual's known wishes are a factor in determining what amounts to her best interest,[279] the court may also consider her financial circumstances, tax liabilities, general economic conditions, and many other factors.[280]

This Section explains why I prefer to qualify the power to avoid transactions for want of capacity with the substituted-judgment standard rather than the best-interest standard. First, the best-interests standard is more

[277] *See generally supra* Sections II.A, II.C.2.

[278] *See generally supra* note 245 and accompanying text; Jaworska, *supra* note 248, § 1; Whitton & Frolik, *Theory and Reality*, *supra* note 189, at 1505–17 (discussing and comparing the best-interest standard, the substituted-judgment standard, as well as their expanded and hybrid versions); Frolik & Whitton, *A Proposal for Reform*, *supra* note 247, at 751–57.

[279] *See, e.g.*, UNIF. POWER OF ATTORNEY ACT § 114 cmt. (Unif. Law Comm'n 2006); UNIF. PROBATE CODE §§ 5-314(a), 5-418(b) (amended 2010).

[280] *See, e.g.*, UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 418(d) (Unif. Law Comm'n 2017).

likely to lead to paternalistic decisions; decisionmakers may act according to their own values, stereotypes and prejudices.[281] *In re Keri* can illustrate this point.[282] In that case, the sons of an elderly incapable woman—Keri—wanted to move her from her own house into a nursing home. Keri's will left her estate to her sons, but they would likely receive nothing if her assets were spent on her nursing-home costs.[283] The sons thus devised a plan to accelerate her eligibility for Medicaid reimbursement of her nursing-home costs. They planned to sell Keri's house and transfer a significant proportion of the proceeds to themselves.[284] The practical effect of the sons' plan was to shift the financial burden of supporting Keri from themselves to the state. An application of the substituted-judgment standard would allow the plan to the extent consistent with what Keri would have wanted if she had capacity.[285] An application of the best-interest standard, on the other hand, can allow courts to rule according to their own assumptions regarding what tends to benefit a reasonable (or rational) person in Keri's position. For instance,

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[281] *See, e.g.*, BRASHIER, *supra* note 58, at 208; Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 633, 641–44 (1982); Linda S. Whitton, *Ageism: Paternalism and Prejudice*, 46 DEPAUL L. REV. 453, 480, 482 (1997).

[282] 853 A.2d 909 (N.J.).

[283] *Id.* at 911–12, 917–18.

[284] *Id.* at 911–12.

[285] *See, e.g.*, *In re* M.L., 879 N.Y.S.2d 919, 920–21, 923 (N.Y. Sup. Ct. 2009).

approving the sons' plan, the New Jersey court in *In re Keri* assumed that it was in the best interest of an incapable individual to increase her children's inheritance at the expense of the state.[286] Some other courts make the opposite assumption to disapprove similar plans.[287] In extreme cases, some courts even act on their own notion of public policy and own view regarding the interests of the taxpayers.[288]

Second, the substituted-judgment standard tends to be more determinate and less informationally-demanding to apply than the best-interest standard. The substituted-judgment standard tends to focus judicial attention upon the incapable individual's past behaviors. By comparison, in addition to past behaviors, the best-interest standard expands the judicial inquiry into a broad range of contextual factors. Moreover, as Professors Elizabeth Scott and Robert Emery argued, the largely-private nature of family life keeps much relevant information hidden from outsiders, such as a court.[289] Another problem pertains to the need to weigh or rank inherently incommensurable

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[286] 853 A.2d 909 (N.J.).

[287] *See, e.g.*, *In re* Estate of Berger, 520 N.E.2d 690, 704 (Ill. App. Ct. 1987) (rejecting gifts to the incapable individual's children notwithstanding tax benefits).

[288] *See, e.g.*, a trial court's statement extracted in *In re* Guardianship of F.E.H., 453 N.W.2d 882, 887 (Wis. 1990).

[289] *See generally* Elizabeth S. Scott & Robert E. Emory, *Gender Politics and Child Custody: Puzzling Persistence of the Best-Interests Standard*, 77 LAW & CONTEMPORARY PROBLEMS 69, 74 (2014) (criticizing best-interest standards).

best-interest factors.[290] Overall, the best-interest standard can only be less determinate and more informationally-demanding to apply than the substituted-judgment standard.

Generating a high degree of indeterminacy, the best-interest standard is ill-suited for resolving inheritance disputes in American jurisdictions. American legislatures have consistently rejected proposals to expand judicial discretion in the law of inheritance.[291] While rules can be informationally-demanding and costly to promulgate ex ante, standards can generate high compliance costs and litigation costs to litigants and high decisional costs to courts.[292] Introducing a substantial judicial discretion to resolve inheritance disputes also heightens the risk of judges acting in accordance with "prejudices—particularly those against traditionally disfavored groups such as unmarried cohabitants, homosexuals and nonmarital children[.]"[293] Thus, being more determinate than the best-interest standard, the substituted-judgment standard is more suitable for resolving inheritance disputes.

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[290] *Id*. at 75.

[291] *See generally* SITKOFF & DUKEMINIER, *supra* note 70, at 569–70.

[292] *See, e.g.*, Kaplow, *supra* note 78.

[293] BRASHIER, *supra* note 58, at 208.

4. Inability to Respect "New" Expressions of Preferences?

Showing great deference to the incapable individual's past conduct, transacting patterns and relational norms, the substituted-judgment standard tends to neglect her transactional preferences expressed in a state of incapacity. If these "new" expressions of preferences contradict the individual's past wishes and behaviors, then the substituted-judgment standard may be subject to the criticism by some Critical Legal Theorists that it may effectuate extreme paternalism[294] and deprivation of personal autonomy and dignity.[295] The tendency to respect the past seems to prioritize the individual's capable "past self" over her incapable "present self".[296]

This Section will defend the proposed substituted-judgment defense against that criticism. First, if adopted to qualify the mental capacity doctrine, the substituted-judgment defense would increase the likelihood of transactions surviving avoidance claims. Critical Legal Theorists criticize courts for paternalistically avoiding, not upholding, transactions affected by

[294] Kennedy, *supra* note 281, at 633, 641–44 (criticizing the mental capacity doctrine as an extreme case of paternalism). Professor Kennedy's criticism in part depends on the understanding that the mental capacity doctrine grants a power of avoidance to the *capable* transacting party, and grants no power to avoid contracts for "necessaries". *Id.* at 633. The modern view among American courts is that the capable transacting party has no power of avoidance, *see supra* note 59 and accompanying text, and that contracts for "necessaries" are voidable, *see generally infra* Section IV.B.2.

[295] Alexander & Szasz, *supra* note 29, at 541.

[296] *See generally* Jaworska, *supra* note 248.

incapacity.[297] Thus the proposed defense avoids their criticism.

Second, adoption of the substituted-judgment defense does not alleviate the need to prove mental incapacity. If the individual was capable of choosing subjectively-beneficial transactions at the time of transacting, then the court should hold that she had capacity at that time; there would then be no occasion for applying the substituted-judgment defense. Critical Legal Theorists are really directing their criticisms at the existing threshold tests of mental incapacity,[298] rather than the qualifications on the resulting power of avoidance. The substituted-judgment defense would become one such qualification, and therefore avoids their criticism.

Third, to remove any possibility of paternalism and deprivation of personal autonomy would require a complete eradication of the mental capacity doctrine. It would also require complete eradication of other functionally-similar doctrines, especially undue influence (when applied to "mentally weak" individuals);[299] eradication of the mental capacity doctrine would have no practical impact if those who seek avoidance could just argue undue influence instead. Such complete eradication would neglect the

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[297] *See* Kennedy, *supra* note 281, at 633, 641–44; Alexander & Szasz, *supra* note 29, at 541.

[298] *See supra* notes 54–58 and accompanying text.

[299] *See generally supra* Section II.B.

alarming problem of elder financial exploitation.[300] Complete eradication would also encourage courts to stretch other doctrines (or invent new doctrines) to resolve cases that would have been covered by the mental capacity doctrine. This happened in the eighteenth and nineteenth centuries, when courts created the cognitive-incapacity test (and the "mental weakness" strand of the undue influence doctrine) due to their dissatisfaction with guardianship law.[301] At the very least, retaining and reforming the mental capacity doctrine force courts to be transparent about their attitude toward mental disorders and elder financial exploitation.

B. Consequences of Successful Avoidance

Section IV.A has argued for the adoption of the substituted-judgment standard to preclude avoidance in cases where the incapable individual would have entered into the impugned transaction if she had capacity. That proposal aims to uphold transactions that meet the description of $B \geq P$ in the stylized example developed in Section IV.A.1: the incapable individual's "true" valuation (B) of what she received pursuant to the transaction is no smaller than what she transacted away (P). This Section now turns to cases where $B < P$.

[300] *See supra* Section I.B.

[301] *See supra* Section II.C.1.

1. Beneficial Goods and Services

A finding that a transaction should be avoided for want of capacity leads to the question of what remedies should follow.[302] The mental capacity doctrine is a double-edged sword; the possibility of avoidance ex post may discourage capable parties from entering into mutually-beneficial transactions with incapable individuals ex ante.[303] This Section proposes to optimize the remedial consequences of successful avoidance to preserve incentives to supply beneficial goods and services.

A modification of the stylized example introduced in Section IV.A.1 can illustrate the economic intuition underlying my present proposal. Suppose that, in the stylized example, the capable transacting party had incurred the costs of C to supply some good or service to the incapable individual. (If such costs were uncertain at the time of supplying the good or service, then let C denote the expected costs.) Suppose further that B—the "true" benefit of the good or service to the incapable individual—was nonetheless smaller than what she transacted away, P. Thus $B < P$; the proposed substituted-judgment defense would not preclude avoidance of the transaction. The successful claimant would recover P from the capable transacting party and would pay a reasonable price R to capable transacting party. The issue is what R should

[302] *See generally supra* notes 76–77 and accompanying text.

[303] *See generally supra* notes 10, 188–90 and accompanying text.

be.

The capable transacting party should be entitled to recover her costs if she can prove (by preponderance of evidence) that such costs were no greater than the benefits of the transaction to the incapable individual; in notation, $R = C$ whenever $B \geq C$. In these cases, the transaction facilitated the provision of some good or service that advanced joint welfare. Although avoidance should be allowed because the incapable individual had paid too much ($B < P$), the capable transacting party should be allowed to recover her costs. Without such recovery, suppliers of beneficial goods and services would be discouraged from benefiting incapable individuals and advancing joint welfare.

The elder-care problem can illustrate the practical implications of these economic arguments. Section III.A.3 has shown that there is a shortage of family caregivers. Care-recipients tend to benefit from receiving care; incentivizing caregiving would promote their individual welfare. Caregiving also promotes joint welfare if the benefits to the care-recipients exceed the costs to the caregivers. Thus, to the extent that a caregiver and a care-recipient have made a transaction with an explicit or implicit intention of facilitating valuable caregiving, welfare considerations would generally caution against avoidance. In some cases, however, the transaction may impose too high a price on the care-recipient (in notation, $B < P$). In these cases, although

avoidance should be allowed (and would not be precluded by the proposed substituted-judgment defense), caregiving could still be joint-welfare-enhancing (in notation, $B > C$). If $B > C$, then welfare considerations would justify allowing the caregiver to recover her costs (C).

To determine whether to allow recovery of C, the court should ask whether the incapable individual would have paid C for what she had received under the avoided transaction, if she had capacity; in notation, whether $B \geq C$ or $B < C$. This question is different from the question of whether the individual would have *made the transaction* if she had capacity; in notation, whether $B \geq P$ or $B < P$.[304] The recovery-of-costs question (whether $B \geq C$) pertains to whether to allow recovery of C notwithstanding avoidance of the transaction, while the avoidance question (whether $B \geq P$) determines whether the transaction should be avoided.

To illustrate the finer differences between the recovery-of-costs question and the avoidance question, consider again *Farnum v. Silvano*, in which an elderly woman sold her house for about half of its market price to her young friend.[305] If asked in that case, the avoidance question would be whether the woman would have sold her house at such a low price if she had capacity.

[304] *See generally supra* Section IV.A.

[305] 540 N.E.2d 202 (Mass. Ct. App. 1989).

The recovery-of-costs question, on the other hand, would be whether the young friend should be allowed to recover the costs of any services provided to the elderly woman. Suppose the young friend could prove that he had indeed provided valuable services, and that the elderly woman would have been willing to pay the costs of providing these services if she had capacity. Then the young friend should be allowed to recover these costs, even if the sale of the house was vitiated.

To be sure, an alternative to the present proposal is to set R = B. If courts could observe and verify the exact value of B, then allowing avoidance and setting R = B would tend to maximize joint welfare. In this hypothetical scenario, the capable transacting party's payoff in the event of avoidance would be B – C (excluding litigation or transaction costs); the same as joint welfare. Hence she would have an incentive to make transactions that advance joint welfare. At the same time, the incapable individual's payoff in the event of successful avoidance would be at least 0. If the incapable individual were to pay R, then she received B and paid R = B. Alternatively and more commonly, if a third-party—the claimant—were to pay R, then the incapable individual received B and paid nothing. Hence setting R = B would not harm the welfare of the incapable individual.

However, the author's proposal to set R = C tends to be less informationally-demanding than proposals to set R = B. The capable

transacting party presumably knows her own costs of transacting, C, and can provide information regarding C to courts and other third parties. On the other hand, there tends to be significant informational challenges to observe and verify B—the exact value the incapable individual would assign to the transaction if she had capacity. As Section III.A.1 has shown, typical capacity disputes concerned potentially incapable individuals who had passed away by the time of litigation. While evidence of her past transacting patterns and preferences may shed light on B *relative* to C (in order to ascertain whether $B \geq C$), such evidence would unlikely be sufficient to enable a precise inference of the exact value of B. Moreover, there is no obvious proxy of B. Market prices are usually poor proxies of B in cases concerning relatives and friends; transactions involving relatives and friends do not take place in a marketplace.[306] The price P stipulated by the avoided transaction also tends to be a poor proxy of B because of the antecedent finding that the incapable individual would not have paid P if she had capacity.[307] Hence the author proposes to set $R = C$ rather than $R = B$.

[306] *See, e.g.*, *supra* notes 188–90 and accompanying text (comparing family-and-friend caregivers and professional caregivers). *See also supra* Section III.B.1 (arguing that cognitive deficiency and other forms of mental limitations cause inefficiencies in marketplaces in which incapable individuals transact with businesses).

[307] *See generally supra* Section IV.A.

2. Necessaries

In many cases, there may be insufficient evidence to ascertain whether B ≥ C or B < C. In particular, caregiving provided in a familial or personal relationship—which is largely private—can be hard to describe and document.[308] Insufficient records can prevent family-and-friend caregivers from proving the value of their services to courts or other third parties. Focusing on cases of evidential deficiency, this Section will argue that the mental capacity doctrine should still allow recovery of costs if the avoided transaction facilitated the provision of necessities of life to the incapable individual.

The traditional formulation of the mental capacity doctrine has a *necessaries exception*: transactional incapacity grounds only a severely limited power to avoid contracts for the supply of necessities of life.[309] Dating back to mediaeval English law, the necessaries exception aims to preserve incentives to supply necessaries to incapable individuals.[310] Centuries of case law has classified some goods and services as objective necessaries; these

[308] Scott & Emery, *supra* note 289, at 74.

[309] *See generally* 5 WILLISTON & LORD, *supra* note 22, §§ 9:18–21, 10:7. *Contra*. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 16 cmt. g, reporter's note e, 33 cmts. d (AM. LAW INST. 2011) (rejecting "necessaries" as a distinct doctrinal category).

[310] 2 COKE, *supra* note 84, § 172.a.

include food, clothing, housing, and medical services.[311] Courts typically respect the existing classification unless there is evidence proving that the relevant good or service is not subjectively beneficial to the incapable individual.[312] Hence, in the presence of evidential deficiency, the necessaries exception sets a majoritarian default position that tends to reduce the potential error costs of avoidance without much sacrifice of its potential benefits.

There remains the question of what suppliers of necessaries should recover from the incapable individual (or her estate). In the traditional view, the necessaries exception denies the power to avoid contracts for necessaries, so the incapable individual is liable to pay the contract price for the necessary, even if she has not yet received it.[313] Modern American law generally allows avoidance, but imposes on the incapable individual (or her estate) a liability in restitution to pay for any necessaries that she has already received;[314] such restitutionary liability is backward-looking, and does not arise if neither

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[311] *See generally* 5 WILLISTON & LORD, *supra* note 22, §§ 9:19–21, 10:7.

[312] *See generally id.* §§ 9:19, 10:7; RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 33 cmt. d (AM. LAW INST. 2011).

[313] 5 WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 418 (2d ed. 1937); 6 WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 632 (1924); 8 WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 51–52 (1925); 2 COKE, *supra* note 84, § 172.a.

[314] *See generally* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 33 cmts. c, d, reporter's notes c, d (AM. LAW INST. 2011); 5 WILLISTON & LORD, *supra* note 22, §§ 9:18–21, 10:7 (citations omitted).

contracting party has performed.[315] Under the Restatement (Third) of Restitution and Unjust Enrichment, the incapable individual's (or her estate's) restitutionary liability is a matter of judicial discretion, which depends on factors such as her subjective valuation (to the extent ascertainable), market prices, the costs of supplying the necessary, any inequitable conduct, and any knowledge of the incapacity.[316]

The capable transacting party's costs of supplying the necessary should be the preferred measure of recovery. As Section IV.B.1 has argued, when an avoided transaction facilitated the supply of a good or service that generated more benefits to the incapable individual than costs to the supplier, the supplier should be allowed to recover such costs. A cost-based measure of recovery promotes the incapable individual's own welfare and as well as the joint welfare of all contracting parties. This argument applies to transactions for the supply of necessaries; necessaries are just a class of goods and services that benefit the incapable individual from an objective perspective, subject always to any evidence of subjective valuation indicating the contrary. Unless

[315] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 16 cmt. a, 33 cmt. a (AM. LAW INST. 2011) (No restitutionary liability arises from a wholly-executory contract.). In modern transactional capacity cases, the main difference between the historical and modern views pertains to how to measure the "price" of the necessary. This is because the capable transacting party typically has already performed her contractual obligation (if any) by the time of litigation. *See generally supra* Section III.A; *infra* this Dissertation, Appendix A (survey of modern cases).

[316] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 cmt. a, cmt. e, §§ 49, 54 (AM. LAW INST. 2011).

there is evidence showing that the incapable individual would not have paid the costs of supplying the particular necessary if she had capacity,[317] such costs should be the preferred measure of recovery.

The proposed cost-based measure of recovery is more determinate than the flexible approach under the Restatement (Third) of Restitution and Unjust Enrichment.[318] First, if the capable transacting party can provide sufficient evidence to prove her costs of supplying the necessary, then she can just recover such costs under the proposed measure; the judicial inquiry is narrowed to one factor—the capable party's costs—and there is no residual discretion to substitute an alternative measure. By comparison, the flexible approach under the Restatement would expand the scope of judicial inquiry to cover a broad range of contextual factors and alternative measures.[319] Second, if the capable party cannot provide sufficient evidence to prove her costs, then the proposed cost-based measure would look for the best *approximation* of her costs. In these cases, the proposed cost-based measure would leave room for judicial discretion, but no broader than under the

[317] *See supra* Section IV.A.

[318] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 16 cmt. a, cmt. e, §§ 49, 54 (AM. LAW INST. 2011).

[319] *See id.* §§ 49, 54.

Restatement.[320] Thus, in these cases, the proposed measure is no more indeterminate, no more complex and no more informationally-demanding to apply than the Restatement approach.

C. Summary of Proposed Reforms

Taking a law-and-economics approach, this Part proposes reforms to the mental capacity doctrine in relation to transactions involving close relatives and friends. The main proposal is to introduce a substituted-judgment defense to qualify the power to avoid transactions for want of capacity. This defense precludes avoidance in cases where the incapable individual would have made the impugned transaction if she had capacity. The other reforms focus on cases where an avoided transaction facilitated the supply of a good or service (especially a necessity of life) that generated more benefits to the incapable individual than costs to the capable transacting party. In these cases, the capable party should be allowed to recover her costs. These reforms all aim to promote the welfare of the incapable individual and the joint welfare of all transacting parties.

In sum, under the proposed reforms, the mental capacity doctrine would take the following form when applied to a transaction between a potentially incapable individual and her close relative or friend:

[320] *See id.* §§ 49, 54.

(1) The impugned transaction should not be avoided if the individual had mental capacity at the time of making the transaction.

(2) Even if the individual lacked mental capacity, the transaction should still not be avoided if the capable transacting party can establish the substituted-judgment defense: the incapable individual would have made the transaction if she had capacity.

(3) If the individual lacked mental capacity and the capable party fails to establish the substituted-judgment defense, then the transaction should be avoided. The capable party should return any benefit that she received pursuant to the avoided transaction. Her recovery from the incapable individual (or the individual's estate) are as follows:

   a. Suppose the capable party can prove that the incapable individual would have paid the costs of supplying her benefits under the avoided transaction, if she had capacity. In this case, the capable party should recover such costs.

   b. Suppose the capable party supplied a necessary to the incapable individual pursuant to the avoided transaction. Then the capable party should recover the costs of supplying the necessary.

   c. The capable party does not recover in other cases.

CONCLUSION

The mental capacity doctrine is a double-edged sword. On the one hand,

the doctrine grants a power to avoid exploitative transactions and disgorge the ill-gotten gains of exploitation. On the other hand, a survey of modern cases reveals that avoidance claims were typically brought by a claimant who expected to inherit from the potentially incapable individual.[321] Rather than the individual's interests, the claimant could be driven by a desire to increase her expected inheritance. Yet prevailing doctrinal theories mistakenly assume that the interests of the claimant and of the potentially incapable individual are necessarily aligned.[322] Theoretical and normative considerations are meant to guide the exercise of a substantial judicial discretion to assess the costs and benefits of avoidance on a case-by-case basis.[323] Distorted by flawed theoretical considerations, the mental capacity doctrine tends to harm the welfare of many seniors by unduly limiting their ability to benefit their close relatives and friends, reward informal caregiving, and recruit their preferred caregivers.

Taking a law-and-economics approach, this Chapter proposes to limit the operation of the mental capacity doctrine in close families and personal relationships. The prevailing doctrinal theories pay insufficient attention to the important differences between transactions involving close relatives and

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[321] *See generally supra* notes 149–50 and accompanying text.

[322] *See generally supra* Section III.A.1.

[323] *See generally supra* Section II.C.2.

friends on the one hand, and transactions with businesses on the other hand. Most cases transactions involving close relatives and friends take place in the estate-planning context. In this context, a broad power of avoidance tends to incentivize avoidance claims that may defeat the testamentary intent of the potentially incapable individual. In contrast, avoidance claims against transactions with businesses (such as nursing-home contracts and annuities) are unlikely to affect the estate plan of the potentially incapable individual. The author thus proposes to limit the extent of avoidance of transactions involving close relatives and friends. When applied to these transactions, the mental capacity doctrine should not generate a power of avoidance if the incapable individual would have made the transaction in a state of capacity. However, the doctrine should continue to apply with full rigor to transactions between potentially incapable individuals and profit-driven businesses.

In sum, the problem of elder financial abuse ought to be resolved in a way that advances the welfare of the elderly, as defined by their own will and preferences. Too broad and indeterminate, the mental capacity doctrine in prevailing American law is ill-suited for resolving typical capacity disputes in the era of aging population. The doctrine ought to be reformulated to deter and sanction elder financial abuse without undue intrusion into close families and personal relationships.

Chapter 2: Mental Capacity in American Fiduciary Law

Elder Financial Abuse: Fiduciary Law and Economics,

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(forthcoming 2020)

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INTRODUCTION

Consider the following hypothetical:[1] Mary, a ninety-seven-year-old woman, entrusted the management of her bank accounts to her son, Chauncey. Just before Christmas, Chauncey took money out of Mary's accounts to buy himself and her grandchildren gifts. Mary was in the habit of making Christmas gifts to family members for as long as everyone could remember. After Mary passed away, her daughter Fern became entitled to a share of Mary's estate. Fern now sues Chauncey and the grandchildren to recover those gifts bought with Mary's money. The question that this Chapter

[1] This hypothetical is based on *In re* Tillman, 137 N.E.2d 172 (Ohio Prob. Ct. Darke Cty. 1956).

aims to resolve is who should succeed in this and similar cases.

The issues presented in the above hypothetical deeply divide legislatures, courts and scholars in the United States. Like most fiduciaries, Chauncey had a significant discretion over the management of Mary's property. Presuming the worst from him,[2] orthodox fiduciary law imposes rigorous and comprehensive duties. Most demanding among these is the duty of *undivided loyalty*: that Chauncey must avoid a conflict of his duties to Mary and his personal interests.[3] Many courts would inflexibly enforce that duty to hold Chauncey liable for using his position to enrich himself and the grandchildren.[4] It is irrelevant that Mary was in the habit of making similar gifts in the past. The result is that Fern successfully recovers the gifts (or their value) from Chauncey; the grandchildren also can be liable in some circumstances.[5] The apparent harshness of this result has led many legislatures and courts to ease the burden of fiduciary regulation. For example, many states have enacted statutory provisions to permit small gifts,

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[2] *See generally* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 944, 951–52 (2005).

[3] *See generally infra* Section I.C.

[4] *See generally infra* Section I.C.

[5] *In re* Tillman, 137 N.E.2d 172, 175–77 (Ohio Prob. Ct. Darke Cty. 1956). *See infra* notes 61–62 and accompanying text.

while others go further to abrogate the duty to avoid conflicts of interest.[6] Scholars and practitioners consistently call for clarification of fiduciary duty,[7] even though clarification may be found in at least three modern Restatements.[8]

How best to regulate fiduciaries who provide property-management services to the elderly is the puzzle that animates this Chapter. Guardianships and powers of attorney commonly facilitate provision of these services. Under prevailing American law, if an adult is mentally incapable of managing her property,[9] then a court may appoint a *guardian* to manage her property

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[6] *See generally infra* Section I.D. These are jurisdictions that adopt UNIF. POWER OF ATTORNEY ACT (Unif. Law Comm'n 2006). *See generally Legislative Fact Sheet – Power of Attorney*, Unif. Law Comm'n, http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Power%20of%20Attorney (last visited Dec. 8, 2018).

[7] *See, e.g.*, Nina A. Kohn, *Elder Empowerment as a Strategy for Curbing the Hidden Abuses of Durable Powers of Attorney*, 59 RUTGERS L. REV 1, 15–17, 52 (2006); Lisa S. Whitton, *Durable Powers as an Alternative to Guardianship: Lessons We Have Learned*, 37 STETSON L. REV. 7, 25–27 (2007) (discussing survey responses on fiduciary duties of agents).

[8] *See* RESTATEMENT (THIRD) OF AGENCY §§ 8.03, 8.05 (AM. LAW INST. 2006); RESTATEMENT (THIRD) OF TRUSTS § 78 (AM. LAW INST. 2007); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 (AM. LAW INST. 2011).

[9] A functional concept in law, *mental incapacity* typically means insufficient mental ability to undertake some task. *See generally* Am. Comm'n Law & Aging, *Capacity Definition & Initiation of Guardianship Proceedings*, AM. BAR ASS'N, http://www.americanbar.org/content/dam/aba/administrative/law_aging/chartcapacityandinitiation.authcheckdam.pdf (last visited Dec. 8, 2018) (surveying definitions of incapacity in American guardianship statutes). Courts tend to have "maximal flexibility" in determining whether an individual is mentally-incapable. PAUL S. APPELBAUM & THOMAS G. GUTHEIL, CLINICAL HANDBOOK OF PSYCHIATRY & THE LAW 181 (4th ed., 2007). Clinical evaluation typically examines the individual's awareness of situation, factual understanding of issues, appreciation of likely consequences, rational manipulation of information, functioning in her

for her, especially when her needs cannot be met by a less restrictive alternative.[10] The guardianship regime can generate cost, emotional stress and embarrassment, as well as deprive liberty and autonomy.[11] Individuals who anticipate the possibility of mental or physical decline in the future may avail themselves of alternative legal regimes. In particular, while she is mentally-capable, an individual may execute a durable *power of attorney* to appoint an agent to act on her behalf. The power of attorney starts to operate, or remains valid, when the individual becomes mentally-incapable.[12]

Fiduciary law can deter and sanction elder financial abuse by guardians and agents—an alarming problem in an era of aging population.[13] While the private nature of elder financial abuse makes it difficult to obtain reliable statistics, one nationwide survey suggests that every year, about 5.2 percent of Americans age sixty years or over potentially experience financial

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own environment, and the extent of demands on her. *See id.* at 181–82.

[10] *See infra* note 32 and accompanying text. Guardians who manage property are also often called *conservators*. *See, e.g.*, UNIF. PROBATE CODE § 5-401 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 401 (Unif. Law Comm'n 2017). Because this Chapter only concerns property managers, all "guardians" discussed here refer to guardians who manage property.

[11] *See infra* note 141; David J. Feder & Robert H. Sitkoff, *Revocable Trusts and Incapacity Planning: More than Just a Will Substitute*, 24 ELDER L.J. 1, 27, 28 (2016).

[12] UNIF. POWER OF ATTORNEY ACT § 104 (Unif. Law Comm'n 2006); RESTATEMENT (THIRD) OF AGENCY § 3.06 cmt. b (AM. LAW INST. 2006).

[13] *See infra* Section I.A.

mistreatment by a family member.[14] Some even describe a power of attorney as "a license to steal".[15] Although tort law or criminal law may deter and sanction a financial abuser, she may still have an incentive to engage in misconduct if her ill-gotten gain exceeds her expected tortious or criminal liability. Fiduciary law can disgorge her ill-gotten gain;[16] it deters and sanctions the abuser by taking away what motivated her to engage in misconduct in the first place.

Taking a law-and-economics approach, this Chapter aims to optimize the fiduciary duties of guardians and agents in order to promote welfare. The main claim is that orthodox fiduciary law unnecessarily deters guardians and agents from supporting elderly incapable individuals to pursue valuable other-regarding goals and preferences. This is because the pursuit of other-regarding goals and preferences benefits someone other than the incapable individual—a violation of the sole-interest duty of loyalty. Most other fiduciaries could have avoided liability by obtaining the fully-informed

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[14] Ron Aciero et al., *Prevalence and Correlates of Emotional, Physical, Sexual, and Financial Abuse and Potential Neglect in the United States: the National Elder Mistreatment Study*, 100 AM. J. PUBLIC HEALTH 292, 292, 296 (2010). These authors broadly defined "financial mistreatment by family member" to mean family member "spent money", "did not make good decisions", "did not give copies", "forged signature", "forced respondent to sign a document" or "stole money". *Id.* at 294. *See also id*. at 292 (summarizing the consistent results of earlier surveys).

[15] Whitton, *supra* note 7, at 29.

[16] *See generally* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 16, 33 (AM. LAW INST. 2011).

consent of their beneficiaries.[17] However, an incapable individual typically cannot give a valid consent. Thus, deterring the pursuit of other-regarding preferences, orthodox fiduciary law can harm the welfare of elderly incapable individuals. This is particularly problematic in cases concerning close families and personal relationships.[18] Moreover, in these cases, orthodox fiduciary law fails to recognize that biological and affective bonds, as well as social and moral norms, already partially disincentivize close relatives and friends from committing misconduct.[19]

This Chapter thus proposes to loosen the fiduciary regulation of close relatives and friends in order to accommodate strong intrinsic bonds and other-regarding preferences.[20] In particular, fiduciary law ought to permit those conflicts of interest that the elderly incapable individual would have authorized if she was mentally-capable.[21] On the other hand, in cases where

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[17] *See infra* Section I.E.

[18] *See infra* Section II.B.

[19] *See infra* Section II.B.2.

[20] While the present analysis focuses on guardians and agents, it can be extended to other fiduciaries who serve incapable individuals. For example, a person can become a de facto fiduciary on the basis of a relationship of trust and confidence. *See, e.g.*, McHugh v. Jeffries, 183 S.W.2d 309 (Ark. 1944); Eagerton v. Fleming, 700 P.2d 1389 (Ariz. Ct. App. 1985). *See also* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 cmt. a (AM. LAW INST. 2011) (restitutionary liability arising from misconduct in a relationship of trust and confidence).

[21] *See generally infra* Section III.A.

intrinsic bonds and other-regarding preferences are weak, the need to deter and sanction misconduct calls for strict fiduciary regulation. These cases mainly concern professional guardians and agents who charge fees for their services. Hence, for professionals, I propose to strengthen fiduciary regulation by harnessing their reputational concerns.[22]

This Chapter should be interesting to several groups of scholars and practitioners. Economic analysis of fiduciary law neglects the special issues arising from mental incapacity;[23] this Chapter fills in that gap. While some disability-rights and doctrinal scholars have studied the fiduciary duties of guardians and agents,[24] they have not considered the law's potential to align or misalign incentives. Moreover, the present subject matter falls squarely within the interests of those who work in trusts and estates, and elder law. Finally, this Chapter offers guidance and reform proposals to legislatures—which are regularly pressed to reform guardianship law and agency law—and to courts—which regularly resolve disputes involving property managers of the elderly.

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[22] *See generally infra* Part IV.

[23] *See generally infra* Sections I.B, I.E, II.A–B.

[24] *See, e.g.*, Robert B. Fleming & Rebecca C. Morgan, *Standards for Financial Decision-making: Legal, Ethical, and Practical Issues*, 2012 UTAH L. REV. 1275; Kohn, *supra* note 7; Nina A. Kohn, *Fiduciary Principles in Surrogate Decision-Making*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW ch. 13 (Evan J. Criddle, Paul B. Miller, Robert H. Sitkoff eds., 2019); Whitton, *supra* note 7.

Part I below offers an overview of fiduciary law and its economic foundations. Part II argues that existing fiduciary law and theory fail to accommodate the special characteristics of mental capacity cases. Parts III and IV then propose reforms to promote welfare.

I. FIDUCIARY REGULATION OF GUARDIANS AND AGENTS

This Part will first discuss the two main legal devices designed to facilitate provision of property-management services to mentally-incapable individuals: guardianship and power of attorney. It will then introduce the standard economic theory of fiduciary relationships, and use that theory to explain the two main models of fiduciary law in American jurisdictions.

A. Property Managers of Elderly Incapable Individuals

Population aging is old news. Since the last century, the percentage of Americans age sixty-five or over [hereinafter, seniors] has tripled. The population of seniors is estimated at 43.1 million in 2016 (15.2 percent of the population), and is projected to reach ninety-six million by 2060.[25] In the modern economy, the stereotype that seniors are "frail, out of touch, burdensome or dependent" is outdated.[26] Physical or mental decline

[25] U.S. ADMIN. COMMUNITY LIVING, 2017 PROFILE OF OLDER AMERICANS 1–2 (2018) https://acl.gov/sites/default/files/Aging%20and%20Disability%20in%20America/2017OlderAmericansProfile.pdf.

[26] WORLD HEALTH ORGANIZATION, WORLD REPORT ON AGEING AND HEALTH 2015 at 10, 16 (2015), https://www.who.int/ageing/events/world-report-2015-launch/en/.

nonetheless remains prevalent. In particular, recent studies estimate that Alzheimer's dementia affects about 5.5 million (one in ten) seniors.[27] "[One in three] seniors dies with Alzheimer's or another dementia. It kills more than breast cancer and prostate cancer combined."[28] The combination of longevity and mental decline can explain the increasing demand for property-management services to mentally-incapable seniors.[29]

The state has long claimed a power as *parens patriae*—meaning "parent of the nation"—to make decisions on behalf of mentally-incapable individuals. The formal legal institution created by that power is commonly called *guardianship*. To create a guardianship under prevailing American law, the relevant state court (typically the probate court) must first be satisfied that the individual lacks mental capacity to manage some aspect of her life or property. Mental capacity is a legal and functional concept that accounts for cognitive functioning, the specific tasks to be undertaken, and concerns for autonomy and protection.[30] The presence of some mental or physical disorder in the medical sense is typically neither sufficient nor necessary for the

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[27] *Facts and Figures*, ALZHEIMER'S ASS'N, https://www.alz.org/alzheimers-dementia/facts-figures (last visited Dec. 8, 2018).

[28] *Id.*

[29] *See, e.g.*, Feder & Sitkoff, *supra* note 11, at 27.

[30] *See supra* note 9 and accompanying text.

individual to lack mental capacity in the eyes of the law.[31] Once the individual is found incapable of managing some aspect of life or property, the court has a discretion to appoint a substitute decision-maker—the guardian—to make decisions regarding that aspect of life or property. To safeguard the autonomy and dignity of the individual, modern guardianship statutes tend to mandate that guardianship be created only as a last resort, when there is no less restrictive alternative to facilitate the decision-making assistance needed.[32] Most individuals subject to guardianship are seniors experiencing cognitive disorders, especially dementia.[33]

While a guardianship is officially created, a power of attorney is a private instrument through which an individual—the *principal*—authorizes another person—the *agent*—to act on behalf of the principal.[34] There was an old

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[31] *See* APPELBAUM & GUTHEIL, *supra* note 9, at 181. *See also* AM. PSYCHIATRIC ASS'N, DIAGNOSTIC AND STATISTICAL MANUAL OF MENTAL DISORDERS xiii–xl (5th ed., 2013) (providing a standard list of mental disorders).

[32] *See, e.g.*, UNIF. PROBATE CODE § 5-401 (amended 2010). While the guardianship system under *id.* is "fairly representative", Feder & Sitkoff, *supra* note 11, at 27, the Uniform Law Commission recently promulgated UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 401(b) (Unif. Law Comm'n 2017). To cover both the representative statute and the modern trend, this Chapter cites the relevant sections of both of these uniform legislation.

[33] *See, e.g.*, Jean Callahan, Requel Malina Romanick & Angela Ghesquiere, *Guardianship Proceedings in New York State: Findings and Recommendations*, 37 BIFOCAL 83, 85–86 (2016); *In re* Caminite (Amelia G.), 57 N.Y.S.3d 724, 726 (N.Y. Nassau Cty. Ct.). Another common class of individuals subject to guardianship are those who have suffered some brain injury, and the guardianship is created to manage the tort judgment or settlement arising from that injury. *See, e.g.*, *In re* Estate of O'Hare, 34 N.E.3d 1126 (Ill. Ct. App. 2015); *In re* Tinsmon, 79 N.Y.S.3d 854 (N.Y. Surr. Ct. 2018).

[34] UNIF. POWER OF ATTORNEY ACT § 102(1) (Unif. Law Comm'n 2006); RESTATEMENT

common law rule that avoids the agent's authority upon the principal losing mental capacity. The rationale was that the agent could only do what the principal was able to do. Abolishing that common law rule, modern power of attorney statutes permit a *durable* agency to commence, or remain valid, upon the principal losing mental capacity.[35] These statutes allow individuals to choose their own representatives in the event of losing mental capacity, and to avoid the cost, emotional stress and embarrassment of invoking the official guardianship regime.[36] In fact, the principal can even stipulate a sui generis definition of "incapacity" and provide a procedure for determining whether that definition is met.[37]

B. Economic Foundations of Fiduciary Law

The economic theory of relational contracts provides a framework for understanding the problem of misuse of power by guardians and durable agents. This Section will introduce the key components of that framework: the guardian or agent's broad discretion; a lack of satisfactory monitoring mechanisms; and the resulting moral hazard problem. Sections I.C–E below

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(THIRD) OF AGENCY § 1.01 (AM. LAW INST. 2006).

[35] UNIF. POWER OF ATTORNEY ACT § 104 (Unif. Law Comm'n 2006); RESTATEMENT (THIRD) OF AGENCY § 3.06 cmt. b (AM. LAW INST. 2006).

[36] *See, e.g.*, Feder & Sitkoff, *supra* note 11, at 28–30.

[37] *See, e.g.*, *id.* at 42–43 (citations omitted).

will use this framework to explain how fiduciary law can deter and sanction misconduct.[38]

1. Broad Fiduciary Discretion

In a fiduciary relationship, the fiduciary tends to have a broad discretion over how to provide her services. At the time of creating the relationship, the creator is unlikely to give comprehensive, rule-like instructions to the fiduciary. This reflects the reality that it is impossible to anticipate all future contingencies, and that it is prohibitively costly to account for all those contingencies that can be anticipated. In other words, the "contract" that governs the fiduciary relationship is incomplete, leaving the fiduciary to respond to unaccounted-for contingencies by exercising her discretion.[39]

For example, at the time of drafting an order to appoint a guardian, the

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[38] This Section adopts the "agency costs" framework. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Economic theories of fiduciary law typically use the "agency costs" framework. *See, e.g.*, Elizabeth S. Scott & Robert E. Scott, *Parents as Fiduciaries*, 81 VA. L. REV. 2401 (1995) (on parents' fiduciary duties as mandatory law); Robert H. Sitkoff, *An Economic Theory of Fiduciary Law*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 197 (Andrew S. Gold & Paul B. Miller eds., 2014) (on fiduciary duties as penalty-defaults). An alternative economic theory conceives fiduciary law as supplying potentially efficient solutions to holdup problems. *See* Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. TORONTO L.J. 299 (1993); Richard R. W. Brooks, *Incorporating Race*, 106 COLUM. L. REV. 2023 (2006). *See generally* Richard R. W. Brooks, *The Economics of Fiduciary Law*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW ch. 35 (Evan J. Criddle, Paul B. Miller, Robert H. Sitkoff eds., 2019) (discussing various economic theories of fiduciary law).

[39] Sitkoff, *supra* note 38, at 199. *See also* Scott & Scott, *supra* note 38, at 2417 (Performance of caring duty is complex and subject to uncertainties, and requires responses to contingencies as they arise.).

court is unable to give rule-like instructions that leave the guardian with no discretion regarding how to respond to all future contingencies. Satisfactory property-management (or care-taking) requires the guardian to perform a broad range of tasks in the light of changing circumstances. Even a simple task like buying groceries requires a comparison of prices, which differ across grocery stores and fluctuate over time; it would be prohibitively costly and unrealistic for the court to tell the guardian exactly where to shop and how much to spend. As predicted by economic theory, the available empirical observations suggest that courts typically give guardians a broad discretion.[40]

For similar reasons, at the time of drafting a durable power of attorney, the drafter is unlikely to give rule-like instructions telling the agent exactly what to do in every eventuality that may arise in the future. Nothing prevents the power of attorney from containing rule-like instructions in respect of *some* eventualities, but it would be prohibitively costly and unrealistic to cover *all* eventualities.

2. Ineffective Monitoring

Fiduciaries are typically subject to limited or no monitoring. First, that

[40] *See, e.g.*, Alison Barnes, *The Liberty and Property of Elders: Guardianship and Will Contests as the Same Claim*, 11 ELDER L.J. 1, 7–8 (2003) [hereinafter Barnes, *The Liberty and Property of Elders*]; Leslie Salzman, *Guardianship for Persons with Mental Illness–A Legal and Appropriate Alternative?*, 279 ST. LOUIS U.J. HEALTH L. & POL'Y 279, 294 (2011); Lawrence A. Frolik, *Guardianship Reform: When the Best is the Enemy of the Good*, 9 STAN. L. & POL'Y REV. 347, 352–53 (1998).

the beneficiary lacks the specialized skills necessary to take the relevant actions without assistance is often the very reason of engaging the fiduciary; the same reason prevents the beneficiary from effectively monitoring the fiduciary.[41] Second, any observable and verifiable output tends to be imperfectly probative of the fiduciary's unmonitored actions. What is typically observable and verifiable is some imperfect signal of the fiduciary's actions, such as incomplete reports.

The problem of ineffective monitoring affects guardianships and agency relationships. First, in the case of guardianship, the individual subject to guardianship lacks mental capacity; this tends to place significant restrictions on her own monitoring efforts. While modern guardianship statutes increasingly provide for public monitoring by courts or state agencies,[42] they typically remain a recipient of information proffered by the parties.[43] Limited funding, heavy caseloads and shortages in staffing are all constraints that

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[41] Sitkoff, *supra* note 38, at 199. *See also* Scott & Scott, *supra* note 38, at 2419–21 (discussing the limits of monitoring mechanisms in the family context).

[42] ADMIN. CONF. U.S., SSA REPRESENTATIVE PAYEE: SURVEY OF STATE GUARDIANSHIP LAWS AND COURT PRACTICES 21–22 (Dec. 24, 2014), https://www.acus.gov/report/ssa-representative-payee-survey-state-guardianship-laws-and-court-practices. *See also id.* at 21–22 (almost nine-tenth of respondents to survey answering all or most guardianship-of-property cases require inventory filing and annual financial accounting).

[43] Alison Barnes, *The Virtues of Corporate and Professional Guardians*, 31 STETSON L. REV. 941, 980–82 (2002) [hereinafter Barnes, *Corporate and Professional Guardians*].

prevent courts or state agencies from engaging in extensive monitoring.[44] For instance, about one-fifth of the respondents to a 2014-survey of American guardianship law and practice answered that financial accountings by guardians were not completely audited or evaluated.[45]

Second, ineffective monitoring is also a problem in the typical agency relationship.[46] The agent continues to act when the principal loses mental capacity. Public monitoring is also limited or non-existent, given the private nature of the agency relationship.[47]

3. Moral Hazard

The combination of broad discretion and ineffective monitoring suggests that the fiduciary may exploit the problem of *moral hazard*: the exact action taken by the fiduciary—such as any actual wrongdoing—can be hidden from others.[48] Moreover, the true costs and benefits of the fiduciary's chosen action are usually not fully-known to others; this prevents an accurate

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[44] *Id*. at 980–84.

[45] ADMIN. CONF. U.S., *supra* note 42, at 25.

[46] Kohn, *supra* note 7, at 38. *See also id.* at 42–45, 52 (proposing to require agents to communicate with their elderly principals in order to promote better monitoring and participation by these principals).

[47] *See generally infra* notes 71, 298 and accompanying text (discussing the accounting and reporting duties of agents).

[48] Sitkoff, *supra* note 38, at 199.

inference of the action taken by the fiduciary based on her financial gains and losses alone. *Assuming* her interests do not align perfectly with her beneficiary's, the fiduciary has incentives to exploit the moral hazard problem.[49]

In re Conservatorship of Smith v. Vandevort illustrates the moral hazard problem.[50] In that case, a long-term partner and caregiver of an elderly woman became her guardian of property when she lost mental capacity. After taking his office, the guardian opened a joint bank account with the woman, and started moving money from the woman's own accounts into that joint account. The motive behind these actions was that upon the woman passing away, the guardian would become the sole owner of the joint account, while the woman's heirs would become entitled to the accounts in her own name.[51] There was a problem of moral hazard because no one other than the guardian would know for sure whether he had actually overreached to get the woman to open the joint account with him. The guardian's financial gain alone was insufficient to support an inference of actual wrongdoing; the woman might well have wished to benefit her guardian, who was her caregiver and long-

[49] *Id.* at 199. *See infra* Part II (explaining and challenging this assumption).

[50] 237 So.3d 852 (Miss. Ct. App. 2017) (reversing and remanding trial court's summary dismissal of breach-of-fiduciary duty claim).

[51] *Id*. at 855–57.

term partner.

C. Prohibition of Conflicts of Interest

To deter and sanction exploitation of the moral hazard problem, American jurisdictions impose fiduciary duties on guardians and agents. This Section introduces the strict model of fiduciary law, which is based on the fiduciary duties of trustees.[52] This model represents the orthodoxy for both guardians and agents.[53] Section I.D below will discuss the modern trend to adopt a relaxed model for agents.

Jurisdictions that follow the strict model of fiduciary law impose rigorous and comprehensive duties on guardians and agents. The most demanding of these is a *duty of undivided loyalty*. Subject to some narrow exceptions,[54] the duty of loyalty prohibits the guardian or agent from acting other than in the *sole* interest of the incapable individual. In particular, the guardian or agent breaches her sole-interest duty by entering into transactions that involve a

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[52] A *trustee* holds the legal title of some property for the benefit of one or more other person, or for the benefit of charity. RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. a (AM. LAW INST. 2012). Guardians and agents are not trustees because they do not hold legal title of the incapable individual's property.

[53] *See* UNIF. PROBATE CODE § 5-418(a) (amended 2010) (applying trust fiduciary law to guardians); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 418 cmt. (Unif. Law Comm'n 2017) ("While a [property guardian's] role is not identical to that of a trustee, many principles of trust law are relevant[.]"); RESTATEMENT (SECOND) OF AGENCY § 387 (AM. LAW. INST. 1958); Lawrence A. Frolik, *Is a Guardian the Alter Ego of the Ward?*, 37 STETSON L. REV. 53, 66–67 (2007) [hereinafter, Frolik, *Alter Ego*].

[54] *See generally infra* Section III.A.4.

substantial conflict between her duties to the incapable individual and her personal interests.[55] There is a *"no further inquiry" rule* holding that it is generally immaterial whether a conflicted action is taken in good faith or results in no loss.[56] There is also a *rule against self-dealing* that prohibits the guardian or agent from entering on her own account any transaction involving the incapable individual's property.[57] Unless permitted by statute, commingling her own property (or someone else's property) with the property of the incapable individual also breaches her sole-interest duty.[58] The main exemption to the duty of loyalty is that the guardian or agent may

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[55] RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. b (AM. LAW INST. 2007); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 425 (Unif. Law Comm'n 2017) (voiding transactions tainted with "substantial conflict between the [property guardian's] fiduciary duties and personal interests"); UNIF. PROBATE CODE § 5-423 (amended 2010) (same); RESTATEMENT (SECOND) OF AGENCY § 387 (AM. LAW. INST. 1958). Unlike many other duties of a fiduciary, the sole-interest duty of loyalty is typically expressed in negative terms, which duty obliges the fiduciary to avoid conflicts rather than positively to take some action. *See* RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. b (AM. LAW INST. 2007).

[56] Langbein, *supra* note 2, at 931, 934–35.

[57] UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 425 (Unif. Law Comm'n 2017) ("A transaction affected by a substantial conflict includes a . . . transaction involving the [guardianship] estate entered into by the [guardian of estate]."); UNIF. PROBATE CODE § 5-423 (amended 2010) (same). *See, e.g.*, Matter of Brownell, 447 N.Y.S.2d 591, 594 (N.Y. Delaware County Ct. 1981) (Guardian violated the rule against self-dealing by charging the guardianship property to pay for her caring of the incapable individual's dog.).

[58] RESTATEMENT (THIRD) OF TRUSTS § 84 (AM. LAW INST. 2007). *See, e.g.*, *In re* Campione, 872 N.Y.S.2d 210, 214 (N.Y. App. Div. 2009) (family guardian in breach of duty of loyalty on grounds including commingling guardianship funds). *See generally* Langbein, *supra* note 2, at 972–73 (discussing legislative relaxation of the rule against commingling in trust law).

receive reasonable remuneration for providing her services, but only if the incapable individual can afford to pay her.[59]

A breach of the sole-interest duty of loyalty makes available a broad range of remedies. These include rescission of any impugned transaction, injunction to restrain a prospective breach, loss-based remedies to compensate any loss to the incapable individual, and gain-based remedies to disgorge the errant guardian's or agent's ill-gotten gain.[60] A third party who participates in or benefits from a breach also can become liable,[61] although many jurisdictions condition such liability on the third party having sufficient knowledge of the breach.[62] The duty of loyalty is also expressive;[63] its morality rhetoric suggests that a finding of breach can impose informal social

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[59] RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(4) (AM. LAW INST. 2012).

[60] RESTATEMENT (THIRD) OF AGENCY § 8.01, cmt. d (AM. LAW INST. 2006); RESTATEMENT (THIRD) OF TRUSTS § 78 (AM. LAW INST. 2007); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 cmt. a (AM. LAW INST. 2011).

[61] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 17 cmt. c, 43 cmt. g (AM. LAW INST. 2011).

[62] *See generally* RESTATEMENT (THIRD) OF TRUSTS § 108 (AM. LAW INST. 2007); UNIF. TRUST CODE § 1012 (2000). *See, e.g.*, Smallwood v. Lupoli, 107 968 N.Y.S.2d 515, 517–19 (N.Y. App. Div. 2013) (applying Palmetto Partners, L.P. v. AJW Qualified Partners, LLC, 921 N.Y.S.2d 260, 265–66 (N.Y. App. Div. 2011), which imposes a knowledge requirement on third-party liability).

[63] Hanoch Dagan & Sharon Hannes, *Managing Our Money: the Law of Financial Fiduciaries as a Private Law Institution*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 118–21 (Andrew S. Gold & Paul B. Miller eds., 2014); Hanoch Dagan & Elizabeth S. Scott, *Reinterpreting the Status-Contract Divide: the Case of Fiduciaries*, *in* CONTRACT, STATUES, AND FIDUCIARY LAW 67 (Paul B. Miller & Andrew S. Gold eds., 2016).

costs of guilt and moral opprobrium.[64] Moreover, the court may remove the errant guardian or agent from her office.[65] The court also may reduce or remove the errant guardian's or agent's remuneration.[66]

The duty of loyalty is peculiarly fiduciary, but it is not the only duty that guardians and agents owe. They also owe duties to act within the scope of their authority,[67] and to act with reasonable care and prudence.[68] In particular, the duty of care and prudence requires guardians to invest and manage the property of the incapable individual as a prudent investor or person would.[69] Moreover, many jurisdictions impose periodic accounting and reporting

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[64] Scott & Scott, *supra* note 38, at 2425–26. *See, e.g.*, Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, Ch. J.).

[65] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS §§ 37 cmt. b, 65 cmt. f (AM. LAW INST. 2012); *In re* Helen S., 13 N.Y.S.3d 516, 517 (N.Y. App. Div. 2015).

[66] *See infra* note 307–11 and accompanying text.

[67] *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY §§ 8.07, 8.09 (AM. LAW INST. 2006); UNIF. PROBATE CODE §§ 5-314(a), 5-410(b) (amended 2010) (court to decide scope of guardian's authority); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 411(c), (d) (Unif. Law Comm'n 2017) (same).

[68] UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 418(a) (Unif. Law Comm'n 2017); UNIF. PROBATE CODE § 5-418(a) (amended 2010); UNIF. POWER OF ATTORNEY ACT § 114(b)(3) (Unif. Law Comm'n 2006); RESTATEMENT (THIRD) OF AGENCY § 8.08 (AM. LAW INST. 2006).

[69] UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 418 cmt. (Unif. Law Comm'n 2017); Fleming & Morgan, *supra* note 24, at 1302–05. Imprudent transactions involving a conflict of interest violate the duty of care and prudence, in addition to the duty of loyalty. *See, e.g.*, Green v. Lombard, 343 A.2d 905,908–10 (Md. Ct. Spec. App. 1975); *In re* Guardianship of Stalker, 953 N.E.2d 1094 (Ind. Ct. App. 2011).

duties on guardians.[70] Agents also tend to own accounting and reporting duties, but these duties are less onerous than guardians'.[71]

Orthodox fiduciary law is prophylactic;[72] it overdeters the guardian or agent to ameliorate the misalignment of her personal interests and the incapable individual's.[73] That misalignment is what gives rise to incentives to exploit the moral hazard problem.[74] As Professor Robert Sitkoff wrote, the sole-interest duty of loyalty deters a fiduciary from placing herself in a position of conflict by disgorging any personal gain arising from that position.[75] The disgorgement remedy adds to the usual deterrence effect of

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[70] *See, e.g.*, UNIF. PROBATE CODE §§ 5-317, 5-420 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT §§ 420, 423 (Unif. Law Comm'n 2017).

[71] *See generally* RESTATEMENT (THIRD) OF AGENCY § 8.12(3) (AM. LAW INST. 2006) and *infra* note 297 and accompanying text.

[72] RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. b (AM. LAW INST. 2012) ("The rationale [underlying the duty of loyalty] begins with a recognition that it may be difficult for a trustee to resist temptation when personal interests conflict with fiduciary duty."); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 cmts. b, d, h (AM. LAW INST. 2011); Sitkoff, *supra* note 38, at 199.

[73] *But see* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U L. REV. 1045 (conceiving fiduciary duties as providing optimal deterrence).

[74] *See supra* Section I.B.3.

[75] Sitkoff, *supra* note 38, at 201–02, 206–07. *See also* Scott & Scott, *supra* note 38, at 2419–21 (discussing the incentive-alignment effects, or "bonding", of fiduciary law in families).

compensatory remedies.[76] Alternatively, Professor Henry Smith conceived the function of fiduciary law as preventing *opportunism* in the sense of behaviors that are detrimental to social welfare but cannot be cost-effectively defined, detected and deterred by explicit ex-ante rulemaking.[77] Because self-dealing and non-avoidance of conflicts are correlated with opportunism, fiduciary law regards such conduct as proxies and presumptions of opportunism.[78] As a prophylactic measure, fiduciary law requires the fiduciary to avoid self-dealing and conflicts of interest, regardless of any bad faith or fraud on her part.[79] This prophylactic objective explains the availability of disgorgement remedies to strip the fiduciary of any personal profit arising from conflicted transactions.[80] Compensatory remedies further strengthen the deterrence function.[81]

In re Estate of O'Hare can illustrate the practical implications of the sole-interest duty of loyalty.[82] This case concerned a young woman—Sarah—who

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[76] Sitkoff, *supra* note 38, at 202, 206–07.

[77] Henry E. Smith, *Why Fiduciary Law is Equitable*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 261, 264, 267, 271, 273 (Andrew S. Gold & Paul B. Miller eds., 2014).

[78] *Id*. at 262, 271.

[79] *Id*. at 271.

[80] *Id*. at 273–74.

[81] *Id*. at 274, 280.

[82] 34 N.E.3d 1126 (Ill. Ct. App. 2015).

suffered injuries at birth and obtained a substantial property as a result of a medical malpractice settlement. Sarah's mother—Virginia—was her primary caregiver and became the guardian of her property when she reached majority. When Sarah's stepfather relocated interstate for his job, the family moved into a house purchased with Sarah's funds. Virginia also used Sarah's funds to pay family expenses and a caregiver's salary to herself.[83] The Illinois court held Virginia in breach of fiduciary duty because she used Sarah's funds to benefit the family as a whole rather than Sarah specifically.[84]

An instructive aspect of this case is the way that the court enforced the duty of loyalty in the presence of informational deficiency. Virginia did not give prior notice to the court regarding her uses of Sarah's funds, and kept poor records.[85] The information that the court could observe and verify mainly consisted of these poor records, Virginia's personal gain, the family's gain, and a reduction in Sarah's funds. However, gift-giving and property-sharing are common in close families.[86] The mere fact that Sarah's family benefited from her funds could not indicate that Virginia engaged in any actual wrongdoing. To the contrary, the court thought Virginia provided

[83] *Id.* at 1128–30.

[84] *Id*. at 1131.

[85] *Id*. at 1130–31.

[86] *See generally infra* Section II.B.3.

"excellent care" to Sarah.[87] What animated the court's ruling against Virginia was not evidence of actual wrongdoing, but her conflict of interest.

D. The Best-interest Standard

This Section introduces an alternative formulation of the duty of loyalty, under which the guardian or agent is permitted to take a conflict-of-interest action if it is in the *best interest* of the incapable individual. The best-interest standard directs an objective, multifactorial analysis of context-sensitive facts and circumstances. The incapable individual's known wishes are the predominant factor in determining what amounts to her best interest.[88] Other factors include the individual's financial circumstances, eligibility for public benefits, and tax consequences of the proposed action.[89]

A leading advocate of the best-interest standard, Professor John Langbein argued that the sole-interest duty of loyalty generates more costs than benefits.[90] In his view, the main problem with the sole-interest duty is the

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[87] *In re Estate of O'Hare*, 34 N.E.3d 1126, 1131 (Ill. Ct. App. 2015).

[88] *See, e.g.*, UNIF. POWER OF ATTORNEY ACT § 114 cmt. (Unif. Law Comm'n 2006); UNIF. PROBATE CODE §§ 5-314(a), 5-418(b) (amended 2010); N.Y. MENTAL HYG. LAW §§ 81.20(a)(6)(i), 81.20(a)(7) (McKinney 2016); ROBERT H. SITKOFF & JESSE DUKEMINIER, WILLS, TRUSTS, AND ESTATES 509–10 (10th ed., 2017) (discussing *In re* Kurrelmeyer, 2008 WL 7810419 (Vt. Super.), aff'd, 992 A.2d 316 (Vt. 2010)).

[89] *See, e.g.*, UNIF. POWER OF ATTORNEY ACT § 114 cmt. (Unif. Law Comm'n 2006).

[90] Langbein, *supra* note 2, at 933. Langbein's arguments specifically address trusteeship, but scholars and law reformers have made similar arguments in relation to other fiduciary relationships. *See, e.g.*, Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1126–30 (1981) (discussing fiduciary duties of parties to relational contracts); Scott & Scott, *supra* note 38, at 2437–39 (opposing application of

overdeterrence of actions that benefit both the beneficiary and the fiduciary.[91] According to Langbein, the old English Court of Chancery developed the sole-interest duty to address the concern that a trustee could easily conceal his own wrongdoing.[92] This concern reflected the "grievous shortcomings" in fact-finding processes at the time, but it no longer reflects the efficacy of recordkeeping and fact-finding processes in modern times.[93] In the language of economic theory, Langbein challenged the assumption that the fiduciary is always poorly monitored. Replacing the sole-interest duty with the best-interest standard would enable a cost-benefit analysis on a case-by-case basis.

Proposals to introduce the best-interest standard have partially informed

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conflict-of-interest rules or standards to parents in close families); UNIF. POWER OF ATTORNEY ACT § 114 cmt. (Unif. Law Comm'n 2006).

[91] Langbein, *supra* note 2, at 933.

[92] *Id*. at 932, 944–45. *Cf.* Joshua Getzler, *Interdisciplinary Review of Fiduciary Law: "As If." Accountability and Counterfactual Trust*, 91 B.U. L. Rev. 973, 981–85 (2011). The modern conception of fiduciary law originally took shape against a culture of corruption and incompetence among private and public officials, including Lord Chancellors and Masters of the English Court of Chancery. In the early eighteenth-century, Lord Chancellor King, an anticorruption reformer and former Chief Justice of the Court of Common Pleas, succeeded as Lord Chancellor after presiding over the impeachment of his predecessor. Lord Chancellor King adopted a prophylactic policy in "a run of stringently moralistic decisions" to restore the integrity and reputation of his Court, *id*. at 983–94, including Keech v. Sandford (1726) 25 Eng, Rep. 223; Sel. Cas. Ch. 61, a leading case in fiduciary law, RESTATEMENT (THIRD) OF TRUSTS § 78 reporter's note on cmt. a (AM. LAW INST. 2012); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 reporter's note b (AM. LAW INST. 2011). An anticorruption sentiment also might underlie Judge Benjamin Cardozo's opinion in Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928), another leading case in fiduciary law. Getzler, *id.* at 985 (citations omitted).

[93] Langbein, *supra* note 2, at 932, 945–51.

the development of modern agency law. Under modern power of attorney statutes, an agent may defend a conflicted transaction by proving that she acted with care, competence and diligence for the best interest of her principal.[94] The availability of this defense largely abrogates the sole-interest duty.[95] Such departure from the orthodoxy reflects "the practical reality that most agents are family members who have inherent conflicts of interest with the principal arising from joint property ownership or inheritance expectations."[96] However, modern agency law continues to prohibit agents from engaging in self-dealing transactions.[97] Similarly, agents are prohibited from using their principals' property for their own (or a third party's) purposes.[98] Both of these prohibitions derive from the sole-interest duty of loyalty.[99] Hence the best-interest standard seems to have displaced the sole-interest duty to a great extent, but not completely.

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[94] UNIF. POWER OF ATTORNEY ACT § 114(d) (Unif. Law Comm'n 2006). This standard is consistent with Langbein's proposal. *See generally* Langbein, *supra* note 2; *supra* Section I.D. *See also* RESTATEMENT (THIRD) OF AGENCY § 8.01, reporter's note a (AM. LAW INST. 2006) ("[A]n agent's loyal service to the principal may, concurrently, be beneficial to the agent.").

[95] Langbein, *supra* note 2, at 933–34.

[96] UNIF. POWER OF ATTORNEY ACT § 114 cmt. (Unif. Law Comm'n 2006). *See also* Langbein, *supra* note 2, at 935–36.

[97] RESTATEMENT (THIRD) OF AGENCY § 8.03 cmt. b (AM. LAW INST. 2006).

[98] RESTATEMENT (THIRD) OF AGENCY § 8.05(1) (AM. LAW INST. 2006).

[99] *See supra* notes 54–58 and accompanying text.

The best-interest standard also has a role to play in modern guardianship law. In addition to her sole-interest duty of loyalty, a guardian owes a stand-alone duty to exercise her discretion to advance the known wishes of the incapable individual.[100] If the individual's wishes are not known, or if giving effect to her wishes would unreasonably harm or endanger her, then the guardian owes a duty to act in her best interest.[101]

In re Keri illustrates how the best-interest standard can permit actions that benefit both the incapable individual and her guardian or agent.[102] In that case, the two sons of an elderly incapable woman—Keri—took care of her in her house for as long as they could; one of the sons was her agent. When the sons could no longer avoid placing her in a nursing home, they devised a plan to accelerate her eligibility for Medicaid reimbursement of her nursing home costs. They planned to sell Keri's house and transfer a significant proportion of the proceeds to themselves.[103] Their justification was that under Keri's

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[100] This duty reflects the doctrine of substituted judgment. *See generally infra* Section III.A.

[101] *See, e.g.*, UNIF. PROBATE CODE §§ 5-314(a), 5-418(b) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 418(c) (Unif. Law Comm'n 2017). *See generally* Lawrence A. Frolik & Linda S. Whitton, *The UPC Substituted Judgment/Best Interest Standard for Guardian Decisions: A Proposal for Reform*, 45 U. MICH. J. L. REFORM 739, 742–43 (2012) (surveying financial decision-making standards in American guardianship statutes).

[102] 853 A.2d 909 (N.J.).

[103] *Id.* at 911–12.

will, they would receive her estate when she passed away, but they would likely receive nothing if her assets were spent on her nursing home costs.[104] Applying the best-interest standard, the New Jersey court approved the sons' plan. The court found that the plan would likely increase the amount that she would leave to her sons and that she would not have disapproved the plan if she was mentally-capable.[105] The plan would not have been approved if the court were to enforce the sole-interest duty of loyalty, because the sons had a conflict of interest.[106]

E. Operation as Default Law

Both the orthodox and relaxed models of fiduciary law are contractarian; they conceive fiduciary law as supplying mostly *default* duties to fill in the gaps in the incomplete "contract" between the fiduciary and the beneficiary.[107] This reflects the prevailing doctrinal position that fiduciary law generally yields to party modification. By modifying the terms of the

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[104] *Id.* at 911–12, 917–18.

[105] *Id.* at 913, 917–18. Although the New Jersey court formally discussed both the best-interest standard and a substituted-judgment standard to be discussed *in infra* Section III.A, it really only applied the best-interest standard. *See* Frolik, *Alter Ego*, *supra* note 53, at 82.

[106] *See In re* Keri, 853 A.2d 909, 918–19 (N.J.).

[107] *See especially* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993). *But see* Tamar Frankel, *Watering Down Fiduciary Duties*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 242 (Andrew S. Gold & Paul B. Miller eds., 2014) (resisting contractarian approaches to fiduciary law).

instrument underlying the fiduciary relationship, the creator or the beneficiary may modify the duties of the fiduciary.[108] Similarly, the beneficiary may consent to a departure from default fiduciary law before it takes place, or ratify it afterward.[109] The fiduciary must make a fair-and-frank disclosure and the beneficiary's consent or ratification must be fully-informed;[110] information asymmetry, cognitive biases, limited willpower and some other obstacles to efficient bargaining can justify the imposition of these procedural safeguards.[111] The beneficiary or creator can therefore discharge the fiduciary from compliance with almost all of her fiduciary

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[108] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS §§ 64, 65 (AM. LAW INST. 2012); RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. c (AM. LAW INST. 2006) ("[A]n agent's fiduciary duties to the principal vary depending on the parties' agreement and the scope of the parties' relationship."). The instrument underlying the fiduciary relationship is the power of attorney in the case of an agency relationship, and the court order that appoints the guardian in the case of a guardianship.

[109] *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 8.06 (AM. LAW INST. 2006); RESTATEMENT (THIRD) OF TRUSTS § 97 (AM. LAW INST. 2012). The fiduciary law literature often denotes by "authorization" or "consent" an ex-ante permission to take the conflicted action or transaction, and by "ratification" or "release" an ex-post permission. *See, e.g.*, Langbein, *supra* note 2, at 963–64; Robert H. Sitkoff, *Fiduciary Principles in Trust Law*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW 58 (Evan J. Criddle, Paul B. Miller, Robert H. Sitkoff eds., 2019). For simplicity, this Chapter uses "authorization" to denote both, and emphasizes timing where relevant.

[110] Matthew Conaglen, *The Extent of Fiduciary Accounting and the Importance of Authorisation Mechanisms*, 70 CAMBRIDGE L.J. 548, 563 (2011). *See also* Sitkoff, *supra* note 38, at 201–02. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 78(3), cmt. g (AM. LAW INST. 2007) (fair-and-frank disclosure requirements).

[111] *See, e.g.*, Dagan & Scott, *supra* note 63, at 22. *See generally* Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, *in* HANDBOOK OF LAW AND ECONOMICS vol. 1 at 30–46 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (discussing the obstacles to efficient contracting).

duties. The only potential exception is a *mandatory core* of fiduciary law that holds the fiduciary liable for breaches taken in bad faith or with indifference.[112] Overall, fiduciary law places few restrictions on a private individual's power to authorize departures from adherence to strict fiduciary duties. Call that power the *power of authorization*.

The essentially-default nature of fiduciary law supplies the standard objection to reform proposals to legitimize conflict-of-interest transactions that are welfare-enhancing.[113] To see this, suppose the fiduciary has an opportunity to commit an *efficient breach* of the sole-interest duty of loyalty. This means that the benefits arising from non-compliance are greater than the costs, so the breach would generate a positive (net) welfare gain. If the fiduciary seeks authorization from the beneficiary, then they can negotiate and form an agreement on how to share the welfare gain. The disclosure requirements help to facilitate an arms-length negotiation at this juncture, which negotiation likely leads to a distribution of the welfare gain to both the

[112] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 96 cmt. c (AM. LAW INST. 2012). Aside from protecting the principal, the mandatory core of fiduciary law reduces the information costs of a third party who deals with the fiduciary. Sitkoff, *supra* note 38, at 205–06.

[113] *See, e.g.*, RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 cmt. h (AM. LAW INST. 2011). *Contra.* Tess Wilkinson-Ryan, *Fiduciary Law and Psychology*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW 717–19 (Evan J. Criddle, Paul B. Miller, Robert H. Sitkoff eds., 2019) (The empirical literature on disclosure of conflicts of interest suggest that "[d]isclosures appear to increase the provision of biased advice and increase compliance with biased advice, while also weakening the trust between the parties.").

fiduciary and the beneficiary. On the other hand, if the fiduciary acts without prior authorization, and is later found in breach, then her personal gain would be disgorged. Thus the fiduciary would be better off acting with the beneficiary's authorization than without. In sum, by simultaneously imposing the sole-interest duty on the fiduciary and granting the power to authorize any departure to the beneficiary, orthodox fiduciary law can incentivize the fiduciary to take a welfare-enhancing action and share the resulting welfare gain with the beneficiary. (This line of reasoning critically depends on the beneficiary having mental capacity, as Part II below will explain.)

A numerical example can illustrate how the sole-interest duty and the power of authorization operate in tandem. Suppose the fiduciary has an opportunity to take an action that generates $100 to herself but harms the beneficiary by $30. Taking this action without authorization would constitute a breach of the sole-interest duty; a conflict of interest arises when the fiduciary gains at the beneficiary's expense. If the fiduciary were sanctioned for committing such a breach, then her gain of $100 would be disgorged; this outcome would leave the fiduciary with $0 and the beneficiary with $100 – $30 = $70.[114] On the other hand, if the fiduciary were to seek prior authorization from the beneficiary, then they could agree on how to share the

[114] To simplify calculation, this example assumes a breach of fiduciary duty is detected and sanctioned with certainty. Little depends on that assumption.

net gain of $70. The exact shares would depend on their respective bargaining powers. For example, the beneficiary could get $50 while the fiduciary $20. The numbers are unimportant, because the fiduciary is incentivized to seek authorization as long as she can obtain more than $0.

F. Rule versus Standard

The extent of indeterminacy also affects the choice between the sole-interest duty of loyalty and the best-interest standard. Brightline rules stipulate in advance the exact legal criteria to be applied in individual cases. Vague standards, on the other hand, leave courts to determine the criteria with the benefit of hindsight. Compared to rules, standards typically generate greater compliance costs and litigation costs to litigants as well as greater decisional costs to courts.[115] On the other hand, rules may be more informationally-demanding and costlier to promulgate ex ante, especially when the facts are complex and future contingencies are hard to foresee or describe.[116]

Scholars have criticized the best-interest standard for its indeterminacy.[117] Breach-of-fiduciary duty claims typically involve a

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[115] *See, e.g.*, Louis Kaplow, *Rules versus Standards: an Economic Analysis*, 42 DUKE L.J. 557 (1992).

[116] *Id.* at 621–22.

[117] *See, e.g.*, Elizabeth S. Scott & Robert E. Emery, *Gender Politics and Child Custody: Puzzling Persistence of the Best-Interests Standard*, 77 LAW & CONTEMPORARY PROBLEMS 69, 72–76 (2014); Robert H. Mnookin, C*hild-Custody Adjudication: Judicial Functions in*

guardian or an agent who is in a familial relationship with the incapable individual.[118] The best-interest standard grants a broad judicial discretion to consider a variety of factors.[119] Yet, as Professors Elizabeth Scott and Robert Emery argued, the largely-private nature of family life keeps much relevant information hidden from outsiders, such as a court.[120] Another problem pertains to the need to weigh or rank inherently incommensurable best-interest factors.[121] In stark contrast, the sole-interest duty of loyalty supplies a highly determinate rule: whether there is an unauthorized conflict of interest, and if there is, does it fall within a recognized exception? This inquiry typically ends with finding some unauthorized financial benefit—an observable and verifiable piece of information—to the guardian or agent (or a third party).[122]

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the Face of Indeterminacy, 39 LAW & CONTEMPORARY PROBLEMS 226 (1975). *See also* Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 573–74 (2003) ("[I]n the trust law context [seal-dealing transactions] are so frequently undesirable that the costs of extirpating the entire class of transaction (a *rule*) are less than the costs of case-by-case adjudication (the fairness *standard*)."); Whitton, *supra* note 7, at 25, 38–39 (discussing survey responses complaining that the fiduciary duties of agents are uncertain and confusing).

[118] *See supra* notes 33, 96 and accompanying text.

[119] *See supra* notes 88–89 and accompanying text.

[120] Scott & Emery, *supra* note 117, at 74.

[121] *Id*. at 75.

[122] *See supra* notes 54–58 and accompanying text.

G. Summary

Orthodox fiduciary law imposes the sole-interest duty of loyalty to remove the fiduciary from situations involving a conflict of her interests with the beneficiary's. Overdetering the fiduciary, the sole-interest duty ameliorates the misalignment of interest that gives rise to perverse incentives. With most successes in modern agency law, reform proposals have led to the adoption of a best-interest standard to permit conflicted transactions that simultaneously benefit the fiduciary and the beneficiary. Those who resist proposals to relax the sole-interest duty often point to the default nature of fiduciary law: assuming the beneficiary is mentally-capable, she can authorize her fiduciary to enter into in conflicted transactions that are welfare-enhancing.

II. FIDUCIARY LAW AS MANDATORY LAW

This Part will argue that orthodox fiduciary law is be too strict on close relatives and friends, while proposals to introduce the best-interest standard are too lenient on professionals. As Section II.A below will elaborate, underlying these arguments is an observation that when applied to incapable individuals, fiduciary law tends to operate as mandatory law rather than default law.

A. Mandatory Application to Mentally-incapable Individuals

1. Stultification of the Power of Authorization

Confined to cases concerning mentally-incapable individuals, fiduciary law becomes problematic because it no longer operates as default law. There are severe restrictions on an incapable individual's power to authorize departures from strict fiduciary law. First, under the law of trusts, a beneficiary must have mental capacity in order to validly exercise her power of authorization.[123] Because American courts typically apply trust fiduciary law to guardians,[124] this mental-capacity requirement removes the power of authorization from individuals subject to guardianship.[125] Some courts even disregard conflict-authorizing agreements formed before the individual's loss of capacity.[126]

Second, even if mental capacity is not a formal requirement for a valid exercise of the power of authorization, it can be very costly to "litigation-proof" any consent obtained from an elderly incapable individual. To

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[123] RESTATEMENT (THIRD) OF TRUSTS § 97(a), cmt. d (AM. LAW INST. 2012).

[124] *See generally supra* Section I.C.

[125] *See, e.g.*, *In re* Conservatorship of Hanson, 682 N.W.2d 207 (Neb. 2004); *In re* Conservatorship of Rininger, 500 N.W.2d 47, 49, 51 (Iowa 1993). *Contra.* Mullins v. Ratcliff, 515 So.2d 1183 (Miss. 1987) (sustaining an incapable individual's gifts to his sister-guardian upon satisfaction of (1) good faith on part of the sister-guardian, (2) the individual's full knowledge and deliberation of his actions and their consequences, and (3) clear and convincing evidence that the individual exhibited independent consent and action).

[126] *See, e.g.*, *In re* Guardianship of Saylor, 121 P.3d 532, 536 (Mont. 2005) ("[A]ny arrangement between [the guardian and the incapable individual] which subsisted prior to the imposition of the [guardianship] does not necessarily determine the standard of care which the [guardian] owes[.]"); *In re* Estate of Clark, 772 P.2d 299, 302 (Mont. 1989) (same for the duty of loyalty).

minimize the risk of overreach at the time of obtaining authorization, fiduciary law requires that the fiduciary make a fair-and-frank disclosure and that the beneficiary's consent be full-informed. Given the typical bases of mental incapacity are dementia and similar degenerative conditions,[127] the guardian or agent may need to incur the cost of engaging a medical professional to verify and document the quality of consent.[128] Even consent given in the presence of a lawyer can be suspicious to a court, especially if the lawyer has previously acted for the fiduciary.[129]

Third, in most cases, the elderly incapable individual cannot forbear a potential breach of fiduciary duty by not commencing proceedings, nor can she testify to support her guardian or agent. Breach-of-duty claims are usually brought by those relatives who would personally benefit from a finding of breach. These claimants often expect to inherit a share of the elderly incapable individual's estate, and they sue the guardian or agent in order to increase the value of that estate.[130] Litigation tends to take place after the

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[127] *See supra* notes 33 and accompanying text. The typical reasons for needing unpaid care are also older age and Alzheimer's or dementia. *See* NATIONAL ALLIANCE FOR CAREGIVING & AARP PUBLIC POLICY INSTITUTE, CAREGIVING IN THE U.S. 2015 at 17–18 (2015), https://www.caregiving.org/caregiving2015/.

[128] *See, e.g.*, AM. BAR ASS'N COMM'N LAW & AGING & AM. PSYCHOLOGICAL ASS'N, ASSESSMENT OF OLDER ADULTS WITH DIMINISHED CAPACITY: A HANDBOOK FOR LAWYERS 20 (2005); SITKOFF & DUKEMINIER, *supra note* 88, at 307.

[129] *See, e.g.*, *In re Conservatorship of Smith v. Vandevort*, 237 So.3d 852, 856, 861 (Miss. Ct. App. 2017).

[130] *See, e.g.*, *In re* Conservatorship of Hanson, 682 N.W.2d 207 (Neb. 2004) (children

individual has passed away, denying her the opportunity to give evidence to support her guardian or agent. Even if she is alive at the time of litigation, her mental incapacity can make it difficult or impossible to give evidence.[131] Many jurisdictions also do not guarantee her representation by an independent counsel.[132]

Fourth, conflict-of-interest transactions are often gifts to the incapable individual's close relatives and friends. Modern guardianship statutes prevent guardians from making large gifts without prior judicial approval.[133] (Section II.A.2 below will discuss the shortcomings of the mechanism for obtaining prior judicial approval.) Modern power of attorney statutes also deny agents of a general power to make large gifts without an express provision in the power of attorney.[134]

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from a deceased incapable individual's previous marriage seeking to recover to the deceased's estate conflict-of-interest payments to his guardian and surviving spouse).

[131] *See, e.g.*, *In re* Caminite (Amelia G.), 57 N.Y.S.3d 724, 729 (N.Y. Nassau Cty. Ct.).

[132] *See generally* Am. Bar Ass'n Comm'n Law & Aging, *Representation and Investigation in Guardianship Proceedings*, AM. BAR ASS'N, http://www.americanbar.org/content/dam/aba/administrative/law_aging/chartrepresentationandinvestigation.authcheckdam.pdf (last visited Dec. 8, 2018) (surveying right to counsel in American guardianship statutes). *Cf. In re* Zhuo, 53 Misc.3d 1121 (N.Y. Surr. Ct. 2016) (holding that incapable individuals have a constitutional right to counsel in guardianship proceedings).

[133] *See, e.g.*, UNIF. PROBATE CODE §§ 5-411(a)(1), 5-427(b) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 414(a)(1) (Unif. Law Comm'n 2017).

[134] *See, e.g.*, UNIF. POWER OF ATTORNEY ACT § 217 (Unif. Law Comm'n 2006); RESTATEMENT (THIRD) OF PROPERTY (WILLS & DON. TRANS.) § 8.1 cmt. l (2003) (Agent

2. Alternative Ways to Authorize Departures from Fiduciary Law

There are two alternative ways to authorize departures from strict fiduciary law, but neither is a substitute for a private individual's power of authorization. First, as Section II.C below will explain in detail, judicial approval may legitimize a potential breach.[135] A problem with the judicial-approval mechanism is the cost of going to court. Modern statutes also typically require *prior* judicial approval to legitimize conflicted transactions.[136] Unsophisticated guardians and agents—in particular, relatives and friends—usually are not aware of the requirement of judicial scrutiny, let alone the importance of timing.[137]

Second, the instrument underlying the guardianship or agency

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cannot make gifts unless expressly or implicitly authorized by power of attorney.).

[135] *See, e.g.*, UNIF. PROBATE CODE § 5-411(a) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 425 (Unif. Law Comm'n 2017); RESTATEMENT (THIRD) OF TRUSTS § 11 cmt. f, note to cmt. f, re. subsection (5) (AM. LAW INST. 2007); Samuel L. Bray, *Fiduciary Remedies*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW 460 (Evan J. Criddle, Paul B. Miller, Robert H. Sitkoff eds., 2019) (discussing an equity court's "supervisory jurisdiction" to give instructions to trustees on the legitimacy of doubtful transactions).

[136] *See, e.g.*, UNIF. PROBATE CODE § 5-411(a) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 425 (Unif. Law Comm'n 2017); Kohn, *supra* note 24, at 257. *But see* DeWald v. Morris, 397 S.W.2d 738, 742–43 (Mo. Ct. App. 1965) (A guardian's failure to seek prior judicial approval of a conflict-of-interest payment does not "militate against the propriety" of the payment, but exposes her to the risk of having the payment invalidated ex post facto.).

[137] Langbein, *supra* note 2, at 984–85. *See, e.g.*, *In re* Estate of O'Hare, 34 N.E.3d 1126, 1128–29 (Ill. Ct. App. 2015) (lay guardian of her incapable daughter failing to seek prior judicial approval of conflict-of-interest payments to herself and her family).

relationship may authorize departures from strict fiduciary law. In the case of agency, the principal may authorize departures in the power of attorney before she becomes mentally-incapable. Similarly, in the case of guardianship, the court that appoints the guardian may authorize departures in the order of appointment.[138] However, the instrument underlying the guardianship or agency relationship tends to be incomplete. As the relational contracts literature has recognized,[139] the drafter of a document to govern a long-term relationship is typically unable to foresee all future contingencies; the cost of accounting-for every foreseeable contingency is also prohibitively high. The resulting incomplete document then fails to respond to unforeseen or unaccounted for contingencies when they arise. This observation squarely applies to guardianships and agency relationships. Elderly incapable individuals now have a high life expectancy, and tend to need years of assistance.[140] In the case of guardianship, it would be unrealistic and too

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[138] *See supra* note 115 and accompanying text.

[139] *See, e.g.*, Victor Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426, especially at 432–33, 439–40 (1976); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990). *Cf. e.g.* Stewart Macaulay, *Non-contractual Relationships in Business: A Preliminary Study*, 28 AM. SOC. REV. 28 (1963) (alternative, norms-based approach to relational contracts); IAN R. MACNEIL, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS (1980) (same).

[140] NATIONAL ALLIANCE FOR CAREGIVING & AARP PUBLIC POLICY INSTITUTE, *supra* note 127, at 20–22.

costly for the court to decide in advance the desirability of departures from strict fiduciary law in all contingencies. For the same reason, powers of attorney drafted before the onset of mental or physical decline typically cannot consider in advance the desirability of all future departures from strict fiduciary law.

B. Mandatory Prohibition of Conflict of Interest in Close Families and Personal Relationships

Section II.A shows that when applied to guardians and agents who serve mentally-incapable individuals, fiduciary law practically operates as mandatory law rather than default law. In this light, the following will argue that mandatory application of the sole-interest duty of loyalty usually does little to align incentives, and can become a genuine obstacle to welfare enhancement.[141]

A preliminary observation is that fiduciary law—either the orthodox form

[141] Welfare enhancement is consistent with the pursuit of personal autonomy, which has emerged as one of the underlying policies of modern disability law in the United States. *See, e.g.*, UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 302 cmt. (Unif. Law Comm'n 2017). There is also an international movement to make disability law more respectful of autonomy. *See generally* Convention on the Rights of Persons with Disabilities, *opened for signature* December 13, 2006, 2515 U.N.T.S. 3; Eilionóir Flynn & Anna Arstein-Kerslake, *The Support Model of Legal Capacity: Fact, Fiction, or Fantasy?*, 32 BERKELEY J. INT'L L. 124 (2014); Michael L. Perlin, *"Striking for the Guardians and Protectors of the Mind": The Convention on the Rights of Persons with Mental Disabilities and the Future of Guardianship Law*, 117 PENN STATE L. REV. 1159 (2013). In the language of economic theory, modern disability law seeks to advance the welfare of the incapable individual as evaluated by her choices, to the extent possible. *See generally infra* Section III.A.

or the relaxed form—does not formally recognize that there is a spectrum of guardians and agents. These fiduciaries differ in their relationship with the elderly incapable individual and in the degree of sophistication. The available empirical evidence suggests that most guardians and agents are lay persons who are closely related to, or friends with, the incapable individual.[142] In particular, courts prefer to appoint the individual's spouse or adult child as guardian unless large and complex property is involved.[143] While close relatives and friends constitute one extreme of the spectrum, the other extreme comprises private professionals who charge fees for their services. These professionals are typically lawyers, financial advisers, mental health professionals, or institutions.[144] Across the spectrums are sophisticated relatives and friends,[145] and publicly-funded professionals.[146] To highlight

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[142] Surveys typically reveal that roughly three-quarters of all guardians are relatives or friends of incapable individuals. *See, e.g.*, ADMIN. CONF. U.S., *supra* note 42, 16; Callahan, Romanick & Ghesquiere, *supra* note 33, at 85; Lawrence K. Marks, *Court-Appointed Fiduciaries: New York's Efforts to Reform a Widely Criticized Process*, 77 ST. JOHN'S L.R. 29, 33 (2003) (citations omitted); REPORT OF THE COMMISSION ON FIDUCIARY APPOINTMENTS 9 (2005), available at https://www.nycourts.gov/reports/fiduciary-2005.pdf. *See also supra* note 96 (Agents are mostly relatives of their incapable principals.).

[143] *See, e.g.*, Barnes, *The Liberty and Property of Elders*, *supra* note 40, at 24.

[144] Barnes, *Corporate and Professional Guardians*, *supra* note 43, at 943.

[145] *See, e.g.*, Black v. Black, 422 P.3d 592 (Colo. Ct. App. 2018) (A family guardian—"a tenured law professor who has written on the subject of corporate directors' fiduciary duties"—got prior approval to make conflicted transactions to benefit himself and his children, but were later held in breach of fiduciary duty for failing to disclose his conflicts to the court.).

[146] *See, e.g.*, ADMIN. CONF. U.S., *supra* note 42, at 16.

the inflexibility of orthodox fiduciary law, the following will compare and contrast how it regulates the two extremes of the spectrum: close relatives and friends versus professionals.

1. Ubiquity of Conflicts

Conflicts of interest are ubiquitous in close families and personal relationships.[147] Relative-and-friend guardians and agents can have conflicts arising from psychological involvement with the incapable individual and financial interests in her property, for example, shared residence, joint ownership or inheritance expectations.[148] The following will argue that mandating avoidance of conflicts in close families and personal relationships can narrow the pool of candidates who can provide safe and reliable fiduciary services to incapable individuals. This is particularly problematic given the current shortage of elder caregivers.[149]

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[147] This Chapter uses "close family" as a shorthand for a familial relationship that satisfies the "core qualities [of] a demonstrated, long-term commitment and the assumption of mutual care and financial responsibility[.]" Elizabeth S. Scott & Robert E. Scott, *From Contract to Status: Collaboration and the Evolution of Novel Family Relationships*, 115 COLUM. L. REV. 293, 306 (2016) (footnote omitted). *See generally id.* at 305 (explaining the key attributes of a contemporary family that is based on adult relationships). Rather than based on biological relationship, *id.* at 305, a close family is a family of "affection and dependence", LAWRENCE M. FRIEDMAN, DEAD HANDS: A SOCIAL HISTORY OF WILLS, TRUSTS, AND INHERITANCE LAW 11 (2009).

[148] UNIF. POWER OF ATTORNEY ACT § 114 cmt. (Unif. Law Comm'n 2006); APPELBAUM & GUTHEIL, *supra* note 9, at 205; Barnes, *Corporate and Professional Guardians*, *supra* note 43, at 956–57.

[149] *See, e.g.*, Barnes, *Corporate and Professional* Guardians, *supra* note 43, at 947; Clare Ansberry, *America Is Running Out of Family Caregivers, Just When It Needs Them Most*,

It may be instructive to consider first the pool of professional fiduciaries who may provide property-management services to elderly incapable individuals. In relation to the law governing financial fiduciaries, Professors Hanoch Dagan and Sharon Hannes argued that rigorous legal regulation makes it safe and reliable to delegate decision-making authority to professionals who have superior knowledge, skills and experience.[150] Their argument can be extended to professional guardians and agents, who tend to have acquired specialist knowledge and skills through training and repeated dealings with many incapable individuals.[151] The prophylactic nature of orthodox fiduciary law makes it safe and reliable to delegate authority to these professionals. Thus orthodox fiduciary law expands the pool of safe and reliable candidates to include professionals with superior knowledge, skills and experience. Incapable individuals can then benefit from the safe and reliable provision of specialist services.

By comparison, when applied to close relatives and friends with mandatory force, orthodox fiduciary law can *narrow* the pool of safe and

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WALL ST. J., Jul. 20, 2018.

[150] Dagan & Hannes, *supra* note 63, at 105. These authors argued that expanding the pool of safe and reliable candidates for fiduciary appointment advances autonomy. *Id*. at 93.

[151] Barnes, *Corporate and Professional Guardians*, *supra* note 43, at 954–55. *Cf*. APPELBAUM & GUTHEIL, *supra* note 9, at 188 (Due to the tendency to standardize or bureaucratize, institutional fiduciaries can fail to cater for incapable individuals with special needs.).

reliable candidates for fiduciary appointment. Unlike professionals, close relatives and friends have acquired their specialist knowledge, skills and experience from having an intimate relationship with the incapable individual and being empathetic of the individual's will and preferences. Compared to professionals, close relatives and friends are far more likely to have conflicts of interest.[152] Compliance with the sole-interest duty of loyalty would require the close relative of friend to remove her conflicts. The costs of doing so can deter her from taking on the fiduciary office. Thus onerous fiduciary duties can narrow the pool of safe and reliable,[153] but nonprofessional, candidates for fiduciary appointment.

In re Estate of O'Hare can illustrate this point.[154] Recall that the mother-guardian in that case—Virginia—kept poor records and did not seek prior judicial approval for using her incapable daughter Sarah's funds to benefit the whole family. Holding Virginia liable for breaching the sole-interest duty, the Illinois court removed her from her office as Sarah's guardian. This was notwithstanding her good intentions and the "excellent care" that she had provided to Sarah. As a result, Sarah, whose own attitude toward her mother's

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[152] Perlin, *supra* note 141, at 1181; Barnes, *Corporate and Professional Guardians*, *supra* note 43, at 956–57; APPELBAUM & GUTHEIL, *supra* note 9, at 205–06.

[153] *See generally infra* Section II.B.2 (discussing the extralegal mechanisms that deter misconduct in close families and personal relationships).

[154] 34 N.E.3d 1126, 1130–31 (Ill. Ct. App. 2015).

behaviors were not apparent on the report of the case, had to incur the costs of replacing her mother with a public guardian.[155] Moreover, this outcome could discourage Sarah's other close family members from taking on the guardianship role.

Another illustrative case is *Moore v. Self*.[156] In that case, an elderly woman—Catherine—acquired accounts and real property as joint tenants with her daughter Nancy with rights of survivorship. Catherine subsequently became mentally-incapable, and Nancy applied for and accepted appointment as Catherine's guardian. After Catherine passed away, her sons sued Nancy to recover the jointly-held properties to Catherine's estate.[157] There was no allegation or evidence of any actual wrongdoing by Nancy. Nancy did *not* attempt to preserve the value of the jointly-held properties to benefit her individual survivorship rights; she even placed a small proportion of the jointly-held accounts in Catherine's own account.[158] Yet the Georgia court ruled in favor of the sons. Holding Nancy in breach of the sole-interest duty of loyalty, the court took the view that if Nancy "intended to claim title to the

[155] *Id*. at 1129–31.

[156] 473 S.E.2d 507 (Ga. Ct. App. 1996).

[157] *Id*. at 508.

[158] *Id*. at 509–10. *See generally infra* paragraph accompanying notes 233–34 (discussing potential misuse of jointly-held properties).

jointly-held accounts and real property as the survivor after her mother's death, she should not have applied for and accepted the guardianship."[159] Given the ubiquity of joint property ownership in close families, the court's ruling could dissuade close relatives and friends from seeking and accepting fiduciary appointment.

2. Intrinsic Bonds and Social Norms

In a close familial or personal relationship, financial conflicts do not necessarily lead to significant misalignment of incentives, nor do they usually warrant extensive legal regulation. In respect of the parent-minor child relationship, Professors Elizabeth Scott and Robert Scott argued that the biological and affective bonds among the members of a close family, together with social and moral norms, have a dominating effect in aligning incentives.[160] These incentive-alignment effects explain the law's preference for engaging close family members as fiduciaries.[161] By comparison, extralegal mechanisms are less effective in aligning incentives in cases

[159] *Id.* at 510.

[160] Scott & Scott, *supra* note 38, at 2430, 2433. The law and economics literature often denote by "bonding" a device that functions to align incentives. *See, e.g.*, *id.* at 2403. To avoid confusion with "bonds" in the insurance sense, *see generally infra* Section IV.C, this Chapter uses "incentive-alignment" to denote what these authors meant by "bonding".

[161] Scott & Scott, *supra* note 38, at 2426.

involving estranged families.[162] The extent of formal legal regulation of a parent-minor child relationship should depend on the strength of extralegal mechanisms.[163]

Extralegal mechanisms can also align incentives when a close relative or friend serves as guardian or agent to an elderly incapable individual.[164] The individual's spouse/partner or adult child is typically the preferred guardian or agent.[165] Close relatives and friends tend to serve as guardian or agent on an unpaid basis.[166] This tendency is consistent with the available evidence on unpaid caregivers, which evidence reveals the critical role of intrinsic bonds and informal norms in close families. A recent empirical study estimates that about 34.2 million Americans provide unpaid care to an adult, with nearly half of the care recipients being seventy-five years or older.[167] Caregivers typically provide four years of unpaid care to an aged parent or a

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[162] *Id.* at 2442–51.

[163] *Id.* at 2452.

[164] *See generally* Elizabeth S. Scott & Ben Chen, *Fiduciary Principles in Family Law*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW ch. 12 (Evan J. Criddle, Paul B. Miller, Robert H. Sitkoff eds., forthcoming 2019).

[165] *See, e.g.*, Unif. Guardianship, Conservatorship, and Other Protective Arrangements Act § 410 (Unif. Law Comm'n 2017); UNIF. PROBATE CODE § 5-413(a) (amended 2010); Kohn, *supra* note 7, at 2–3.

[166] *See, e.g.*, RESTATEMENT (THIRD) OF PROPERTY (WILLS & DON. TRANS.) § 8.3 cmt. g (2003).

[167] NATIONAL ALLIANCE FOR CAREGIVING & AARP PUBLIC POLICY INSTITUTE, *supra* note 127, at 17–18.

spouse/partner. Caregiving is burdensome and time-consuming; it generally takes 24.4 hours per week on average, and increases to 44.6 hours per week on average when the care-recipient is a spouse/partner.[168] Yet orthodox fiduciary law cynically ignores the presence of well-intended family fiduciaries who are motivated by biological and affective bonds as well as social and moral norms.

In close families or personal relationships, where intrinsic bonds and informal norms tend to be strong, there is typically no need to impose the sole-interest duty of loyalty. Extralegal mechanisms can more cost-effectively align the guardians' or agent's incentives with the incapable individual's. In the language of economic theory, the fiduciary exploits the moral hazard problem to the extent that her incentives are misaligned with the beneficiary's. When intrinsic motivations and informal norms become more effective in aligning incentives, the fiduciary becomes less likely to exploit her discretion.[169] This then diminishes the need for incentive-

[168] *Id.* at 20–21, 34. To provide care, family caregivers often have to reduce their own work hours, sacrifice their own careers or tap into their own retirement savings. *See generally* U.S. GOV'T ACCOUNTABILITY OFF., GAO-19-382, RETIREMENT SECURITY: SOME PARENTAL AND SPOUSAL CAREGIVERS FACE FINANCIAL RISKS 23–25 (2019).

[169] Strong other-regarding preferences, especially reciprocity fairness and inequality aversion, can also align incentives. *See infra* Section II.B.3. *See, e.g.*, Florian Englmaier & Stephen Leider, *Contractual and Organizational Structure with Reciprocal Agents*, 4 AM. ECON. J. MICROECON. 146, 171 (2012); Hideshi Itoh, *Moral Hazard and Other-regarding Preferences*, 55 JAPANESE. ECON. REV. 18 (2004).

alignment by strict legal regulation.[170]

To be sure, courts can strictly enforce the sole-interest duty of loyalty, and reward the errant guardian or agent with remuneration that commensurate with her services.[171] For example, in *In re Estate of O'Hare*, the mother-guardian was allowed to keep some of her caregiver's salary notwithstanding her breach of the sole-interest duty of loyalty.[172] However, monetary remuneration can have complex effects in close familial and personal relationships. While monetary remuneration can generate incentives to provide fiduciary services, it can also "crowd out" intrinsic motivations.[173] Tying monetary remuneration to fiduciary service can commodify the

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[170] The incentive-alignment effects of intrinsic bonds and social norms in the relationship between the guardian (or agent) and the incapable individual depend little on the guardian's (or the agent's) relationship with another person. This clarification matters because many disputed cases concern someone *other than* the elderly incapable individual bringing claims against the guardian (or agent). *See generally* Barnes, *The Liberty and Property of Elders*, *supra* note 40. The active litigants are often related to the elderly incapable individual, for example, her children from different marriages. *See, e.g.*, *In re* Conservatorship of Hanson, 682 N.W.2d 207 (Neb. 2004). The relationship between the claimant and the guardian (or agent) is typically acrimonious. However, it is the characteristics of the guardian's (or agent's) relationship with the incapable individual, not with the claimant, that matter for aligning incentives. Thus the fact that the disputed cases often involve litigants who are related does not weaken the argument that strong intrinsic bonds and social norms can align incentives in the relationship between the guardian (or agent) and the incapable individual.

[171] *See generally infra* Section IV.D.

[172] 34 N.E.3d 1126, 1129–30 (Ill. Ct. App. 2015).

[173] Empirical research shows that the likelihood such "crowding out" is increased when the monetary remuneration is small relative to the services provided. *See, e.g.*, Uri Gneezy & Aldo Rustichini, *Pay Enough or Don't Pay at All*, 115 Q. J. ECON. 791 (2002).

underlying familial or personal relationship.[174] Relatives and friends who request remuneration also risk signaling that they are driven by money rather than intrinsic bonds and moral norms.[175] An additional complication is the risk of signaling distrust of the relative or friend;[176] the signal may be that the court or the incapable individual believes the relative or friend would shirk her responsibilities without monetary reward. Moreover, services provided in a familial or personal relationship—which is largely private—can be hard to describe and document;[177] insufficient records can stand in the way of a request for remuneration.[178]

However, in cases concerning professional guardians and agents, extralegal mechanisms are unlikely to be strong enough to justify weakened formal regulation. While professionals may be constrained by social and moral norms, they tend not to be constrained by biological and affective

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[174] *See generally* Melanie B. Leslie, *Enforcing Family Promises: Reliance, Reciprocity, and Relational Contract*, 77 N.C. L. REV. 551 (1999).

[175] *See* Benjamin Ho & David Hoffman, *Trust and the Law*, *in* RESEARCH HANDBOOK ON BEHAVIORAL LAW AND ECONOMICS 307–08 (Joshua C. Teitelbaum & Kathryn Zeiler eds., 2018) (explaining the likely causes of "crowding out"). *But see* APPELBAUM & GUTHEIL, *supra* note 9, at 206 (Remuneration can inculcate seriousness and responsibility to a lay fiduciary, and reduce her emotional conflicts.).

[176] *See, e.g.*, Roland Bénabou & Jean Tirole, *Intrinsic and Extrinsic Motivation*, 70 REV. ECON. STUD. 489, 492 (2003).

[177] *See supra* Scott & Emery, *supra* note 117, at 74.

[178] *See, e.g.*, *In re* Estate of O'Hare, 34 N.E.3d 1126, 1129–30 (Ill. Ct. App. 2015).

bonds. Moreover, professionals serve a multitude of incapable individuals; rather than becoming intimate with and empathetic for a specific incapable individual, professionals have the incentive to develop transferable skills and expertise.[179] In particular, institutional guardians often standardize and bureaucratize, especially when under budgetary pressures.[180] These tendencies can weaken any intrinsic bonds between a professional and each incapable individual she serves.

It must be clarified that the author does not suggest that formal legal regulation is completely unnecessary when a close relative or friend serves as guardian or agent to an elderly incapable individual. Intrinsic bonds and informal norms can be strong in these relationships, but not as strong as in a close parent-minor child relationship.[181] Moreover, the incentive-alignment effects of intrinsic bonds can be asymmetric. For example, a parent's affection for her child can be stronger than the child's affection for the parent. Thus, as Professor Elizabeth Scott and the author recently argued, the strength and direction of affective bonds and informal norms can explain the

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[179] *See* Barnes, *Corporate and Professional Guardians*, *supra* note 43, at 954–55; Linda S. Whitton & Lawrence A. Frolik, *Surrogate Decision-making Standards for Guardians: Theory and Reality*, 3 UTAH L. REV. 1491, 1508 (2012) [hereinafter, Whitton & Frolik, *Theory and Reality*].

[180] APPELBAUM & GUTHEIL, *supra* note 9, at 188.

[181] *See generally* Scott & Scott, *supra* note 38, at 2430, 2433.

contrast between American law's deference to parents who take care of minor children, and its imposition of formal fiduciary duties on adult children who serve as guardians to their elderly parents.[182] Hence I do not argue for the complete removal of guardians' and agents' formal fiduciary duties; I argue that the rigor of these duties ought to depend on the strength of intrinsic bonds and informal norms in typical cases.

3. Other-Regarding Preferences

Experimental research in psychology and behavioral economics shows that individual preferences are often other-regarding, rather than purely self-regarding. Other-regarding preferences can take various forms. One form is altruism, and other forms include preferences for *reciprocity fairness*—returning kindness for another's kindness but unkindness for another's unkindness—and *inequality aversion*—deriving value from comparing oneself with another person.[183] In close families and personal relationships, strong other-regarding preferences can manifest in gift-giving norms and

[182] *See generally* Scott & Chen, *supra* note 164.

[183] *See, e.g.*, Ernest Fehr & Klaus M. Schmidt, *A Theory of Fairness, Competition, and Cooperation*, 114 Q. J. ECON. 817 (1999); Gary E. Bolton & Axel Ockenfels, *ERC: a Theory of Equity, Reciprocity, and Competition*, 90 AM. ECON. REV. 166 (2000); Gary Charness & Matthew Rabin, *Understanding Social Preferences with Simple Tests*, 117 Q. J. ECON. 817 (2002). *See generally* SANJIT DHAMI, THE FOUNDATIONS OF BEHAVIORAL ECONOMIC ANALYSIS chs. 5.2, 5.3, 6.7 (2016) (surveying experimental research on other-regarding preferences). *See also id.* ch. 5.5 (discussing external validity of experimental research); Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1646, 1685–90 (2003) (Preferences for reciprocal fairness provide a source of self-enforcement in deliberately incomplete contracts).

property-sharing arrangements. For instance, gift-giving is often reciprocated in long-term relationships.[184]

While the subsequent arguments do not depend on which exact form of other-regarding preferences is involved, reciprocity fairness stands out as particularly relevant. A recent survey reveals that almost half of unpaid caregivers take care of their aged parents, with spouses/partners being the next largest category of care-recipients.[185] Adult children and spouses/partners are also the most common categories of guardians and agents.[186] Reciprocity fairness can partially explain what motivates adult children to take care of their aged parents; a child receives care from her parents in her minority, and she later returns the favor in her parents' old age. Similarly, couples who receive unpaid care from each other may well reciprocate in their old age.

In cases where other-regarding preferences are strong, mandatory application of the sole-interest duty of loyalty tends to harm welfare. Strict enforcement of the sole-interests duty typically leads to a one-sided distribution of welfare gains—in favor of the incapable individual and no one

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[184] *See generally* Leslie, *supra* note 174, at 564–78.

[185] NATIONAL ALLIANCE FOR CAREGIVING & AARP PUBLIC POLICY INSTITUTE, *supra* note 127, at 20. *See also id.* at 21 ("As caregiver age rises, it is more likely they care for their spouse.").

[186] *See supra* note 33.

else.[187] This remains the case even in the absence of harm to the incapable individual. A one-sided distribution is far from optimal if the incapable individual has strong other-regarding preferences. Such one-sidedness is particularly stark in cases concerning close relatives and friends, because they usually do not receive remuneration for providing fiduciary services (especially when the incapable individual's estate is small).[188] This is in contrast to cases involving professional guardians and agents who charge fees for their services.[189] Moreover, providing services to the incapable individual can generate high opportunity costs; the guardian or agent becomes less available to generate income to herself.[190] The sole-interest duty thus forces the incapable individual to be selfish; her welfare is harmed whenever she has other-regarding preferences.

An illustrative case is *In re Conservatorship of Hanson*,[191] in which a married couple formed an agreement years before the husband became the subject of a guardianship. Pursuant to the agreement, Mr Hanson regularly

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[187] For instance, in the numerical example discussed in Section I.E, strict enforcement of the sole-interests duty gives all of the welfare gain of $70 to the beneficiary and none of it to the errant fiduciary.

[188] Barnes, *Corporate and Professional Guardians*, *supra* note 43, at 954.

[189] *Id.* at 943–44, 949–50.

[190] *See* NATIONAL ALLIANCE FOR CAREGIVING & AARP PUBLIC POLICY INSTITUTE, *supra* note 127, at 55, 60.

[191] 682 N.W.2d 207 (Neb. 2004).

paid Mrs Hanson for the added expense of his living in her home. After her appointment as guardian to her husband, Mrs Hanson continued to receive payments without prior judicial approval. When Mr Hanson passed away, his children from his former marriage sought to recover the payments that Mrs Hanson received during the period of guardianship. The Nebraska court found a breach of the sole-interest duty of loyalty on the basis of self-dealing, and disgorged those payments from Mrs Hanson. This was notwithstanding a lack of sinister motive on her part.[192] The court also deliberately paid no attention to "family financial management in the family's accustomed manner."[193] In the language of economic theory, the strict enforcement of the sole-interest duty harmed Mr Hanson's welfare by denying his preferences to benefit his wife.

Another illustrative case is *In re Campione*.[194] This case concerned an elderly incapable woman whose guardian—Carol—was one of her daughters. Carol commingled her own funds with her mother's funds, and purchased property in her own name with her mother's funds. Because these funds were previously held on trust for her benefit, Carol mistakenly thought they belonged to her. After her mother passed away, some of Carol's relatives

[192] *Id*. at 209–12.

[193] *Id*. at 211.

[194] 872 N.Y.S.2d 210, 214 (N.Y. App. Div. 2009).

succeeded in their claim to recover the relevant property and guardianship funds from Carol. The court did not enquire into whether Carol's actions reflected her familial understanding with her mother. It was also unclear whether, if she were mentally-capable, the mother would have wanted to share her funds with Carol.[195] What was clear, however, was that Carol would not have been able to enjoy her mother's funds even if her mother wanted her to.

C. Incentives to "Game the System"

A further reason for regulating professional guardians and agents more strictly than close relatives and friends is to ensure that judicial scrutiny of professional conduct is more rigorous before the fact than after the fact. This Section argues that relaxed fiduciary regulation can blur the distinction between judicial scrutiny before the fact and after the fact, which in term gives professionals a perverse incentive to avoid judicial scrutiny before the fact.

The distinction between judicial scrutiny of suspicious conduct before the fact and after the fact is critical for the operation of fiduciary law. The discussions so far concern judicial scrutiny after the fact, that is, when the guardian or agent is sued for having committed the suspicious conduct. To

[195] *Id*. at 212–14.

minimize the risk of liability after the fact, the guardian or agent can petition the relevant state court for approval before committing the suspicious conduct.[196] To obtain such ex-ante judicial approval, the guardian or agent is typically required to give notice to the incapable individual and any interested parties, and disclose any conflict of interest.[197] This procedure gives the court and any interested parties an opportunity to evaluate the pros and cons of the suspicious conduct.[198] In some cases, independent legal representation can also be afforded to the incapable individual;[199] her own view on the suspicious conduct can be expressed directly or through legal counsel to be extent possible. If properly granted, prior judicial approval protects the guardian or agent from liability for any potential breach of fiduciary duty. However, a failure to comply with the notification and disclosure procedures

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[196] *See* UNIF. PROBATE CODE § 5-411 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 414 (Unif. Law Comm'n 2017). An agent can invoke the procedure to obtain prior judicial approval by petitioning for the appointment of a guardian (such as herself). For example, when a bank or financial institution doubts an agent's instruction regarding the property of her incapable principal, the agent is often asked to initiate a guardianship proceeding. *See. e.g.* Whitton, *supra* note 7, at 38–39. The agent can then ask the court to scrutinize and approve the relevant transaction.

[197] *See, e.g.*, UNIF. PROBATE CODE § 5-411(a) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 414(a) (Unif. Law Comm'n 2017).

[198] *In re* Castner, 661 A.2d 344, 348 (N.J. Super. Ct. 1995).

[199] *See, e.g.*, *In re* Keri, 853 A.2d 909 (N.J.). *See generally* Am. Bar Ass'n Comm'n Law & Aging, *supra* note 132 (surveying right to counsel in American guardianship statutes).

would withdraw the protection afforded by prior judicial approval.[200]

The equitable doctrine of substituted judgment (or its statutory adoption) provides the substantive standard for determining whether to grant prior judicial approval. This standard typically requires the court to give effect to what the incapable individual would have wanted if she was capable.[201] If her wishes are not known, or if giving effect to her wishes would unreasonably harm or endanger her, then the court applies the best-interest standard.[202] In particular, the court can pre-approve transactions tainted with a conflict of interest, especially if there is evidence showing that such approval would carry out the incapable individual's wishes.[203]

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[200] *See, e.g.*, *In re* Guardianship and Conservatorship of Jordan, 616 N.W.2d 553, 558–61 (Iowa 2000) (guardian held in breach of the rule against self-dealing for selling his elderly incapable mother's property to his shell company with prior judicial approval obtained without complying with the requirement to give notice); Black v. Black, 422 P.3d 592 (Colo. Ct. App. 2018) (guardian held in breach of fiduciary duty for engaging in conflicted transactions with prior judicial approval obtained without disclosing his conflicts).

[201] *See, e.g.*, UNIF. POWER OF ATTORNEY ACT § 217(c) cmt. (Unif. Law Comm'n 2006) (gifting by agent); UNIF. PROBATE CODE §§ 5-411(a), 5-411 (c), 5-427(b) (amended 2010) (gifting by guardian); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 414(c) (Unif. Law Comm'n 2017); N.Y. MENTAL HYG. LAW § 81.21 (McKinney 2016); RESTATEMENT (THIRD) OF TRUSTS § 11 cmt. f, note to cmt. f, re: subsection (5) (AM. LAW INST. 2003).

[202] UNIF. PROBATE CODE §§ 5-314(a), 5-418(b) (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 418(c) (Unif. Law Comm'n 2017). *See generally* Lawrence A. Frolik & Linda S. Whitton, *The UPC Substituted Judgment/Best Interest Standard for Guardian Decisions: A Proposal for Reform*, 45 U. MICH. J. L. REFORM 739, 742–43 (2012) (surveying financial decision-making standards in American guardianship statutes). *See, e.g.*, *In re* Tinsmon, 79 N.Y.S.3d 854 (N.Y. Surr. Ct. 2018) (granting prior approval to gifts to the incapable individual's children, upon taking into account his intention to do so before becoming incapable).

[203] Kohn, *supra* note 24, at 257.

In respect of professional guardians and agents, the availability of prior judicial scrutiny weakens the case for relaxed judicial scrutiny after the fact.[204] An examination of proposals to replace the sole-interest duty of loyalty with the best-interest duty can illustrate this point.[205] If the best-interest standard governs judicial scrutiny after the fact, then the distinction between judicial scrutiny before the fact and after the fact essentially disappears; both the substantive and procedural aspects of ex-ante and ex-post judicial scrutiny become very similar, if not identical. This implies that a given suspicious conduct has roughly the same chance of passing judicial scrutiny before the fact and after the fact. As a result, sophisticated guardians and agents are encouraged to avoid ex-ante scrutiny of suspicious conduct, and "chance it" if and when they get sued.[206]

A numerical hypothetical can illustrate what may happen if the distinction between judicial scrutiny before the fact and after the fact is blurred. Suppose a sophisticated professional guardian has an opportunity to take an action that generates $50 to herself and harms the incapable individual by $100.

[204] However, prior judicial scrutiny is not a substitute for a private individual's power of authorization. *See supra* Section II.A. Hence the availability of prior judicial scrutiny does not weaken the case for applying the sole-interest duty of loyalty to scrutinize suspicious conduct after the fact.

[205] *See generally supra* Section I.D.

[206] Conaglen, *supra* note 110, at 576.

Monitoring and detection of misconduct are far from perfect,[207] so that with 50% probability, the guardian can take the action without getting sued later. The incapable individual's own wishes are not known in this case, so judicial scrutiny of the action can only be done in the light of evidential uncertainty regarding the harm done to her; the court would never know for sure whether the action is truly harmful. Due to such evidential uncertainty, an application of the best-interest standard would approve the action with 60% probability, and prohibit it with 40% probability.[208] These probabilities are the same whether judicial scrutiny is undertaken before the fact or after the fact.

In this hypothetical, given some technical assumptions to simplify analysis,[209] the professional guardian's expected monetary outcome for seeking prior judicial scrutiny is $\$50 \times 60\% + \$0 \times 40\% = \$30$. On the other hand, if she "chances" it by taking the action without prior scrutiny, then her expected monetary outcome is $\$50 \times 60\% \times 50\% + \$0 \times 40\% \times 50\% = \$15$. She is twice-better off taking the action and risking judicial scrutiny after the

[207] *See supra* Section I.B.2.

[208] If the sole-interest duty of loyalty applied, then the action would be prohibited with 100% probability due to the guardian's personal benefit. *See supra* Section I.C.

[209] Assume that the guardian is risk-neutral, would have no incentives to take the relevant action if it was prohibited by the court before the fact, and would be liable to disgorge her personal benefit if she got sued and found in breach. Another assumption is she pays the same legal costs for seeking prior judicial approval and for litigating a breach-of-fiduciary duty claim after the fact.

fact than inviting judicial scrutiny before the fact. Thus the professional guardian has the incentive to take the action and risk judicial scrutiny after the fact.

The above result critically depends on two factors: that the professional guardian enjoys a positive probability of taking the action without getting sued; and that the action has the same chance of surviving judicial scrutiny before the fact and after the fact. While the real world is obviously more complex, the above numerical hypothetical illustrates a broader problem that arises from assimilating the standards for judicial scrutiny of fiduciary conduct before the fact and after the fact. The problem is that sophisticated guardians and agents can be encouraged to "game the system" when they have a good chance of evading judicial scrutiny completely and a similarly-rigorous standard of scrutiny applies in the event that they get sued.

The "gaming-the-system" problem primarily affects cases concerning professional guardians and agents, because they tend to be sophisticated and well-informed of the law. By comparison, lay relatives and friends are unlikely to be aware of, and exploit, the similarities and differences between ex-ante and ex-post scrutiny. Moreover, professionals tend to be able to spread the risk and cost of liability across the multitude of incapable individuals they serve. Hence, compared to relative and friends, professionals tend to have a bigger risk-appetite for committing suspicious conduct without

seeking prior scrutiny.

D. Summary

This Part has argued that fiduciary law practically applies by mandatory force to guardians and agents; mentally-incapable individuals usually cannot authorize departures from adherence to strict fiduciary duty. Unable to be modified, fiduciary law—both the orthodox form and the relaxed form—can be detrimental to welfare. Orthodox fiduciary law tends to harm welfare in cases where the guardian or agent is a close relative or friend of the incapable individual. These cases tend to exhibit strong intrinsic bonds and informal norms, as well as other-regarding preferences. In these cases, mandatory application of the sole-interest duty of loyalty adds little in terms of incentive-alignment, but can discourage the guardian or agent from supporting the incapable individual to pursue valuable other-regarding goals and preferences. Moreover, given the ubiquity of conflicts of interest in close families and personal relationships, strict enforcement of the sole-interest duty can discourage relatives and friends from seeking and accepting fiduciary appointment to provide valuable services.

On the other hand, strict fiduciary regulation remains justified in cases concerning professional guardians and agents. In these cases, intrinsic bonds and other-regarding preferences are unlikely to be strong. Professionals also tend to be sophisticated and well-informed of the law; they can take

advantage of the mechanism for obtaining ex-ante judicial authorization of suspicious conduct. Moreover, relaxed fiduciary regulation can give professionals perverse incentives to "game the system"; reducing the rigor of judicial scrutiny of suspicious conduct after the fact can discourage professionals from seeking judicial authorization before the fact.

III. INTRODUCING A SUBSTITUTED-JUDGMENT DEFENSE

This Part and Part IV below will make reform suggestions to loosen fiduciary regulation of close relatives and friends and tighten fiduciary regulation of professionals. More precisely, this Part will propose to retain the sole-interest duty of loyalty and make available a *substituted-judgment defense* to close relatives and friends who serve as guardians or agents. This defense protects the guardian or agent from liability for exposing herself to a conflict of interest if she can prove that:

(1) the incapable individual would have authorized the conflict if she was mentally-capable and fully-informed; and

(2) mental incapacity was the only reason that prevents the individual from validly authorizing the conflict on her own.[210]

Section III.A below will explain that the proposed defense aims to

[210] Mental incapacity is not the only basis for inability to authorize departures from strict fiduciary law. In particular, even mentally-capable individuals cannot authorize a departure from the "mandatory core" of fiduciary law. *See supra* note 112 and accompanying text.

approximate a valid exercise by the incapable individual of the power to authorize departures from strict fiduciary law. Section III.B will compare the proposed defense with the best-interest standard—the main reform alternative. Section III.C will suggest that fiduciary law should not relax its usual rigor on account of assent to suspicious conduct given after the appointment of guardian or agent.

A. Approximation of the Power to Authorize Departures from Adherence to Overbroad Fiduciary Duties

As Part II has shown, by removing a fiduciary's unauthorized profits arising from a conflict of interest, the sole-interests duty of loyalty incentivizes her to seek authorization from her beneficiary. Valid authorization requires the fiduciary to make a fair-and-frank disclosure, so that the beneficiary is fully-informed. The combination of the sole-interest duty and the power of authorization thus facilitates agreements to permit the conflict and share the welfare gain arising from it, *assuming* the parties are mentally-capable.[211] However, in cases concerning incapable individuals, mental incapacity tends to stultify the power to authorize departures from strict fiduciary law.[212] The proposed substituted-judgment defense approximates the outcome that arises from a valid exercise of the power of

[211] *See supra* Section I.E.

[212] *See supra* Section II.A.

authorization: the guardian or agent is allowed to keep her personal gain in cases where the incapable individual would have authorized the relevant conflict if she was mentally-capable and fully-informed.

1. Relaxation of Mandatory Fiduciary Law

When made available to close relatives and friends, the proposed substituted-judgment defense prevents the sole-interest duty of loyalty from stultifying the pursuit of other-regarding goals and preferences. A capable individual who wishes to be other-regarding may exercise her power to authorize a conflict of interest; this can facilitate a relatively even distribution of welfare gains between her and her fiduciary (or a third party). The proposed defense performs a similar function for an incapable individual. It does so by allowing the conflicted guardian or agent to defend a distribution of welfare gains that enriches herself (or a third party) to the extent that such distribution would have been authorized by the incapable individual. The proposed defense thus permits the guardian or agent to support the incapable individual to pursue non-selfish goals and preferences.[213]

The proposed defense also eases the burden of fiduciary regulation on close relatives and friends. Section II.B.1 has argued that compliance with strict fiduciary law can require close relatives and friends to incur the costs

[213] *See generally supra* Section II.B.3.

of removing conflicts of interest. Such costs can be substantial because conflicts are ubiquitous in close familial and personal relationships. The propose defense can reduce the costs of removing conflicts; it does so by permitting those conflicts that are consistent with what the incapable individual would have wanted. When the costs of complying with fiduciary law are reduced, close relatives and friends are more likely to take on the fiduciary office.

Moreover, the proposed defense accommodates strong intrinsic bonds and informal norms. Mandatory enforcement of strict fiduciary law ignores the fact that these extralegal mechanisms can partially and more cost-effectively align incentives.[214] Loosening fiduciary regulation of close relatives and friends, the proposed defense thus leaves room for extralegal mechanisms to deter misconduct.

2. Evidence of Subjective Will and Preferences

To ascertain what the incapable individual would have wanted if she was capable, the proposed substitute-judgment defense typically looks to evidence of her past conduct, transacting patterns, and relational norms.[215] The individual's own choices made in a mentally-capable state are evidence

[214] *See generally supra* Section II.B.2.

[215] *See, e.g.*, *In re* Brice's Guardianship, 8 N.W.2d 576, 578 (Iowa 1943).

of her subjective will and preferences.[216] To be sure, breach-of-fiduciary duty claims often concern one-off transactions that the incapable individual may not have had an opportunity to make in the past.[217] However, most incapable individuals are seniors who have had a life-time of opportunities to make use of testamentary instruments, such as wills and wish letters.[218] They also tend to have left behind a "memory trail" of informed opinions and value preferences in the minds of their family and friends.[219] Moreover, transactions made near the end of an individual's life may be the final manifestation of property-sharing and gift-giving norms within close familial or personal relationships.[220] The substituted-judgment defense directs courts

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[216] *See generally* Agnieszka Jaworska, *Advance Directives and Substitute Decision-Making*, THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY § 1 (Mar. 24, 2009), https://plato.stanford.edu/entries/advance-directives/; RONALD DWORKIN, LIFE'S DOMINION: AN ARGUMENT ABOUT ABORTION, EUTHANASIA, AND INDIVIDUAL FREEDOM 222–29 (1993) (discussing how the substituted-judgment standard promotes individual autonomy); B. Douglas Bernheim, *Behavioral Welfare Economics*, 7 J. EUR. ECON. ASSO'N 267, 290–93 (2009).

[217] *See, e.g.*, Dubree v. Blackwell, 67 S.W.3d 286 (Tex. Ct. App. 2001) (a potentially incapable individual making a one-off transfer of her house to her life-long friend and carer).

[218] *See, e.g.*, *In re* Miller, 935 N.E.2d 729, 733–34 (Ind. Ct. App. 2010).

[219] Terry Carney, *Financial Planning Mechanisms for People with Cognitive Impairment in Australia*, *in* SPECIAL NEEDS FINANCIAL PLANNING: A COMPARATIVE PERSPECTIVE 5–6 (Lusina Ho & Rebecca Lee eds., 2019).

[220] *See generally* Leslie, *supra* note 174, at 564–78; Alexander M. Meiklejohn, *Contractual and Donative Capacity*, 39 CASE WESTERN RESERVE L. REV. 307, 342, 364–67, 379, 387 (1988-89) (analysis of contractual capacity cases from the 1960s to 1980s showing that court tended to uphold contracts made in the course of long-term and close relationships).

to consider the individual's past relational norms and succession plans, in addition to her past conduct and transacting patterns.

In re Miller provides an example of how courts should apply the substituted-judgment defense.[221] That case concerned Xenia, a wealthy elderly woman who had a long history of giving to the community. When she lost mental capacity, one of her children—William—and a close family adviser started managing her property as her agents. The two agents continued to use her money toward philanthropy, and on maintaining a family home to be inherited by William.[222] After Xenia passed away, one of her other children sued the agents for breach of fiduciary duty. The Indiana court applied a substituted-judgment analysis to rule in favor of the agents. In so ruling, the court aimed to uphold Xenia's known wishes as manifested by what she had historically said and done as well as the wish letters that she and her husband wrote to their children.[223]

In re Campione[224] can illustrate how the proposed substituted-judgment defense may operate in marginal cases. Recall that in that case, the court restored to the estate of an elderly incapable woman those guardianship funds

[221] 935 N.E.2d 729 (Ind. Ct. App. 2010).

[222] *Id*. at 733–36.

[223] *Id*. at 739–43.

[224] 872 N.Y.S.2d 210, 214 (N.Y. App. Div. 2009).

that her daughter-guardian—Carol—had commingled and used to benefit herself.[225] Strictly enforcing the sole-interests duty of loyalty, the court did not give significance to the limited and inconclusive evidence of property sharing in that family.[226] The proposed substituted-judgement defense would have incentivized Carol (or her legal representative) to adduce more evidence of her mother's will and preferences before she lost capacity, and would not shield Carol from liability if such evidence were not adduced. The proposed defense would facilitate the pursuit of other-regarding goals and preferences only to the extent supported by evidence.

In cases involving conflicting evidence of what the incapable individual would have wanted if she had capacity,[227] there should be a rebuttable presumption in favor of respecting her testamentary intent expressed in any properly-executed will (or will substitute).[228] The individual must have executed the testamentary instrument when she was mentally-capable.[229] The

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[225] *Id.* at 212.

[226] *Id*. at 214.

[227] *See generally* Whitton & Frolik, *Theory and Reality*, *supra* note 179, at 1492–93.

[228] Will substitutes are transactions to effectuate transfers of wealth at death without going through the formal probate system. *See generally* John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV. L. REV. 1108 (1984); RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 7.1 (AM. LAW INST. 1999).

[229] *See generally* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 8.1 (AM. LAW INST. 1999).

testamentary instrument also generally needs to comply with formality requirements. For example, an attested will needs to be in writing, signed by the individual and attested by several witnesses.[230] Similarly, a revocable trust of interest in land created in the individual's lifetime—a will substitute—needs to be in writing and signed by her.[231] Formality requirements function to generate solid evidence of the individual's wishes. Another function is to caution the individual against making ill-considered choices. A further function is to protect the individual from fraud and imposition. Finally, formality requirements perform the channeling function of facilitating standardization, so that testamentary instruments can be distinguished from other expressions of intention.[232] Thus properly-executed testamentary instruments should be afforded special weight in the application of the proposed substituted-judgment defense.

In cases involving insufficient evidence of what the incapable individual would have wanted if she had capacity, the criterion for judicial scrutiny of

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[230] *See generally id.* § 3.1. Courts may excuse some harmless errors in executing a will. *See generally id.* § 3.3.

[231] *See generally* RESTATEMENT (THIRD) OF TRUSTS §§ 23, 24 cmt. a (AM. LAW INST. 2003).

[232] *See generally* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 3.3 cmt. a (AM. LAW INST. 1999); RESTATEMENT (SECOND) OF CONTRACTS § 72 cmt. c. (AM. LAW INST. 1981); Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941); John H. Langbein, *Substantial Compliance with the Wills Act*, 88 HARV. L. REV. 489, 492–97 (1975).

fiduciary conduct (after the fact) should fall back to the sole-interest duty of loyalty.[233] In these cases, the substituted-judgment standard would provide no practical guidance on what to do.[234] Moreover, as Section III.A.4 below will explain further, relaxed fiduciary regulation is not justified when evidence of strong intrinsic bonds and other-regarding preferences is absent. Thus, in cases of insufficient evidence, the sole-interest duty should continue to prohibit previously-unauthorized conflicts of interest; a substituted-judgment analysis would be unnecessary and useless in these cases.

3. Doctrinal Support

The proposed substituted-judgment defense has doctrinal support. First, courts already tend to apply the substituted-judgment standard when they scrutinize suspicious fiduciary conduct *before the fact*.[235] This criterion can facilitate ex-ante judicial approval of transactions that benefit the close family members of an incapable individual.[236] With some qualifications to be explained in Section III.B.3 below, the proposed defense largely extends the substituted-judgment standard to govern judicial scrutiny of suspicious

[233] *See also supra* Section II.C and *infra* Section III.B.3 (discussing the differences between judicial scrutiny before the fact and after the fact).

[234] Whitton & Frolik, *Theory and Reality*, *supra* note 179, at 1506.

[235] *See supra* note 201 and accompanying text.

[236] Kohn, *supra* note 24, at 257.

conduct *after the fact*. Such extension in particular protects those relative-and-friend guardians and agents who seek legal advice and assistance only after being sued.

Second, courts also sometimes apply a substituted-judgment analysis in cases concerning non-fiduciaries. For example, in *Dubree v. Blackwell*, an elderly woman gifted her house to her lifelong friend and caregiver, and changed her own bank account to a joint account with the friend (with a right of survivorship).[237] After the woman passed away, her nephew—the sole beneficiary of her estate—sought to avoid these transactions on grounds of mental incapacity and undue influence. Medical experts and lay witnesses gave conflicting testimonies on the woman's mental conditions at the time of transacting.[238] The Texas court upheld these transactions upon taking into account a long history of property sharing between the woman and her friend.[239] Guided by the woman's past transacting patterns and relational norms that took place when her capacity was not in doubt, the court essentially applied a substituted-judgment analysis.

Moreover, the proposed substituted-judgment defense extends and improves upon several existing exemptions in fiduciary law, most of which

[237] 67 S.W.3d 286, 288 (Tex. Ct. App. 2001).

[238] *Id.* at 290–91.

[239] *Id.* at 288.

protect close relatives and friends.[240] The proposed defense subsumes an existing exception that may permit conflicts pre-dating the creation of the fiduciary relationship. For example, a couple may become joint owners of some property before one of them is appointed guardian to the other. The guardian will inherit the property upon the death of her spouse—the incapable individual. Before the individual passes away, the guardian may be tempted to transfer the jointly-owned property to herself, or to preserve its value by spending the incapable individual's solely-owned resources. Conduct like these are suspicious because, contrary to a prohibition of the sole-interest duty of loyalty, they benefit the guardian or agent. Some courts permit the guardian to benefit from a pre-appointment conflict if the suspicious conduct results in no actual harm to the incapable individual.[241] Some other courts disagree, holding the guardian in breach of the sole-interest duty even if she has done no more than merely accepting her appointment without renouncing the pre-existing conflict.[242] The proposed defense sides with those courts that permit pre-appointment, harmless conflicts; such

[240] Langbein, *supra* note 2, at 985.

[241] *See, e.g.*, Fielder v. Howell, 631 P.2d 249, 250–51 (Kan. Ct. App. 1981); *In re* Estate of Ross, 131 A.3d 158 (R.I. 2016).

[242] *See, e.g.*, Dowdy v. Jordan, 196 S.E.2d 160 (Ga. Ct. App. 1973); Moore v. Self, 473 S.E.2d 507, 509–10 (Ga. Ct. App. 1996); SunTrust Bank, Middle Georgia N.A. v. Harper, 551 S.E.2d 419, 426–27 (Ga. Ct. App. 2001).

conflicts are consistent with strong intrinsic bonds and other-regarding preferences, which should be respected.

Finally, a court of equity has a discretion to excuse an errant guardian or agent in whole or in part from her liability for a breach of fiduciary duty.[243] That discretion can excuse a breach that the fiduciary has taken to further her beneficiary's interests.[244] In such a case, the proposed defense achieves the same practical outcome as an exercise of judicial discretion to excuse the fiduciary in whole. However, the proposed defense reduces the indeterminacy arising from judicial discretion, and relieves the fiduciary of the guilt and moral opprobrium accompanying a finding of disloyalty.

4. Preservation of Existing Protection

Two conditions restrict the availability of the proposed substituted-judgment defense: first, the guardian or agent bears the burden of proving (by the usual civil standard of preponderance of evidence) that the incapable individual would have authorized the suspicious conduct or transaction if she was capable; and second, mental incapacity is the only reason that prevents

[243] RESTATEMENT (THIRD) OF TRUSTS § 95 cmt. (d) (AM. LAW INST. 2012). Modern guardianship and power of attorney statutes typically preserve the principles of equity. *See, e.g.*, UNIF. PROBATE CODE § 1-103 (amended 2010) (applying trust fiduciary law to guardians); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 103 (Unif. Law Comm'n 2017); UNIF. POWER OF ATTORNEY ACT § 121 (Unif. Law Comm'n 2006).

[244] RESTATEMENT (THIRD) OF TRUSTS § 95 cmt. (d) (AM. LAW INST. 2012).

the individual from making a valid authorization. Failing any of these conditions, the proposed defense does not diminish the usual rigor and breadth of orthodox fiduciary law. Mental incapacity justifies a relaxation of the fiduciary prophylaxis only to the extent of its stultification of a private individual's power to authorize suspicious conduct.[245] The following will argue that the two conditions preserve the usual operation of orthodox fiduciary law when mental incapacity does not justify weakened fiduciary regulation.

First, by placing the burden of proof on the guardian or agent, the proposed defense preserves the usual operation of orthodox fiduciary law in cases of insufficient evidence. In these cases, the guardian or agent remains able to seek prior judicial scrutiny according to the best-interest standard;[246] substituted judgment is no longer the juridical standard due to evidential deficiency. The process of prior judicial scrutiny may impose significant costs on the guardian or agent, and tend demand a high degree of sophistication from her. However, these problems also affect fiduciaries who serve mentally-capable individuals. In other words, what really prevents the guardian or agent from seeking judicial authorization is *not* mental incapacity, but is another aspect of fiduciary law that applies equally to

[245] *See supra* Section II.A.

[246] *See supra* note 202 and accompanying text.

capable and incapable individuals. Moreover, it is hard to attribute significance to mental incapacity in the absence of sufficient evidence on what the individual would have wanted if she was capable. Hence the proposed defense does not interrupt the usual operation of orthodox fiduciary law in cases of insufficient evidence. In particular, the proposed defense does not subvert the fiduciary prophylaxis when there is no evidence of potential displacement of other-regarding preferences.

Second, the "only reason" condition—that the proposed defense protects the guardian or agent only if mental incapacity is what prevents a valid authorization by the incapable individual—preserves those restrictions on modification of fiduciary law that give equal protection to capable and incapable individuals. The "only reason" condition is imposed to ensure that any modification of fiduciary law by the proposed defense does *not* go beyond what is necessary to address the special problems arising from mental incapacity. In particular, the "only reason" condition preserves the mandatory core of fiduciary law, because the individual could not modify it even if she were mentally-capable.[247] Moreover, in a rare case involving a limited guardianship that does not withhold the individual's power of authorization,[248] the "only reason" condition is not satisfied. Thus imposition

[247] *See supra* note 112 and accompanying text.

[248] Modern guardianship law encourages the use of limited guardianships that are tailored to the individual's specific needs, but the available evidence suggests that broad

of the "only reason" condition preserves the guardian's incentives to seek authorization from the individual when she can still validly exercise the power of authorization.

B. Comparison with the Best-interest Standard

The best-interest standard is the main alternative to the substituted-judgment standard and to the sole-interest duty of loyalty.[249] Under this alternative, even without prior authorization, a guardian or an agent can retain some benefit to herself if her conduct advances the best interest of the incapable individual. Empirical research has shown that guardians who apply the best-interest standard often consider the family of the incapable individual.[250] The best-interest standard thus relaxes mandatory fiduciary regulation in close families and personal relationships; inevitable conflicts can be accommodated, and intrinsic bonds and other-regarding preferences recognized and respected. This Section argues that the proposed substituted-judgement defense should be preferred to proposals to adopt the best-interest standard.

1. Indeterminacy

The proposal to adopt the substituted-judgement defense leads to a greater

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guardianships remain the norm. *See supra* note 40 and accompanying text.

[249] *See supra* Section I.D.

[250] Whitton & Frolik, *Theory and Reality*, *supra* note 179, at 1532–35.

degree of determinacy than proposals to introduce the best-interest standard. Under my proposal, in cases involving sufficient evidence of what the incapable individual would have wanted, the proposed substituted-judgment defense requires that her wishes be given effect. By comparison, in addition to factors that are relevant to applying the substituted-judgment standard, the best-interest standard requires consideration of many other factors.[251] Thus the best-interest standard can only tend to produce greater indeterminacy and be more informationally-demanding to apply. This tendency generates greater decisional costs and error costs than the substituted-judgment standard.

Similarly, in cases where evidence of what the incapable individual would have wanted is deficient, my proposal leaves the sole-interest duty of loyalty to guide judicial scrutiny of fiduciary conduct. Courts tend to look for some financial benefit—typically in the form of money or property—to the guardian or agent (or a third party). Such financial benefit is usually observable and verifiable.[252] By comparison, the best-interest standard requires consideration of a broader range of context-specific factors.[253] Thus,

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[251] *See supra* notes 88–89 and accompanying text.

[252] What is typically not observable and verifiable is any actual wrongdoing by the guardian or agent. *See generally supra* Sections I.B.2–3.

[253] *See supra* notes 88–89 and accompanying text.

given insufficient evidence to apply the substituted-judgment standard, falling back to the sole-interest duty tends to lead to a more predictable outcome than the best-interest standard.[254]

To be sure, elsewhere the author has argued that English and Australian fiduciary law should adopt a best-interest defense to protect family guardians and agents from liability for noncompliance with the sole-interest duty.[255] That best-interest defense imposes objective restrictions on the extent to which a family guardian or agent can assist the incapable individual to pursue subjective will and preferences.[256] The Anglo-Australian best-interest defense is also less determinate than the substituted-judgment defense that I propose for adoption in American jurisdictions.[257] My proposal to introduce a best-interest defense in Anglo-Australian jurisdictions but not in American jurisdictions reflects the substantial differences between American and Anglo-Australian inheritance law and policy.

First, much litigation involving guardians and agents takes place in the inheritance context. Testamentary freedom is more heavily regulated in Anglo-Australian law than in prevailing American law. In prevailing

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[254] *See supra* Section I.F.

[255] *See* this Dissertation, ch. 3).

[256] *See id.*, Section V.C.

[257] *See id.*, Section D.1.

American law, an individual's freedom of testation is qualified only by a few restrictions, such as her spouse's optional share in her estate.[258] Anglo-Australian jurisdictions, on the other hand, have adopted family provision statutes to oblige individuals to make adequate provisions for their families and dependents.[259] For example, Anglo-Australian law qualifies an individual's freedom of testation with a duty to provide for her dependent children (including adult children), while prevailing American law imposes no such duty.[260] Thus it is realistic and consistent with inheritance law and policy to introduce objective restrictions of testamentary freedom in Anglo-Australia fiduciary law, but not in American fiduciary law.

Second, the qualifications of testamentary freedom tend to be rules in prevailing American law but standards in Anglo-Australian law. Formulated in terms of standards, Anglo-Australian family provision statutes confer a substantial discretion on courts. For example, Anglo-Australian courts have a discretion to decide whether a claimant for family provision relief is a 'dependent', and if so, how much provision from the deceased's estate should

[258] *See generally* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 10.1 cmts. a, c (AM. LAW INST. 1999); SITKOFF & DUKEMINIER, *supra* note 88, 1–2, ch. 8.

[259] *See generally* JOHN G ROSS MARTYN ET AL., THEOBALD ON WILLS ch. 11 (18th ed., 2016); ROSALIND CROUCHER & PRUE VINES, SUCCESSION: FAMILIES, PROPERTY AND DEATH: TEXT AND CASES ch. 15 (4th ed., 2013).

[260] *See generally* SITKOFF & DUKEMINIER, *supra* note 88, at 564–65.

be made.[261] In contrast, showing a strong preference for rules, American legislatures have consistently rejected proposals to introduce family provision statutes.[262]

In this light, adoption of the best-interest standard would have different implications in American jurisdictions and in Anglo-Australian jurisdictions. Adopting the best-interest standard in American jurisdictions would introduce unwanted indeterminacy in the inheritance context. On the other hand, the typical Anglo-Australian inheritance dispute already exhibits a high degree of indeterminacy. Fiduciary claims against guardians and agents tend to be part and parcel of broader disputes over inheritance. Guardians and agents who are in a close relationship with the incapable individual have a strong case for family provision relief. When an inheritance dispute is viewed as a whole, introducing a best-interest analysis adds little to the high degree of indeterminacy already arising from family provision statute. In other words, in Anglo-Australian jurisdictions, the marginal indeterminacy arising from adoption of a best-interest analysis would be negligible.[263] Hence, unlike in American jurisdictions, adoption of the best-interest standard in

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[261] *See generally* CROUCHER & VINE, *supra* note 259, paras. 2.35–36; ROSS MARTYN ET AL., *supra* note 259, paras. 11–049, 11–068.

[262] *See generally* SITKOFF & DUKEMINIER, *supra* note 88, at 569–70.

[263] *See generally* this Dissertation, ch. 3, Section V.D.1.

Anglo-Australian jurisdictions would make little difference in terms of legal indeterminacy.

2. Room for Paternalism

Another reason for rejecting the best-interest standard is that it leaves more room for paternalism and discrimination than does the substituted-judgment standard. A subjective notion, the substituted-judgment standard permits a conflict of interest if the incapable individual would have authorized it. The best-interest standard, on the other hand, traditionally directs courts to do what is objectively best for a reasonable or rational person in like circumstances.[264] The best-interests can be a vehicle for paternalism and discrimination; rather than the incapable individual's wishes, the decisionmaker may act according to her own values, stereotypes or prejudices.[265]

Cases involving Medicaid or tax planning are illustrative.[266] These cases

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[264] *See generally* text accompanying *supra* notes 88–89; Jaworska, *supra* note 216, § 1; Whitton & Frolik, *Theory and Reality*, *supra* note 179, at 1505–17 (discussing and comparing the best-interest standard, the substituted-judgment standard, as well as their expanded and hybrid versions); Lawrence A. Frolik & Linda S. Whitton, *The UPC Substituted Judgment/Best Interest Standard for Guardian Decisions: A Proposal for Reform*, 45 U. CHI. J.L. REFORM 739, 751–57 (2012).

[265] *See, e.g.*, Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 633, 641–44 (1982); Linda S. Whitton, *Ageism: Paternalism and Prejudice*, 46 DEPAUL L. REV. 453, 480, 482 (1997).

[266] *See generally* Frolik, *Alter Ego*, *supra* note 53, at 65–85.

typically involve guardians who seek prior judicial approval to make large gifts of an elderly incapable individual's estate in order to qualify the individual for certain Medicaid or tax benefits. The family members of the individual are typically the intended recipients of such gifts. The practical effect of these gifts is typically to shift the financial burden of caring for the individual from her family to the state. An application of the substituted-judgment standard would allow these gifts to the extent consistent with what the incapable individual would have wanted.[267] Courts that apply the best-interest standard, on the other hand, can rule according to their own assumptions regarding whether a reasonable (or rational) person would have benefitted from helping her family at the expense of the state. For example, while the court in *In re Keri* assumed that it was in the best interests of an incapable individual to increase her children's expected inheritance at the expense of the state,[268] other courts often make the opposite assumption.[269] In extreme cases, courts may even act on their own notion of public policy and own view regarding the interests of the taxpayers.[270]

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[267] *See, e.g.*, *In re* M.L., 879 N.Y.S.2d 919, 920–21, 923 (N.Y. Sup. Ct., 2009).

[268] 853 A.2d 909 (N.J.) (discussed in text accompanying *supra* notes 102–06).

[269] *See, e.g.*, *In re* Estate of Berger, 520 N.E.2d 690, 704 (Ill. App. Ct. 1987) (rejecting gifts to the incapable individual's children notwithstanding tax benefits).

[270] *See, e.g.*, a trial court's statement extracted in *In re* Guardianship of F.E.H., 453 N.W.2d 882, 887 (Wis. 1990).

3. Incentives to "Game the System"

Section II.C has shown that a problem with proposals to replace the sole-interest duty with the best-interest standard is that essentially the same criteria end up governing judicial scrutiny before the fact and after the fact. This can generate incentives to "game the system"; sophisticated guardians and agents are encouraged to avoid ex-ante scrutiny of suspicious conduct with the hope of escaping sanction after the fact.[271] The following will argue that, unlike proposals to adopt the best-interest standard, the proposed substituted-judgment defense does not generate incentives to "game the system".

Recall that the criterion for judicial scrutiny of suspicious conduct before the fact is typically the substituted-judgment standard if there is sufficient evidence of what the incapable individual would have wanted if she was capable. If such evidence is deficient, then courts tend to rule according to what is in the best interest of the individual.[272] Introducing the proposed substituted-judgment defense would lead to ex-post scrutiny according to the substituted-judgment standard in cases of sufficient evidence, but would fall back to the sole-interest duty of loyalty in cases of insufficient evidence. Hence, in cases of insufficient evidence, the criterion for ex-ante judicial scrutiny tends to be the best-interest standard, while the sole-interest duty

[271] *See generally supra* Section II.C.

[272] *See generally supra* Section II.C.

continues to guide ex-post judicial scrutiny. Table 1 below summarizes these similarities and differences.

	Before the fact	After the fact
Sufficient evidence	Substituted judgment	Substituted judgment
Insufficient evidence	Best-interest standard	Sole-interest duty of loyalty

Table 1: criteria for judicial scrutiny of suspicious conduct, under the author's proposal

Table 1 shows that, under my proposal, judicial scrutiny of suspicious conduct tends to be more demanding after the fact than before the fact; in cases of insufficient evidence, the sole-interest duty is more rigorous than the best-interest standard.[273] In other words, unlike proposals to adopt the best-interest standard, my proposal to introduce the substituted-judgment defense does not lead to convergence of the criteria for judicial scrutiny before the fact and after the fact. My proposal thus limits any incentive to "game the system"; judicial scrutiny remains more demanding after the fact than before the fact.

[273] *See generally supra* Sections I.C–D.

C. Disrespecting Assent Expressed after the Guardian or Agent Takes Office?

The proposed substitute-judgment defense tends to show great deference to the incapable individual's past transacting patterns and relational norms, which took place before the appointment of her guardian or agent. However, the proposed defense is unlikely to excuse a breach of the sole-interest duty of loyalty on the basis of assent expressed after the guardian or agent took office. This is unlikely to be a problem in most cases; courts usually cannot access evidence of expressions of assent from an individual in an incapable state anyway.[274] Cases involving such expressions of assent nonetheless exist, and this Section explains the author's reluctance to relax the fiduciary prophylaxis in these rare cases.

Two cases can illustrate how orthodox fiduciary law treats assent to suspicious conduct expressed after the guardian or agent takes office. Consider first *In re Conservatorship of Rininger*.[275] In that case, Darrel—the incapable individual—had paranoid schizophrenia and was the beneficiary of a trust created by his father's will. In his final years of life, Darrel was very close to and dependent upon his twin sister, who was his caregiver. After

[274] *See In re* Caminite (Amelia G.), 57 N.Y.S.3d 724, 726 (N.Y. Nassau Cty. Ct.).

[275] *In re* Conservatorship of Rininger, 500 N.W.2d 47 (Iowa 1993). *Id.* is known as the "never competent" case in the philosophical literature on surrogate decisionmaking. *See generally* Jaworska, *supra* note 216, § 2.

seeking advice from his professional guardian but without obtaining prior judicial approval, Darrel used his trust income to purchase properties with his twin sister as joint owners. When the Darrel passed away, his estranged children sought compensation from the professional guardian. These children argued that the guardian breached the sole-interest duty of loyalty by allowing Darrel's purchase to go ahead. Ruling in favor of the children, the Iowa court held the professional guardian liable to reimburse Darrel's estate for the value of the relevant properties. In so ruling, the court disregarded the professional guardian's sincerity and good intentions and the "substantial evidence" that Darrel wanted to help his twin sister with her poor financial situation.[276]

A less obvious case is *Conservatorship of Smith v. Vandevort*.[277] Recall that in that case, an elderly woman and her guardian opened a joint account together after the guardian took office. The guardian then started moving money from the woman's own accounts into that joint account; he would become the sole owner of the account upon the woman passing away. The Mississippi Court of Appeals reversed the lower court's summary dismissal

[276] *In re* Conservatorship of Rininger, 500 N.W.2d 47, 49, 51 (Iowa 1993). *Cf.* Laufert v. Wegner 62 N.W.2d 758 (Iowa 1954) (allowing gifts to a family guardian and some other relatives of the incapable individual where those gifts reflected the individual's wishes before he became incapable).

[277] 237 So.3d 852 (Miss. Ct. App. 2017).

of the breach-of-fiduciary duty claim that followed.[278] Finding the claim viable, the Court of Appeals drew a distinction between opening a joint account before and after the guardian was appointed; it was permissible to open a joint account before appointment, but not after appointment.[279] This is a subtle example of respecting past expressions of assent, but not new expressions; by going to the bank with her guardian to open a joint account,[280] the elderly incapable woman could be said to have expressed assent to her guardian using the joint account to enrich his own pockets.

Cases like these reveal the problem of evidential uncertainty in judicial scrutiny of suspicious conduct after the fact. Actual wrongdoing is hard to observe and verify. Guardians and agents tend to be in a position to obtain expressions of assent from incapable individuals. For example, an intimate caregiver can use her position to procure from the incapable individual a manifestation of assent to a harmful transaction.

For the reasons that follow, the sole-interest duty of loyalty should not be relaxed on account of assent to suspicious conduct expressed after the appointment of guardian or agent. First, although not a substitute for a private

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[278] *Id*.

[279] *Id*. at 860–61.

[280] *Id*. at 855.

individual's power to authorize departures from strict fiduciary law,[281] the process for obtaining prior judicial approval can scrutinize post-appointment expressions of assent. Before the guardian or agent takes advantage of a post-appointment expression of assent, she can invoke the process for obtaining prior judicial approval.[282] That process is imperfect, but it nonetheless partially facilitates the pursuit of valuable goals and preferences that are expressed post-appointment.[283]

Second, and more importantly, the guardian or agent can argue that the individual was mentally-*capable* at the time of expressing her assent. If the individual was functionally competent, then she should be held to be capable of giving valid assent.[284] If the individual was capable, then the issue for the court becomes whether the guardian or agent had complied with the procedural safeguards to obtain the individual's fully-informed authorization to engage in the suspicious conduct.[285] For example, in *In re Conservatorship of Rininger*,[286] the guardian could have argued that Darrel was mentally-

[281] *See supra* Section II.A.

[282] *See, e.g.*, *In re* Guardianship of Bose, 158 N.W.2d 337, 341 (Wis. 1968).

[283] *See generally supra* notes 196–203 and accompanying text.

[284] *See generally supra* notes 9, 30–32 and accompanying text.

[285] *See, e.g.*, *In re* Guardianship of Bose, 158 N.W.2d 337, 341 (Wis. 1968).

[286] 500 N.W.2d 47 (Iowa 1993).

capable at the time of gifting his twin sister, and that he had authorized the conflicted transactions with the guardian's detailed advice.[287] Whether the guardian had breached his duty would then depend on judicial evaluation of the Darrel's functional competency to give such authorization, and of the guardian's compliance with the procedures for obtaining authorization. That judicial evaluation can determine whether to uphold Darrel's authorization.

D. Summary

This Part proposes to loosen the fiduciary regulation of close relatives and friends by introducing a substituted-judgment defense. Effectuating what the incapable individual would have wanted if she was capable, the proposed defense tends to respect intrinsic bonds and other-regarding preferences. The proposed defense preserves the fiduciary prophylaxis in cases of insufficient evidence. The usual operation of orthodox fiduciary law is also preserved when mental incapacity is not what really prevents the individual from authorizing the suspicious conduct on her own. Introducing the proposed defense thus amounts to taking an intermediate position between strict application of the sole-interests duty of loyalty and complete departure from it. This intermediate position tends to restore the welfare-enhancing property of fiduciary law. This position also tends to preserve the usual rigor of the

[287] The report of the case suggested that the guardian gave Darrel detailed advice on the conflicted transactions. *Id.* at 49–50.

fiduciary prophylaxis in cases where it is unlikely to displace other-regarding goals and preferences.

IV. HARNESSING REPUTATIONAL CONCERNS

The proposed substituted-judgment defense should not be made available to professional guardians and agents. As Part II has argued, strict fiduciary regulation is too onerous in cases concerning close families and personal relationships, but it continues to perform valuable incentive-alignment functions in cases concerning professionals.[288] Thus, while Part III above proposes to loosen fiduciary regulation of close relatives and friends, this Part offers suggestions to tighten fiduciary regulation of professionals.

More precisely, this Part will propose an *interrelational reporting duty* that requires professional guardians and agents to report proven misconduct to all courts and individuals who contemplate to engage their services. As Sections IV.A–B below will explain, this duty aims to harness, as much as possible, the reputational concerns of professionals who serve multiple incapable individuals. Regardless of whether she is serving an incapable individual, a professional fiduciary often has reputational concerns that may deter her from committing misconduct.[289] The following will argue that the

[288] *See supra* Section II.B.

[289] *See* Langbein, *supra* note 2, at 937–38. Lawyers who provide guardianship services are also subject to professional regulations and disciplinary actions. *See, e.g.*, *In re* D'Angelo, 158 A.D.3d 197 (N.Y. App. Div.); Iowa Supreme Court Attorney Disciplinary Bd. v. Murphy, 800 N.W.2d 37 (Iowa 2011). *Cf.* Robert E. Scott, *Conflict and Cooperation in Long-*

proposed interrelational reporting duty further harnesses the reputational concerns of professionals.

A. Repeated Dealings between Courts and Professionals

A preliminary observation is that the relationship between a professional guardian or agent and the relevant state court can involve repeated dealings and interactions.[290] Professional guardians and agents serve multiple incapable individuals. At least in theory, the court can acquire knowledge of a professional through multiple proceedings and ongoing dealings. Upon discovering a wrongdoing by the professional, the court may impose informal reputational sanctions, such as denial of future appointments. Such informal reputational sanctions are in addition to the usual sanctions for breaches of fiduciary duty.[291]

By comparison, reputational sanctions tend to have limited effects on

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Term Contracts, 75 CAL. L. REV. 2005, 2033 (1987) (That any ongoing relationship inevitably ends limits the deterrence effect of reputational concerns arising from repeated interactions.).

[290] For each potentially incapable individual, there is typically only one state court that has the power to appoint a guardian to her. The widely-adopted UNIF. PROBATE CODE §§ 5A-202-203 (amended 2010) provides jurisdictional rules to ensure that each potentially incapable individual is subject the guardianship regime of only one state—usually the individual's home state. In a state with more than one court that can appoint guardians, there is usually very little overlap between the respective jurisdictions of these courts. *See, e.g.*, N.Y. SURR. CT. PRAC. ACT art. 17-A (McKinney 2016) (special guardianship regime for persons with intellectual disability or traumatic head injuries); N.Y. MENTAL HYG. LAW art. 81 (McKinney 2016) (standard guardianship regime).

[291] *See generally* Section I.C.

relatives and friends. Relatives and friends typically only serve one (or very few) incapable individuals. The court tends to know little about, and have limited ongoing dealings with, relatives and friends. Any ongoing dealings are usually confined to inspection of reports.[292] Hence the relationship between the court and a relative-and-friend guardian or agent is best described as a short-term, one-off interaction that does not allow relational norms to develop.

B. Introducing Interrelational Reporting

Section IV.A observes that the relationship between a professional guardian or agent and the relevant state court can involve repeated dealings and effectuate reputational sanctions. In this light, this Section will propose a monitoring mechanism to harness the reputational concerns of professional guardians and agents.

The existing monitoring mechanism primarily takes the form of record-keeping and reporting duties. The extent and effectiveness of these duties depend on the nature of the fiduciary relationship. Modern guardianship law typically imposes detailed reporting duties on a guardian and requires her to report to a court or state agency.[293] The incapable individual also may inspect

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[292] *See supra* notes 70–71, 298 and accompanying text (the accounting and reporting duties of guardians and agents).

[293] *See, e.g.*, UNIF. PROBATE CODE §§ 5-317, 5-420 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT §§ 420, 423 (Unif. Law Comm'n 2017); *In re* Mark C.H., 906 N.Y.S. 2d 419, 432 (N.Y. Surr. Ct.

her guardian's reports.[294] A breach of these reporting duties may lead to a loss-based remedy and,[295] in extreme cases, removal of the errant guardian from her office.[296] Modern agency law also imposes reporting duties, but affords great latitude to any contrary instruction that the principal gave before losing mental capacity.[297]

Existing reporting duties are typically activity- or relationship-specific, and can be ineffective in harnessing the reputational concerns of professionals. For example, a professional agent A may owe a duty to send reports to her principal B, but A owes no duty to send the same reports to a potential principal C who is contemplating to engage A's services. Neither agency law nor fiduciary law provides a mechanism to inform C of what B may learn about A from A's reports. In other words, neither agency law nor fiduciary law prevents A from confining her reputational costs to each agency relationship. This remains the case even if A and B proceed to litigation, as long as their dispute is not well-publicized. Similarly, guardianship law

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2010).

[294] *See, e.g.*, UNIF. PROBATE CODE §§ 5-307, 5-407 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT §§ 420(b), 423(d) (Unif. Law Comm'n 2017).

[295] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 83 cmt. a(1) (AM. LAW INST. 2012).

[296] *See, e.g.*, *In re* Estate of O'Hare, 34 N.E.3d 1126 (Ill. Ct. App. 2015).

[297] *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 8.12(3) (AM. LAW INST. 2006).

typically does not prevent a professional guardian from confining her reputational costs to each guardianship. In particular, limiting public access to guardianship reports and proceedings, confidentiality provisions in many guardianship statutes may even assist professional guardians to confine their reputational costs to each guardianship.[298]

The proposed interrelational reporting duty aims to strengthen the existing monitoring mechanisms. This duty requires professional guardians and agents to report proven misconduct to all courts and individuals who contemplate to engage their fiduciary services. Strengthening interrelational sharing of information and monitoring, this duty primarily aims to deter and sanction misconduct by amplifying the errant guardian's or agent's reputational costs. For example, in the scenario above, upon seeing the reports about agent A's potential misconduct against principal B, principal C may be less willing to engage A's services. The proposed duty also elicits valuable information to inform the court. In particular, the court may refuse to offer future appointments to professionals who repeatedly commit misconduct. Alternatively, to bargain for advantageous terms and conditions

[298] *See, e.g.*, UNIF. PROBATE CODE §§ 5-307, 5-407 (amended 2010). *See generally* Am. Bar Ass'n Comm'n Law & Aging, *Privacy and Confidentiality: Guardianship Statutes and Court Rules*, AM. BAR ASS'N, https://www.americanbar.org/content/dam/aba/administrative/law_aging/chartguardianship privacy.authcheckdam.pdf (last visited Dec. 8, 2018). *Cf.* UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 409 (Unif. Law Comm'n 2017).

for a particular incapable individual,[299] the court may use reports regarding the professional guardian's misconduct against other incapable individuals.

The proposed interrelational reporting duty only marginally increases the reporting costs of professional guardians and agents. Professionals already have to comply with reporting duties;[300] their pre-existing reporting mechanisms (such as account officers and computers)[301] can easily accommodate the additional costs of complying with the proposed duty. By comparison, the proposed duty should not be imposed on relatives and friends. There is no point to insist on reports to multiple courts and potential principals when relatives and friends typically only serve one incapable individual. Without the benefit of professional reporting mechanisms, relatives and friends can also struggle to cope with onerous reporting duties.[302]

Moreover, the proposed interrelational reporting duty should apply as a default duty that is waivable at the option of the court in the case of a

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[299] For example, the court may bargain for a bond to secure the proper performance of duties. *See infra* Section IV.C.

[300] *See supra* notes 70–71, 298 and accompanying text (discussing the accounting and reporting duties of guardians and agents).

[301] *See, e.g.*, Langbein, *supra* note 2, at 948.

[302] *See, e.g.*, BRENDA K. UEKERT, CENTER ELDERS & CTS., ADULT GUARDIANSHIP COURT DATA AND ISSUES: RESULTS FROM AN ONLINE SURVEY 18 (2010), http://www.eldersandcourts.org/~/media/Microsites/Files/cec/GuardianshipSurveyReport_FINAL.ashx.

guardianship, or the principal (before she loses capacity) in the case of an agency relationship. This ameliorates concerns about attention costs;[303] taking into account the particular circumstances of the case, the court or principal may decide whether to insist on a report about the guardian's or agent's proven misconduct in other relationships.[304]

By facilitating better monitoring and sharing of information, the proposed interrelational reporting duty strengthens other incentive-alignment mechanisms in fiduciary law. These include insurance bonds, remuneration for services and loss-based liabilities. The remainder of this Part will explain.

C. Bond

The proposed interrelational reporting duty can strengthen the incentive-alignment functions that bonds perform in a guardianship or an agency relationship. As a condition of appointment as guardian, the court may require that a bond be obtained to insure the incapable individual against any losses arising from misconduct.[305] When creating an agency relationship, the

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[303] *See generally* DHAMI, *supra* note 183, ch. 19.17 (surveying empirical research on limited attention and limited cognitive abilities).

[304] *Id.* ch. 19.17.4 (economic models of rational inattention).

[305] *See, e.g.*, Am. Bar Ass'n Comm'n Law & Aging, *Conservatorship and Guardianship Bonds: State Statutory Requirements*, AM. BAR ASS'N, http://www.americanbar.org/content/dam/aba/administrative/law_aging/2014_guardian_bond_chart.authcheckdam.pdf (last visited Dec. 8, 2018) (surveying bonding provisions in American guardianship statutes). *See generally* RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 71 cmt. d (AM. LAW INST. 1996).

principal also may stipulate similar bonding requirements. In the event of misconduct, the bond provider first pays the incapable individual (or her estate), and then pursues the errant guardian or agent to recover such payment.[306] Thus, in addition to insuring the incapable individual, the bond exposes the errant guardian or agent to claims from the bond provider. The bond provider is typically better resourced and more sophisticated than the incapable individual (and those who expect to inherit from her). Moreover, upon becoming aware of misconduct, the bond provider may increase the guardian's or agent's premiums for obtaining bonds in the future. Overall, bonds disincentivize guardians and agents from committing misconduct by the threat of claims from bond providers and by the possibility of increased premiums.

Strengthening the existing monitoring mechanisms, the proposed interrelational reporting duty can provide to bond providers additional information regarding an errant professional guardian or agent. The proposed duty requires reporting of misconduct in multiple relationships to the court. The court may provide such report to bond providers. Bond providers can then increase the errant guardian's or agent's premiums for obtaining bonds to insure multiple incapable individuals. The threat of such a large increase

[306] *See, e.g.*, Seaboard Sur. Co. v. Boney, 761 A.2d 985, 996–98 (Md. Ct. Spec. App. 2000) (discussing the functions of guardianship bonds). *See generally* RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 27 (AM. LAW INST. 1996) (on subrogation).

in premiums amplifies the deterrence effects arising from bonds.

D. Remuneration for Services

As an established exemption to the sole-interest duty of loyalty, a fiduciary may receive reasonable remuneration for her services.[307] The court typically has a discretion to grant reasonable remuneration to a guardian.[308] When creating an agency relationship, the principal also may stipulate remuneration to the agent.[309] Remuneration primarily functions to incentivize professional guardians and agents to provide specialist services.[310] Moreover, a grant of remuneration encourages professional guardians and agents to comply with their duties, because the court may reduce their remuneration in part or in whole in response to misconduct.[311]

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[307] RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(4) (AM. LAW INST. 2012). *See also In Re* Alice D. (Lupoli), 113 A.D.3d 609, 613–14 (N.Y. App. Div.) (factors affecting a guardian's remuneration).

[308] *See, e.g.*, UNIF. PROBATE CODE §§ 5-316(a), 5-417 (amended 2010); UNIF. GUARDIANSHIP, CONSERVATORSHIP, AND OTHER PROTECTIVE ARRANGEMENTS ACT § 120(b) (Unif. Law Comm'n 2017); N.Y. MENTAL HYG. LAW § 81.28 (McKinney 2016).

[309] RESTATEMENT (THIRD) OF AGENCY § 8.01 cmts. b, c (AM. LAW INST. 2006).

[310] *See* Langbein, *supra* note 2, at 939–41; RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. b, cmt. c (AM. LAW INST. 2006).

[311] *See generally* RESTATEMENT (THIRD) OF TRUSTS § 38 cmt. c(1) (AM. LAW INST. 2012); RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. d(2) (AM. LAW INST. 2006); Deborah A. DeMott, *Fiduciary Principles in Agency Law*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW 297 (Evan J. Criddle, Paul B. Miller, Robert H. Sitkoff eds., 2019) (footnote omitted). *See e.g In re* Lillian A., 868 N.Y.S.2d 695, 697 (N.Y. App. Div. 2008) (upholding lower court's denial of remuneration to an errant guardian who disbursed guardianship funds after expiration of appointment).

The proposed interrelational reporting duty further strengthens the deterrence effects of typing remuneration to proper performance of duties. It does so by providing the court with information about misconduct in multiple relationships. Upon obtaining information about misconduct against one incapable individual, the court may reduce the professional guardian's or agent's remuneration for providing services to *other* incapable individuals as well. This can lead to a large reduction in the guardian's or agent's remuneration. The threat of such a large reduction can be a strong deterrent against misconduct.

E. Loss-based Liability

Loss-based remedies are available to deter and sanction breaches of fiduciary duty. In addition to the duty of loyalty and reporting duties, guardians and agents owe duties to comply with the instrument underlying the fiduciary relationship, to act within the scope of their authority, and to exercise a reasonable degree of care and prudence.[312] A breach of these duties makes available compensatory damages to cover the incapable individual's losses.[313] The imposition of loss-based liability disincentivizes inefficient

[312] *See supra* notes 68–69 and accompanying text.

[313] *See generally* RESTATEMENT (THIRD) OF TRUSTS § 95 cmt. b (AM. LAW INST. 2012); RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. d(1) (AM. LAW INST. 2006).

breaches by shifting to the guardian or agent the resulting losses.[314] Moreover, responding to concerns about elder abuse, many jurisdictions now impose criminal penalties to sanction culpable misconduct.[315] These penalties further deter professional guardians and agents from harming incapable individuals.

The proposed interrelational reporting duty strengthens the deterrence effects of these loss-based liabilities and penalties. It does so by empowering the court to consider prior misconduct in determining the size of compensatory damages or penalties. For example, when dealing with misconduct against one incapable individual, the court can increase the size of damages or penalties if the errant guardian or agent had committed misconduct against other incapable individuals in the past. This can be a strong deterrent against repeated breaches.

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[314] Sitkoff, *supra* note 38, at 207. An efficient breach occurs when the gain it accrues to the fiduciary exceeds the loss it imposes on the beneficiary. A loss-based remedy permits such a breach by shifting the beneficiary's loss to the fiduciary, so the fiduciary has incentives to breach only if the net gain is positive. *See, e.g.*, RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 39 cmt. h (AM. LAW INST. 2011) (discussing the interplay of disgorgement liability and efficient breach arising from loss-based liability).

[315] *See, e.g.*, Lori Stiegel & Ellen Klem, Am. Bar Ass'n Comm'n Law & Aging, *Undue Influence: Context, Provisions, and Citations in Adult Protective Services Laws, By State*, AM. BAR ASS'N, http://www.americanbar.org/content/dam/aba/administrative/law_aging/Undue_Influence_Context_Provisions_and_Citations_Chart.authcheckdam.pdf (last visited Dec. 8, 2018) (surveying select American statutes penalizing undue influence).

CONCLUSION

Prohibiting conflicts of interest, orthodox fiduciary law is meant to align a fiduciary's incentives with her beneficiary's.[316] Such prohibition is too strict on close relatives and friends who serve as guardians or agents to elderly incapable individuals. In close families and personal relationships, strict prohibition of conflicts tends to disregard the incentive-alignment effects of biological and affective bonds, as well as social and moral norms. Such strict prohibition also tends to stultify the pursuit of valuable other-regarding goals and preferences. These tendencies harm the welfare of many seniors.[317]

Recognizing these problems, this Chapter proposes reforms to optimize the fiduciary duties of guardians and agents. The main suggestion is that a substituted-judgment defense should be made available to close relatives and friends; this defense permits those conflicts of interest that the incapable individual would have authorized if she was capable. To the extent consistent with the individual's own wishes, the substituted-judgment defense aims to accommodate intrinsic bonds and informal norms, and to facilitate the pursuit of valuable other-regarding goals and preferences.

The proposed substituted-judgment defense admittedly weakens the protection against elder financial abuse offered by fiduciary law. Such

[316] *See supra* Section I.C.

[317] *See supra* Section II.B.

weakened protection is justified in cases concerning close relatives and friends, but not in cases concerning professional guardians and agents. Cases concerning professionals tend to exhibit weak intrinsic bonds and other-regarding preferences; strict fiduciary regulation continues to perform valuable incentive-alignment functions. Thus the substituted-judgment defense should not be made available to professionals. Moreover, to deter and sanction elder financial abuse by professionals, I propose an interrelational reporting duty to harness their reputational concerns. This duty requires professional guardians and agents to report proven misconduct to all courts and individuals who contemplate to engage their services. The goal is to amplify the reputational costs of misconduct.

Overall, fiduciary law ought to regulate different guardianships and agency relationships differently. In particular, the incentives of close relatives and friends tend to differ from professionals'. Ignore these important differences, prevailing fiduciary law tends to operate as "an instrument of hardship and injustice in individual cases."[318]

[318] *Chan v Zacharia* (1984) 154 CLR 178, 205 (Austl.).

Chapter 3: Mental Capacity in Anglo-Australian Fiduciary Law

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I. INTRODUCTION

As baby boomers in Anglo-Australian jurisdictions enter retirement with a higher life expectancy and more wealth than any generation before them, courts and legislatures are increasingly pressed to resolve disputes over the properties of the elderly. Empirical research consistently reveals the prevalence of financial misconduct against the elderly.[1] Mental and

[1] Yongjie Yon and others, 'Elder Abuse Prevalence in Community Settings: a Systematic Review and Meta-analysis' (2017) 5 Lancet Glob Heath e147, e147, e154 (comprehensive review of prevalence studies showing that about 6.8 percent of people aged 60 or over experience financial abuse) (cited with approval in 'Elder Abuse' (*World Health Organization*, 8 June 2018) <https://www.who.int/en/news-room/fact-sheets/detail/elder-abuse> accessed 11 February 2019). Generally Rae Kaspiew, Rachel Carson and Helen Rhoades, 'Elder Abuse: Understanding Issues, Frameworks and Responses' (Report, Australian Institute of Family Studies, 2015) (discussing empirical studies of elder abuse).

physical decline can make it difficult or impractical for many older people to safeguard their own financial interests. While their family members may provide assistance, they may also be swayed by their own inheritance expectations. This Chapter addresses the problem of how best to tackle financial abuse by family guardians and attorneys who manage property for the elderly.[2]

Fiduciary law is the silver bullet that Anglo-Australian legislatures and law reformers have offered to deter and sanction financial abuse by guardians and attorneys. While there is no precise and unexceptional definition of a 'fiduciary', fiduciary law uniquely prohibits fiduciaries from making an unauthorised profit from their position, and from acting other than in the sole interests of their beneficiaries. This dual-prohibition arises from the fiduciary *duty of loyalty*. Responding to alarming statistics and widespread community concerns, law reform commissions typically recommend to impose the strictest form of fiduciary regulation on

[2] See generally below Section II.A (introducing guardianships and durable powers of attorney). For simplicity, this paper uses 'guardian' to denote a person who is appointed by a court or tribunal to make decisions on behalf of another person. Depending on the jurisdiction, the period and the function performed, alternative names for guardians include administrators, committees, conservators, deputies and financial managers. This paper uses 'attorney' to denote a person who is privately appointed to act on behalf of the appointor. Alternative names for attorneys include agents and donees.

guardians and attorneys.[3] The majority of Anglo-Australian jurisdictions have adopted those recommendations by statute.[4]

Bucking the trend, this Chapter will argue that a moderate and flexible model of fiduciary law should be applied to regulate family guardians and attorneys.[5] In recent times, the typical property dispute concerns an elderly incapable person, and her guardian or attorney is likely a family member.[6] It will be argued that the prevailing, strict model of fiduciary regulation overreacts to harmless conflicts within close families. As a result of such overreaction, family guardians and attorneys can expose themselves to liability merely by acting in accordance with familial norms and carrying out the wishes of the elderly incapable person. Moreover, many property disputes concern inheritance; someone who expects to inherit from the elderly incapable person sues the guardian or attorney in order to enlarge the asset pool available for distribution when the person

[3] Australian Law Reform Commission, *Elder Abuse – a National Legal Response: Final Report* (No 131, 2017) 12, 17 (ALRC Elder Abuse Report); Queensland Law Reform Commission, *A Review of Queensland's Guardianship Law: Report* (No 67, 2010) vol 3, 247–48, 263 (Queensland Guardianship Report); Victorian Law Reform Commission, *Guardianship: Final Report* (No 24, 2012) 48, 412–13 (Victorian Guardianship Report). Also Trevor Ryan, 'Developments in Enduring Powers of Attorney Law in Australia' in Lusina Ho and Rebecca Lee (eds), *Special Needs Financial Planning: A Comparative Perspective* (CUP 2019) 181 ('[R]egulation of conflict transactions is a key area that can contribute to reducing elder financial abuse[.]').

[4] See below Section III-B.

[5] 'Mental incapacity' is typically a conclusion regarding a person's mental ability. See below Section II-A.

[6] See below Section II-A.

passes away.[7] The strict model fails to recognise potential conflicts between the elderly incapable person and the inheritance-motivated claimant. The primary beneficiaries of strict regulation are often not the incapable persons themselves, but those claimants who are driven by inheritance expectations.

In contrast, moderate and flexible fiduciary regulation appropriately responds to the problem of financial abuse by family guardians and attorneys. This Chapter favours a flexible model that originates from historical Chancery jurisprudence and continues to find support in English and New South Wales case law. A small number of first-instance judgments from these jurisdictions recently incorporated much-needed flexibility into the fiduciary regulation of guardians and attorneys. These judgments continue to impose a duty of loyalty to prohibit conflicts of interest, but the errant guardian or attorney can avoid liability if he or she had acted to promote the best interests of the incapable person. This Chapter proposes a *subjective* interpretation of best interests. This interpretation recognises that conflicts of interest are ubiquitous and often harmless in close familial relationships. It further recognises that biological and affective bonds, as well as moral and social norms, can partially deter misconduct. In the subset of cases brought by claimants who are motivated by inheritance expectations, the proposed subjective

[7] See below Section V-C.

interpretation further mitigates the perverse incentives that these claimants may have.

The approach taken in this Chapter is primarily grounded in equitable doctrine and theory. Although guardianship and power of attorney statutes and statutory instruments are diverse across Anglo-Australian jurisdictions, on the specific issue of fiduciary duty, they either adopt the equitable principles governing trustees or stay silent.[8] Equitable doctrine and theory thus remain relevant even in the 'age of statutes'. For instance, in England and Wales, an official code of practice codifies the fiduciary duties of guardians and attorneys.[9] A court 'must' consider the code and any failure to comply with it,[10] but the code is 'not a statute and should not be construed as one'.[11] Equitable doctrine and theory can therefore shed light on the extent to which the code should be followed to the letter in individual cases. In justifying the occasional departure from the code, the English Court of Protection (the specialist superior court of record in charge of mental capacity matters) already pays attention to the

[8] Generally Section III-B.

[9] Department for Constitutional Affairs, *Mental Capacity Act 2005: Code of Practice* (London 2007) paras 7.60, 8.58 (MCA Code of Practice).

[10] Mental Capacity Act 2005 (UK) s 42(5).

[11] *Aintree University Hospitals NHS Trust v James* [2013] UKSC 67, [2014] AC 591 [29] (Lady Hale DPSC, with whom Lord Neuberger, Lord Clarke, Lord Carnwath and Lord Hughes JJSC agreed). Also Peter Bartlett, 'Editorial: The Code of Practice and the Ambiguities of "Guidance"' (2009) 19 Criminal Behaviour and Mental Health 157 (criticising the MCA Code of Practice for undermining the distinction between law and guidance).

development of equitable doctrine in New South Wales.[12] Moreover, the Convention on the Rights of Persons with Disabilities (CRPD) — the focus of recent scholarship and law reform regarding guardianship and power of attorney — is ambiguous on the issue of fiduciary duty.[13] Equitable doctrine and theory can provide a surer guide to adjudicators and law reformers.

This Chapter aims to fill in several gaps in the private law literature and disability rights literature. While there is a large body of scholarship on mental capacity to make healthcare and medical decisions,[14] issues regarding property and financial decisions are typically marginalised.[15] This is notwithstanding the fact that property and financial matters

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[12] Eg *Re JW; GGW v East Sussex County Council* [2015] EWCOP 82, [2016] COPLR 36 [20], [32], [42], [50](b).

[13] Opened for signature 13 December 2006, 2515 UNTS 3 (entered into force 3 May 2008), discussed in Section V-D-2.

[14] Eg Peter Bartlett, 'The United Nations Conventions on the Rights of Persons with Disabilities and Mental Health Law' (2012) 75 MLR 752, 758–72 (The CRPD and Mental Health Law); Mary Donnelly, 'Best Interests in the Mental Capacity Act: Time to Say Goodbye?' (2016) 26 Med LR 318 (Best Interests); Mary Donnelly, 'Changing Values and Growing Expectations: The Evolution of Capacity Law' (2017) CLP 305, 314–21 (The Evolution of Capacity Law); Brenda Hale and others, *Mental Health Law* (6th ed, Sweet & Maxwell 2017) ch 6; the literature cited in n 268.

[15] For instance, empirical studies tend to consider a large sample of healthcare and medical matters but only a very small sample of property and financial matters. Eg Val Williams and others, *Making Best Interests Decisions: People and Processes* (Mental Health Foundation 2012) 5, 13, 45; Select Committee on the Mental Capacity Act 2005, *Mental Capacity Act 2005: Post-legislative Scrutiny* (HL 2013-14, 139) para 4. Exceptions include Rosie Harding, 'The Rise of Statutory Wills and the Limits of Best Interests Decision-Making in Inheritance' (2015) 78 MLR 945 (Statutory Wills); Rosie Harding, *Duties to Care: Dementia, Relationality and Law* (CUP 2017) (Duties to Care) ch 4.

dominate the workload of the courts.[16] Leading texts on equity and fiduciary law also tend to avoid grappling with the complex web of statutes and equitable principles that govern the fiduciary duties of guardians and/or attorneys.[17] Moreover, existing studies of private law's response to elder financial abuse tend to focus on the doctrines of undue influence and unconscionability.[18] Covering all Anglo-Australian jurisdictions, this Chapter joins a small but growing number of specialist treatises to provide an account of how fiduciary law can deter and sanction misuse of power by guardians and attorneys.[19]

There are nonetheless important issues that fall outside the scope of this Chapter. In atypical cases, the guardian or attorney is a private professional or government agency, rather than a relative or friend of the incapable person. Focusing on typical cases, this Chapter has little to say

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[16] Eg Select Committee on the Mental Capacity Act 2005 (n 15) para 212.

[17] Eg Paul Finn, *Fiduciary Obligations: 40th Anniversary Republication with Additional Essays* (first published 1977, Federation Press 2016) para 9.

[18] Eg Fiona Burns, 'Undue Influence Inter Vivos and the Elderly' (2002) 26 MULR 499; Fiona Burns, 'The Equitable Doctrine of Unconscionable Dealing and the Elderly in Australia' (2003) 29 Mon LR 336; Fiona Burns, 'Elders and Testamentary Undue Influence in Australia' (2005) 28 UNSWLJ 145 (Elders); Roger Kerridge, 'Wills Made in Suspicious Circumstances: The Problem of the Vulnerable Testator' (2000) 59 CLJ 310; Pauline Ridge, 'Equitable Undue Influence and Wills' (2004) 120 LQR 617; C Peisah and others, 'The Wills of Older People: Risk Factors for Undue Influence' (2009) 21 International Psychogeriatrics 7; Brian Sloan, *Informal Carers and Private Law* (Hart Publishing 2013) ch 7; Yvette Maker and others, 'From Safety Nets to Support Networks: Beyond "Vulnerability" in Protection for Consumers with Cognitive Disabilities" (2018) 41 UNSWLR 818; Victorian Law Reform Commission, *Succession Laws: Report* (2013) ch 2; ALRC Elder Abuse Report (n 3) 211–14. Exceptions include Ryan (n 3).

[19] Eg GE Dal Pont, *Powers of Attorney* (2nd edn, LexisNexis Butterworths 2015) ch 8; Richard McCullagh, *Australian Elder Law* (Lawbook Co 2018) ch 19; Nick O'Neil and Carmelle Peisah, *Capacity and the Law* (2nd edn, AustLii 2017) chs 8.11.1, 10.6.1, 10.7.

about how best to regulate professional guardians and attorneys. Cases involving misconduct by professionals exist,[20] and issues regarding their regulation are left to another day. Another issue concerns the fiduciary regulation of supporters — defined as persons who offer supportive, rather than substituted, decision-making assistance to persons who may lack mental capacity. While law reform commissions and human rights scholars tend to recommend supported decision-making,[21] they disagree on whether to impose fiduciary duties on supporters.[22] How best to regulate supporters is an issue that may arise when supported decision-making systems become more prevalent.

Part II below will elaborate upon the problem of financial misconduct by guardians and attorneys, and provide illustrative examples. Part III will introduce the prevailing, strict model of fiduciary regulation. Part IV will show that recent first-instance judgments from England and New South

[20] Eg *Public Guardian v Matrix Deputies Ltd & Anor* [2017] EWCOP 14, [2017] COPLR 415.

[21] Eg Law Commission, *Mental Capacity and Deprivation of Liberty* (Law Com No 372, 2017) para 14.51; Law Commission, *Making a Will* (Law Com CP No 231, 2017) para 4.29 (Making a Will); ACT Law Reform Advisory Council, *Guardianship Report* (No 4, 2016) 10 (ACT Guardianship Report); Australian Law Reform Commission, *Equality, Capacity and Disability in Commonwealth Law* (No 124, 2014) 11 (ALRC Commonwealth Law Report); New South Wales Law Reform Commission, *Review of Guardianship Act 1987: Report* (No 145, 2018) 71 (NSW Guardianship Report); Victorian Guardianship Report (n 3) 136.

[22] Eg Victorian Guardianship Report (n 3) 143–44 (arguing supporters should owe fiduciary duties); ACT Guardianship Report (n 21) 59 (same). Cf NSW Guardianship Report (n 21) 84 (arguing supporters may not owe fiduciary duties); Law Commission, Making a Will (n 21) para 4.55 (questioning whether supporters should owe fiduciary duties).

Wales have developed an alternative, flexible model. The crux of this Chapter, Part V will argue in favour of the flexible model that emerges from these judgments. Part VI will conclude.

II. FINANCIAL MISCONDUCT BY GUARDIANS AND ATTORNEYS

A. Asset Management for the Elderly: Guardianship and Durable Power of Attorney

Population ageing is old news. Recent estimates suggest that 3.8 million Australians (15 percent of the Australian population) and 12 million Britons (18 percent of the British population) are aged 65 years or over, and both the number and the proportions of older people are projected to grow.[23] The trend in population ageing coincides with decades of significant economic growth. Since 1960, the Australian economy has grown 71-fold, and the British economy 36-fold.[24] In the modern economy, the stereotype that older people are 'frail, out of touch, burdensome or dependent' is outdated.[25] Physical and/or cognitive

[23] 'Older Australia at a Glance' (*Australian Institution of Health and Welfare*, 10 September 2018) <https://www.aihw.gov.au/reports/older-people/older-australia-at-a-glance/contents/demographics-of-older-australians/australia-s-changing-age-and-gender-profile> accessed 17 October 2018 (citations omitted); 'Overview of the UK Population: July 2017' (*Office for National Statistics*, 21 July 2017) <https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/articles/overviewoftheukpopulation/july2017> accessed 17 October 2018.

[24] 'GDP (Current US$) | Data' (*The World Bank*) <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=AU-GB> accessed 17 October 2018.

[25] The World Health Organization, *World Report on Ageing and Health 2015* (2015) 10, 16.

decline is nonetheless common among the elderly. In particular, recent studies estimate that about 430,000 Australians and 850,000 Britons live with dementia.[26]

Guardianship is a common legal mechanism to facilitate the provision of property-management services to the elderly. To create a guardianship for a person, an Anglo-Australian court or tribunal must first be satisfied that the person lacks mental capacity to manage an aspect of his or her life or property. Mental capacity is typically a functional concept that accounts for cognitive functioning, the specific tasks to be undertaken, and concerns for autonomy and protection.[27] The presence of some mental or physical disability in the medical sense is usually neither sufficient nor necessary for meeting the legal test of mental incapacity.[28] Once a person is found mentally incapable of managing some aspect of life or property, the court or tribunal has a discretion to appoint a

[26] 'Facts for the Media' (*Alzheimer's Society*) <https://www.alzheimers.org.uk/about-us/news-and-media/facts-media> accessed 17 October 2018; 'Dementia Statistics' (*Dementia Australia*, September 2018) <https://www.dementia.org.au/statistics> accessed 19 October 2018.

[27] Eg Mental Capacity Act 2005 (UK) s 2; *Secretary, Department of Health and Community Service v JWB and SMB (Marion's Case)* (1992) 175 CLR 218, 266 (Brennan J); *Gibbons v Wright* (1954) 91 CLR 423, 437–38; *CJ v AKJ* [2015] NSWSC 498 [17]–[29] (citations omitted); *P v NSW Trustee and Guardian* [2015] NSWSC 579 [52]–[62] (citations omitted). Generally Hale and others (n 14) paras 2–024, 2–025; O'Neil and Peisah (n 19) chs 1.1, 8.11.5.

[28] Hale and others (n 14) para 2–023; O'Neil and Peisah (n 19) para 1.3. Eg *CJ v AKJ* [2015] NSWSC 498 (finding that a young adult with autism has mental capacity). Cf *Guardianship and Administration Act 1986* (Vic) s 22(1) (requiring a 'disability' before a guardian may be appointed); *Guardianship and Administration Act 1995* (Tas) s 20(1)(a) (same); *Guardianship and Administration Act 1990* (WA) s 64(1)(a) (same).

substitute decision-maker — the guardian — to make decisions regarding that aspect of life or property. The discretion to create a guardianship is typically exercised to promote the best interests of the incapable person, taking into account his or her known wishes and the availability of less restrictive forms of decision-making support.[29]

While a guardianship is officially created, a power of attorney is a private instrument through which a person — the principal — authorises another person — the attorney — to act on behalf of the principal.[30] There was an old common law rule that avoids the attorney's authority upon the principal losing mental capacity. The rationale was that the attorney could only do what the principal had capacity to do. In the last few decades, Anglo-Australian legislatures followed US jurisdictions to remove that common law rule.[31] Modern power of attorney statutes permit a *durable* (or enduring, or lasting, depending on the jurisdiction) power of attorney to commence, or remain valid, upon the principal losing mental capacity. These statutes allow individuals who anticipate their loss of capacity in the future to choose their own representatives. The underlying purposes

[29] Mental Capacity Act 2005 (UK) s 4; O'Neil and Peisah (n 19) chs 8.11.7–8.

[30] Dal Pont (n 19) para 1.1; Denzil Lush and Caroline Bielanska, *Cretney & Lush on Lasting and Enduring Powers of Attorney* (8th ed, LexisNexis 2017) para 1.1.

[31] Lush and Bielanska (n 30) paras 1.1–1.19; Dal Pont (n 19) paras 3.8, 3.14, 3.24–25 (citations omitted). Statutes sometimes preserve the common law rule in limited circumstances, such as in respect of the principal's powers and discretions as a trustee. Eg Conveyancing Act 1919 (NSW) s 163B, discussed in *Belfield v Belfield* [2012] NSWCA 416, (2012) 83 NSWLR 189 [38]–[67] (Campbell JA).

are to promote personal autonomy and dignity, and to avoid the cost, emotional stress and embarrassment of invoking the official guardianship system.[32]

The elderly are the main users of guardianships and durable powers of attorney, typically with a family member serving as guardian and/or attorney.[33] Empirical observations suggest that the combination of wealth and natural decline contributes to a steady increase in demand for guardianship.[34] While the private nature of powers of attorney renders it difficult to obtain reliable statistics on them, informal observations suggest that their primary users are older persons who have had a whole working life to accumulate wealth.[35]

B. Misuse of Power or Discretion

Guardians and attorneys typically have a broad discretion over how to take actions that affect the incapable persons they serve. (This Chapter

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[32] Lush and Bielanska (n 30) para 1.6; Dal Pont (n 19) paras 1.25–27, 1.58–65, 8.57–58.

[33] Terry Carney, 'Adult Guardianship and Other Financial Planning Mechanisms for People with Cognitive Impairment in Australia' in Ho and Lee (eds) (n 3) 9; Lucy Series, 'Applications for Permission to the Court of Protection: a Statistical Analysis' (2012) 2 Elder LJ 175 (using data collected and provided by Denzil Lush, who recently retired from the Court of Protection after 20 years' service); *Re Various Incapacitated Persons (Appointment of Trust Corporations as Deputies)* [2018] EWCOP 3 [45]–[46].

[34] Eg Ministry of Justice, 'Family Court Statistics Quarterly: April to June 2018) (*GOV.UK*, 27 September 2018) <https://www.gov.uk/government/statistics/family-court-statistics-quarterly-april-to-june-2018> accessed 17 October 18, table 22; 'NCAT Annual Report 2016-2017' (*NSW Civil & Administrative Tribunal*, 2017) <http://www.ncat.nsw.gov.au/Pages/about_us/publications_and_resources/annual_reports.aspx> accessed 17 October 2018, 43–45.

[35] Eg Carney (n 33) 6–7.

does not consider attorneys who do not act according to a durable power.) Such discretion may be abused. First, the incapable person tends to lack the ability to monitor the exercise of discretion by the guardian or attorney to a satisfactory degree.[36] Secondly, any actual wrongdoing by the guardian or attorney is often undetectable; record keeping can be imperfect or poor, and the guardian or attorney is easily able to produce evidence favourable to his or her position. Thus, unless sufficiently constrained, the guardian or attorney has the opportunity to abuse his or her discretion. He or she may be well be tempted to act on that opportunity.

C. Examples

This Section will introduce two examples to facilitate subsequent analysis of fiduciary law and its practical operation. Consider first the New South Wales case of *Smith v Smith* (*Smith*).[37] In that case, the wife of an elderly incapable person (both in their second marriages) served as his attorney while he lived in a nursing home. Using her husband's money without proper prior authorisation,[38] the wife 'enjoyed holiday cruises

[36] Generally Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 J Fin Econ 305 (describing the 'agency' problem); Robert H Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 BU L Rev 1039, 1041 (discussing the limited role of monitoring in fiduciary law); Elizabeth S Scott and Robert E Scott, 'Parents as Fiduciaries' (1995) 81 Va L Rev 2401, 2419–21 (discussing the limits of monitoring mechanisms in the family context). Also *Murad v Al-Saraj* [2005] EWCA Civ 959 [74] (Arden LJ, with whom Jonathan Parker LJ agreed) (recognising the 'agency' problem in trust law).

[37] [2017] NSWSC 408.

[38] Section V-A below will explain the significance of authorisation.

with her side of the family, bought an expensive car and expensive jewellery, gambled and enjoyed regular entertainment.'[39] She also used her husband's money to buy real property in her own name and in the names of her children from her first marriage. Some of these expenses substantially devalued what her husband's children from his first marriage expected to inherit under his will.[40] After the husband passed away, these children sued to recover the wife's expenses (or their proceeds) to the deceased's estate. The children did so to increase their expected inheritance. They were successful.[41]

The second example is the Nebraska case of *In re Conservatorship of Hanson* (*Hanson*),[42] which also concerned a married couple in their second marriages. Years before the husband became mentally-incapable, the couple made an agreement pursuant to which the husband regularly paid the wife for the added expense of his living in her home. The wife became the husband's guardian when he lost mental capacity, and she continued to receive payments without proper authorisation. The wife had no sinister motive and merely engaged in 'family financial management

[39] [2017] NSWSC 408 [5].

[40] ibid [6], [248]–[249]. See generally below Section V-C (discussing fiduciary conduct that aims to diminish the incapable person's estate upon his or her passing away).

[41] [2017] NSWSC 408 [12], [434], [448], [464]–[465].

[42] 682 NW 2d 207 (Neb 2004).

in the family's accustomed manner.'[43] The husband lived in the wife's home until he passed away. His children from his first marriage then sued to recover the payments that the wife received during the period of guardianship. The children again did so to increase their expected inheritance, and were again successful.[44]

A preliminary observation is that these two cases illustrate how disputes over property and financial decisions present different challenges than disputes over medical treatment. First, the wives were sued after their incapable husbands had passed away. Unlike in cases concerning medical treatment, the incapable husbands here were not alive to express their own views. Secondly, even if the husbands had consented to their wives' impugned conduct before they died, any expert opinion on their mental abilities at the time of consenting would unlikely be based on contemporaneous observation at that time.[45] This again distinguishes typical property cases from typical medical-treatment cases, in which adjudicators can benefit from (more) reliable expert opinion derived from direct observation and examination of the incapable person. Thirdly, the impugned conduct in these two cases — enjoying an unauthorised personal benefit while managing the incapable person's property —

[43] ibid 211.

[44] ibid.

[45] Eg *Birch v Birch & Ors* [2018] QSC 289 [94], [106].

might have harmed Mr Smith, but seemed to have benefited Mr Hanson. Mrs Hanson's conduct also reflected a pre-existing agreement with Mr Hanson. In addition, the wives' impugned conduct affected the children's expected inheritance. The point is that, in typical property cases, persons other than the incapable person could assert their own interests, which the law would often openly recognise and protect. In contrast, the law governing medical decision-making focuses exclusively upon the interests of the incapable person.[46]

In sum, courts in resolving disputes over the property of an elderly incapable person typically have to balance the incapable person's own interests against the potentially legitimate interests of others. Except perhaps in guardianship cases involving a prior finding of mental incapacity, evidence of mental ability is also often unreliable. These challenges have long rendered 'disparities in mental ability . . . less salient as a matter of law.'[47] 'The issue of capacity is . . . not one on which expert evidence will be determinative, and the experts themselves fully

[46] Generally the literature cited in n 14. Also Jonathan Herring, *Vulnerable Adults and the Law* (OUP 2016) 66–69 (criticising the traditional notion of autonomy in medical decision-making for isolating the patent from his or her relationships) (Vulnerable Adults).

[47] Susanna L Blumenthal, *Law and the Modern Mind: Consciousness and Responsibility in American Legal Culture* (Harv UP 2016) 17 (discussing Anglo-American mental capacity law in the late nineteenth century).

appreciate that.'[48] While medical evidence is not irrelevant, litigation outcome strongly depends on doctrine, policy, and incentive. It is against this background that legislatures, courts, and law reformers have developed legal frameworks to regulate guardians and attorneys who manage property for elderly incapable persons.

III. THE STRICT MODEL OF FIDUCIARY REGULATION

This Part and Part IV below will use *Smith*[49] and *Hanson*[50] to explain and contrast the two models of fiduciary regulation that operate in Anglo-Australian jurisdictions. Fiduciary law is a diverse and flexible body of law; its content and rigour depend on the particular fiduciary relationship and the facts and circumstances of the case.[51] This Part will introduce the strict model — based on the fiduciary duties of trustees — that most Anglo-Australian legislatures and law reform commissions prefer. Part IV below will introduce an alternative, flexible model that finds support in English and New South Wales case law.

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[48] Penelope Reed, 'Capacity and Want of Knowledge and Approval' in Birke Häcker and Charles Mitchell (eds), *Current Issues in Succession Law* (Hart Publishing 2016) 180.

[49] [2017] NSWSC 408.

[50] 682 NW 2d 207 (Neb 2004).

[51] Eg *Barnes v Addy* (1874) LR 9 Ch App 244, 251 (Lord Selborne); *Chan v Zacharia* (1984) 154 CLR 178, 205 (Deane J).

A. The Prophylactic Theory of Trust Fiduciary Law

The pre-Judicature Act English Court of Chancery laid the foundation for modern fiduciary law in Anglo-Australian jurisdictions. In the early eighteenth century, after years of financial exploitation and ineffectiveness under a disgraced judge, the Chancellorship went to Lord King LC, who penned a series of moralist judgments to pursue an anti-corruption agenda.[52] Professor Joshua Getzler observed that Lord King's efforts culminated in *Keech v Sandford*, a seminal case concerning a trustee who renewed to himself a lease held on trust for the benefit of a minor.[53] This was after the lessor had refused to renew the lease to the minor beneficiary. Ruling the new lease was held on trust, Lord King opined that '[t]hough I do not say there is a fraud in this case, yet [the trustee] should rather have let it run out than to have the lease to himself. … [F]or it is very obvious what would be the consequences of letting trustees have the lease on refusal to renew to [beneficiaries].'[54]

Keech v Sandford is a foundational judgment for the fiduciary duty of loyalty — that a fiduciary is to avoid an unauthorised conflict of interest or personal profit.[55] While not all duties owed by a fiduciary are fiduciary

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[52] Joshua Getzler, '"As If." Accountability and Contractual Trust' (2011) 91 BU L Rev 973, 982–84.

[53] (1726) Sel Cas t King 61, 62; 25 ER 223, 223.

[54] ibid.

[55] Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing 2010) 40–44 (Fiduciary Loyalty).

in nature, the duty of loyalty is peculiarly fiduciary.[56] Professor Matthew Conaglen's influential thesis articulates that the duty of loyalty serves a *prophylactic* purpose to protect the proper performance of the non-fiduciary duties that are fundamental to the fiduciary's role.[57] In addition to compensatory remedies, profit-stripping remedies are available to sanction a breach of the duty of loyalty. These profit-stripping remedies remove the personal gain that tempted fiduciaries to place themselves in situations of conflict, where they might neglect their fundamental duties. Moreover, good faith on the part of the fiduciary does not excuse a breach of fiduciary duty.[58] Lord King in *Keech v Sandford*, for instance, '[did] not say there is a fraud in this case'.[59]

While the duty of loyalty is meant to deter and sanction misconduct,[60] it can also prohibit conduct that benefits both the beneficiary and the fiduciary.[61] To ameliorate this problem of *over-deterrence*, fiduciary law

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[56] Eg *Breen v Williams* (1996) 186 CLR 71, 137 (Gummow J); *Bristol & West Building Society v Mothew* [1998] Ch 1 (CA) 16–18 (Millett LJ).

[57] ibid 57, 62–63, 185–87.

[58] *Regal (Hastings) Ltd v Gulliver* (1942) [1967] 2 AC 134n.

[59] (1726) Sel Cas t King 61, 62; 25 ER 223, 223.

[60] Conaglen, Fiduciary Loyalty (n 55) 57, 62–63, 185–87; *Murad v Al-Saraj* [2005] EWCA Civ 959 [74], [107] (citations omitted); *Ancient Order of Foresters in Victoria Friendly Society Ltd v Lifeplan Australia Friendly Society Ltd* [2018] HCA 43 [8] (Kiefel CJ, Keane and Edelman JJ) (citations omitted), [78] (Gageler J) (citations omitted).

[61] Eg *Boardman v Phipps* [1967] 2 AC 46. Generally John H Langbein, 'Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?' (2005) 114 Yale LJ 929, 944–45.

permits the fiduciary to seek *prospective* authorisation of most potential breaches of fiduciary duty. First, the fiduciary can seek the fully-informed consent of the beneficiary to pursue personal gains, and the beneficiary can condition consent on sharing some of these gains.[62] Safeguards against fiduciary overreach at this juncture include strict disclosure requirements,[63] and potentially a non-waivable core of fiduciary law that nullifies consent for bad faith and dishonest breaches.[64] Secondly, trustees (and some other types of fiduciaries) can seek prospective authorisation from a court.[65] To the extent that prospective authorisation is sought, the court can scrutinise the proposed action before it is taken.

B. Application to Guardians and Attorneys

Smith[66] and *Hanson*[67] can illustrate the consequences of applying trust fiduciary law to guardians and attorneys who serve elderly incapable persons. Without prior authorisation, the wife-attorney in *Smith* breached

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[62] Matthew Conaglen, 'The Extent of Fiduciary Accounting and the Importance of Authorisation Mechanisms' (2011) 70 CLJ 548, 563–64 (citations omitted) (Authorisation Mechanisms).

[63] ibid 576 (citations omitted).

[64] Eg *Bristol and West Building Society v Mothew* [1998] Ch 1, 18–19 (Millett LJ) (precluding a fiduciary to act in bad faith even with his or her beneficiary's fully-informed consent); *Armitage v Nurse* [1998] Ch 241, 253 (Millett LJ) (accepting the existence of 'an irreducible core of obligations' owed by trustees to their beneficiaries, which core comprises the duty 'to perform the trusts honestly and in good faith for the benefit of the beneficiaries').

[65] Generally Conaglen, Authorisation Mechanisms (n 62).

[66] [2017] NSWSC 408.

[67] 682 NW 2d 207 (Neb 2004).

her duty of loyalty by using her incapable husband's money to benefit herself and her side of the family.[68] Similarly, the wife-guardian in *Hanson* breached her duty of loyalty by taking her incapable husband's money.[69] Good faith on the part of the fiduciary is irrelevant; it does not matter that Mrs Hanson had no sinister motive,[70] while Mrs Smith's conduct was 'wilful' and exhibited a lack of honesty and reasonableness.[71] Similarly, no difference turns on the fact that Mrs Smith entrusted Mr Smith's primary care to a nursing home,[72] while Mrs Hanson took care of Mr Hanson in her home pursuant to their agreement; Mrs Hanson could have, but did not, seek prior judicial authorisation to benefit from that agreement.[73]

Holding both Mrs Smith and Mrs Hanson in breach of fiduciary duty is the outcome that most Anglo-Australian legislatures and law reform commissions prefer. There is a trend towards codifying the duty of loyalty

[68] [2017] NSWSC 408 [12], [434], [448], [464]–[465].

[69] 682 NW 2d 207, 211 (Neb 2004).

[70] ibid 211.

[71] [2017] NSWSC 408 [464].

[72] ibid [2].

[73] 682 NW 2d 207, 211 (Neb 2004). Nor could Mrs Hanson successfully argue implied consent on the basis of Mr Hanson's knowledge of their agreement. A court which had no knowledge of such agreement had appointed Mrs Hanson as guardian.

in strict and inflexible terms, modelled upon trust fiduciary law.[74] For example, Queensland's guardianship and power of attorney statutes prohibit transactions 'in which there may be conflict, or which results in conflict' between a guardian's (or an attorney's) duty to the incapable person and his or her own interests or another duty. Also prohibited is a conflict between the guardian's (or attorney's) duty to the incapable person and 'the interests of a person in a close personal or business relationship' with the guardian (or attorney).[75] In similarly strict terms, the Australian Capital Territory and Tasmania have codified the duty of loyalty for both guardians and attorneys, while Victoria has codified the duty for attorneys.[76] Moreover, in England and Wales, an official code of practice codifies the duty of loyalty for both guardians and attorneys.[77] Except in a small number of cases (cited in Section IV-B below), the English Court of Protection has applied trust fiduciary law to guardians and attorneys.[78]

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[74] Eg Dal Pont (n 19) paras 2.9–10, 55.8 [sic]. This codification effort aims to clarify the law for the profession and the public. Eg Queensland Guardianship Report (n 3) vol 3, 263.

[75] *Guardianship and Administration Act 2000* (Qld) s 37; *Powers of Attorney Act 1998* (Qld) s 73.

[76] *Powers of Attorney Act 2006* (ACT) s 42; *Guardianship and Management of Property Act 1991* (ACT) s 14; *Powers of Attorney Act 2014* (Vic) s 64; *Guardianship and Administration Act 1995* (Tas) s 32C; *Powers of Attorney Act 2000* (Tas) s 32AC.

[77] MCA Code of Practice (n 9) paras 7.60, 8.58.

[78] *Re Buckley*: *the Public Guardian v C* [2013] EWCOP 2965, [2013] COPLR 39 [43] (for attorneys); *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [87], [99] (for guardians).

Also consistent with trust fiduciary law is the availability of prospective approval to legitimise a potential breach of fiduciary duty. In England, prospective judicial approval is available to both guardians and attorneys.[79] The guardianship statutes in the Australian Capital Territory, Queensland, Tasmania and Victoria expressly provide for prospective approval by a court or tribunal.[80] The power of attorney statutes in these jurisdictions also expressly provide for prospective approval by the principal when he or she had (or regained) capacity.[81] Notwithstanding the judicial preference for prospective scrutiny,[82] the Victorian power of attorney statute permits *retrospective* validation by a tribunal (and by the principal when he or she had or regained capacity).[83] Queensland further makes available retrospective judicial approval to both guardians and attorneys.[84]

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[79] *Re Buckley: the Public Guardian v C* [2013] EWCOP 2965, [2013] COPLR 39 [43] (for attorneys); *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [87], [99] (for guardians).

[80] *Guardianship and Management of Property Act 1991* (ACT) s 14; *Guardianship and Administration Act 2000* (Qld) ss 37(1), 152; *Guardianship and Administration Act 1995* (Tas) s 32C(1); *Guardianship and Administration Act 1986* (Vic) s 30.

[81] *Powers of Attorney Act 2006* (ACT) s 42(3); *Powers of Attorney Act 1998* (Qld) s 73(1); *Powers of Attorney Act 2000* (Tas) s 32AC(1); *Powers of Attorney Act 2014* (Vic) ss 65(1), (2), (4).

[82] McCullagh (n 19) para [19.400] (citations omitted).

[83] *Powers of Attorney Act 2014* (Vic) ss 65(3), (5).

[84] *Guardianship and Administration Act 2000* (Qld) s 58 (enabling a court to excuse a guardian from liability for non-compliance with statutory duties if he or she had 'acted honestly and reasonably and ought fairly to be excused'); *Powers of Attorney Act 1998* (Qld) s 105 (same for attorneys).

Efforts to adopt trust fiduciary law should be seen as part and parcel of broader reforms to tighten fiduciary regulation of guardians and attorneys. First, all Anglo-Australian jurisdictions impose record-keeping and reporting obligations on guardians [85] and attorneys. [86] These obligations strengthen fiduciary regulation by facilitating public and private monitoring of guardians and attorneys. A breach of record-keeping and reporting obligations can have serious consequences. For example, in *Public Guardian v MP*, a husband who served as guardian to his wife of 25 years failed to comply with his reporting obligations.[87] Although the English judge was 'absolutely certain that there has been no dishonest misappropriation' of the wife's property,[88] his Honour removed the husband from the guardianship office for fears of eroding and undermining the safeguarding system.[89] Similarly, in resolving doubtful

[85] For England, *Re PL* [2015] EWCOP 14 [27]; MCA Code of Practice (n 9) para 8.66. For Australian jurisdictions, *Guardianship and Management of Property Act 1991* (ACT) s 26; *NSW Trustee and Guardian Act 2009* (NSW) s 116; *Guardians of Adults Act 2016* (NT) s 28; *Guardianship and Administration Act 2000* (Qld) s 49; *Guardianship and Administration Act 1993* (SA) s 44; *Guardianship and Administration Act 1995* (Tas) s 32D; *Guardianship and Administration Act 1986* (Vic) s 85; *Guardianship and Administration Act 1990* (WA) s 80.

[86] For England, MCA Code of Practice (n 9) para 7.67. For Australian jurisdictions, *Powers of Attorney Act 2006* (ACT) s 47; *Powers of Attorney Regulation 2016* (NSW) sch 2; *Power of Attorney Act 1980* (NT) s 11; *Powers of Attorney Act 1998* (Qld) s 85; *Powers of Attorney Act 1984* (SA) s 8; *Powers of Attorney Act 2000* (Tas) s 32AD; *Powers of Attorney Act 2014* (Vic) s 66; *Guardianship and Administration Act 1990* (WA) s 107(b).

[87] [2015] EWCOP 21.

[88] ibid [39].

[89] ibid [42].

questions, Australian courts and tribunals construe the evidential deficiency arising from a failure to keep proper records against the guardian or attorney.[90]

Secondly, a court or tribunal may require a guardian to obtain a security bond to indemnify the incapable person against any losses caused by the guardian's misconduct.[91] In the event of misconduct,[92] the bond provider can be called upon to compensate the incapable person (or his or her estate). The errant guardian can then face a claim from the bond provider. Thus, in addition to providing a remedy for misconduct, the security bond spares the incapable person (or his or her estate) of the cost and delay of suing the guardian.[93] The standard practice in England is to require guardians to obtain a security bond.[94] Australian courts and

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[90] *Smith* [2017] NSWSC 408 [448] (citations omitted), followed in *Ash v Ash (No 2)* [2017] VSC 569 [105]; *In the Matter of LQL (Guardianship)* [2018] ACAT 53 [52].

[91] A 'security bond' is also commonly known as a 'surety bond'. For consistency, this paper will use 'security bond' to refer to both.

[92] In cases where the guardian disputes the alleged misconduct or loss, there is a summary procedure to call in a bond before the final determination of her liability. Generally *The London Borough of Enfield v Matrix Deputies Ltd & Anor* [2018] EWCOP 22 [18]–[22].

[93] *Re Gladys Meek; Jones v Parkin and Others* [2014] EWCOP 1, [2014] COPLR 534 [38], [44]–[45] (*Meek*); *The London Borough of Enfield v Matrix Deputies Ltd & Anor* [2018] EWCOP 22 [13].

[94] *The London Borough of Enfield v Matrix Deputies Ltd & Anor* [2018] EWCOP 22 [6]; *Re PL* [2015] EWCOP 14 [27]. Generally *Baker v H* [2009] EWHC B31 (Fam), [2010] 1 WLR 1103 (detailed guidance on setting the level of security bond). New South Wales recently abolished its compulsory security bond scheme. *CTS v NSW Trustee and Guardian* [2017] NSWCATAD 2017; NSW Trustee & Guardian, 'Surety Bond Scheme' <http://www.tag.nsw.gov.au/surety-bond-scheme.html> accessed 17 October 2018.

tribunals prefer to determine whether a security bond should be required on a case-by-case basis.[95]

C. Narrow Exemptions

There are narrow exemptions to a guardian or an attorney's statutory duty of loyalty. First, many statutes permit gifts out of the incapable person's property in limited circumstances. Because a gift benefits someone other than the incapable person, the guardian or attorney by making the gift can breach his or her duty of loyalty. Statutory gifting exemptions typically authorise gifts that (i) reflect the incapable person's known or expected wishes; and (ii) are reasonable in the light of his or her financial circumstances.[96] Some jurisdictions impose further restrictions. New South Wales, Queensland and Tasmania allow attorneys to make gifts only if their powers of attorney expressly authorise them to do so.[97] England, the Australian Capital Territory, and Victoria *limit* the operation of express gifting provisions in powers of attorney, so that they only authorise gifts for special occasions or to charities.[98]

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[95] ALRC Elder Abuse Report (n 3) 331–32. Eg *H v H* [2015] NSWSC 837 [56].

[96] *NSW Trustee and Guardian Act 2009* (NSW) s 76; *Guardianship and Administration Act 2000* (Qld) s 54; *Powers of Attorney Act 1998* (Qld) s 88; *Advance Personal Planning Act 2014* (NT) s 22(8); *Guardians of Adults Act 2016* (NT) s 30; *Powers of Attorney Act 2014* (Vic) s 67; *Guardianship and Administration Act 1986* (Vic) s 50A.

[97] *Powers of Attorney Act 2003* (NSW) ss 11, 12; *Powers of Attorney Act 1998* (Qld) s 88; *Powers of Attorney Act 2000* (Tas) ss 32AB, 32AC. Generally Dal Pont (n 19) paras 7.15–22 (discussing the extent to which the Australian gifting provisions depart from the general law).

[98] Mental Capacity Act 2005 (UK) s 12; *Powers of Attorney Act 2006* (ACT) ss 34, 39; *Powers of Attorney Act 2014* (Vic) s 67.

Secondly, some statutes expressly authorise provision out of the incapable person's property for the needs and maintenance of his or her dependants. Benefiting someone other than the incapable person, such provision can amount to a breach of fiduciary duty. The Australian Capital Territory, New South Wales, the Northern Territory and Queensland have enacted statutory exemptions to permit reasonable provision for the incapable person's dependants.[99] On the other hand, England and Victoria impose various restrictions on an attorney's powers to make provision for dependants pursuant to express authority in his or her power of attorney.[100]

Thirdly, some statutes exempt various transactions involving proprietary interests jointly held by the guardian (or attorney) and the incapable person. These exemptions permit the guardian (or attorney) to deal with joint proprietary interests without violating the statutory duty of loyalty. For both guardians and attorneys, the Australian Capital Territory and Queensland exempt dealings in relation to joint proprietary interests.[101] Tasmania and Victoria have a similar exemption for

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[99] *Guardianship and Management of Property Act 1991* (ACT) s 21; *Powers of Attorney Act 2006* (ACT) s 41; *NSW Trustee and Guardian Act 2009* (NSW) s 102; *Advance Personal Planning Act 2014* (NT) s 33; *Guardians of Adults Act 2016* (NT) s 31; *Guardianship and Administration Act 2000* (Qld) s 55; *Powers of Attorney Act 1998* (Qld) s 89.

[100] Lush and Bielanska (n 30) paras 13.48–52; *Powers of Attorney Act 2014* (Vic) s 68.

[101] *Guardianship and Management of Property Act 1991* (ACT) s 14(2); *Powers of Attorney Act 2006* (ACT) s 42(2); *Guardianship and Administration Act 2000* (Qld) s 37(3); *Powers of Attorney Act 1998* (Qld) s 73(3).

attorneys.[102] England generally requires guardians and attorneys to keep their property separate from the incapable person's, but makes an exception for married couples.[103]

Hanson can illustrate the narrowness of these statutory exemptions.[104] Mrs Hanson received payments from her husband pursuant to an agreement between them;[105] her case therefore fell outside the scope of statutory exemptions for gifts or joint proprietary interests.[106] Moreover, to include her case within the statutory exemptions for provision to dependants would require an expansive construction of the relevant statutory provision. This can often be difficult. For example, in Queensland, a 'dependant' is defined as 'a person who is completely or mainly dependent' on the incapable person.[107] It would be a stretch to suggest that Mrs Hanson — the carer and owner of the family home —

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[102] *Powers of Attorney Act 2014* (Vic) s 64(2)(c); *Powers of Attorney Act 2000* (Tas) s 32AC(3).

[103] MCA Code of Practice (n 9) paras 7.68, 7.88, 8.56, 8.67.

[104] 682 NW 2d 207 (Neb 2004).

[105] ibid 207, 211.

[106] Section III-C.

[107] *Guardianship and Administration Act 2000* (Qld) sch 4; *Powers of Attorney Act 1998* (Qld) sch 3. Queensland is the only Anglo-Australian jurisdiction that expressly defines a 'dependant' in its power of attorney statute. Dal Pont (n 19) para 7.24 n 113.

was ‘completely or mainly’ dependent on her mentally-incapable husband.[108]

IV. THE FLEXIBLE MODEL OF FIDUCIARY REGULATION

While the strict model of fiduciary regulation finds favour among most Anglo-Australian legislatures and law reformers, a small number of first-instance judgments from England and New South Wales take a different view. This Section will introduce the flexible model of fiduciary regulation that these judgments have developed.

A. Equity’s Flexible Approach

1. Historical Foundations

Keech v Sandford had a little twist that eventually became a source of confusion and litigation some 300 years later: the beneficiary was a minor, and her trustee was also her guardian.[109] A guardian is technically not a trustee, even though they both often manage property for someone else; in a trust relationship, the trustee holds the title to the managed property,

[108] In England, prior to the 2014 amendments to the Inheritance (Provision for Family and Dependants) Act 1975, a similar problem affected applicants who sought family provision relief on the dependent basis pursuant to s (1)(1)(e) of that Act. The deceased’s assumption of responsibility for the applicant’s maintenance — which appeared in s 3(4) — was interpreted as a threshold requirement for a claim on the dependent basis. To avoid injustice in some cases, the courts adopted a rebuttable presumption that the fact of maintenance implies assumption of responsibility. The 2014 amendments alleviated the need for such judicial workaround. Generally Law Commission, *Intestacy and Family Provision Claims on Death* (Law Com No 331, 2011) paras 6.43–6.62; John G Ross Martyn and others, *Theobald on Wills* (18th ed, Sweet & Maxwell 2016) para 11-052.

[109] (1726) Sel Cas t King 61; 25 ER 223 and its discussion in *Clay v Clay* [2001] HCA 9, (2001) 202 CLR 410 [43].

but in a guardianship, the title remains with the incapable person.[110] The question is whether, notwithstanding that technicality, guardians should be held to the same standard of behaviour expected of trustees?

A cautious 'no' has been the longstanding view of courts of equity. To understand that view requires an appreciation of the historical foundations of a guardian's duty to account. Medieval common law developed the action of account as an early form of legal regulation against abuse of power by property managers. An account at common law involved two steps: first, a judgment determining whether the defendant was accountable; second, if the defendant was accountable, a judgment for the return of the relevant property or for the payment of a sum found due.[111] Some category of guardians was among the initial accounting parties.[112] In the early seventeenth century, the King or Queen's lunacy jurisdiction over mentally-incapable persons and wardship jurisdiction over minors went to the Court of Chancery, and developed into one protective jurisdiction covering all categories of guardians.[113] Chancery

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[110] Generally *Clay v Clay* [2001] HCA 9, (2001) 202 CLR 410 [37]–[42] (discussing the relevant English, American and Australian authorities).

[111] JA Watson, *The Duty to Account: Development and Principles* (Federation Press 2016) 67. Generally JD Heydon, MJ Leeming and PG Turner, *Meagher, Gummow and Lehane's Equity: Doctrines and Remedies* (5th edn, LexisNexis Butterworths 2015) para [26-005].

[112] Watson (n 111) 29, 33, 83.

[113] Generally *Mrs E v Eve* [1986] 2 SCR 388, 407–17 (La Forest J), approved in *Secretary, Department of Health and Community Services v JWB and SMB (Marion's Case)* [1992] HCA 15, (1992) 175 CLR 218, 258–59 (Mason CJ, Dawson, Toohey and

also introduced its own accounting process to hold guardians accountable in equity.[114] Accounting in equity was more streamlined and effective such that it eventually supplanted its common law progenitor.[115]

Dr James Watson's historical analysis shows that the fiduciary duty of loyalty 'assumes the existence of the duty to account; while accounting is perfectly well adapted to effect and facilitate protection of the fiduciary one.'[116] Conaglen wrote that an account of profits 'seeks to nullify the temptation [to enter into a conflicted transaction] by rendering it pointless[.]'[117] Thus, although the duty of loyalty and the duty to account are not identical, the remedial consequences of a breach of the duty of loyalty depend on the rigour of the duty to account.

In this light, Sir Henry Studdy Theobald — an English judge who wrote a seminal treatise on the protective jurisdiction in the early twentieth century[118] — described a flexible duty to account. 'It is a question depending upon the circumstances of each case whether [a

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Gaudron JJ); Lawrence B Custer, 'The Origins of the Doctrine of *Parens Patriae*' (1978) 27 Emory LJ 195, 202–04 (citations omitted).

[114] Watson (n 111) 130, 132–35; Heydon, Leeming and Turner (n 111) para [26-035].

[115] Watson (n 111) 133; Heydon, Leeming and Turner (n 111) para [26-005].

[116] Watson (n 111) 147.

[117] Conaglen, Fiduciary Loyalty (n 55) 80.

[118] GC Lindsay, 'Chapter 1: a Province of Modern Equity: Management of Life, Death and Estate Administration' (2016) 48 Aust Bar Rev 1, 28 (Modern Equity).

guardian] ought to be required to account or not.'[119] In particular, the existence of a close familial relationship would ease the burden of accounting. Theobald wrote:

> If [the incapable person] lives with the [guardian], and an allowance is made for his maintenance, prima facie, the intention is that the [guardian] is not to account as long as the [incapable person] is properly maintained. The [guardian] has difficult duties to perform, and it is intended that the payment made shall be as profitable as the circumstances of the case will allow. Of course, in such a case, anything like a strict account would be impossible. The [incapable person] lives as a member of the family, and it could not be ascertained exactly how much of the general outlay ought to be borne by him.[120]

Thus, while beneficiaries of a trust were entitled 'as of right' to call upon their trustees to account,[121] a guardian's duty to account was flexible.[122]

For example, in *Brown v Smith*,[123] a ten-month-old girl became entitled to an income under some testamentary trusts when her father

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[119] Henry Studdy Theobald, *The Law Relating to Lunacy* (Steven & Sons 1924) 51.

[120] ibid 52. Also *Warman International Ltd v Dwyer* (1995) 182 CLR 544, 561 (holding that 'the stringent rule requiring a fiduciary to account for profits can be carried to extremes and that in cases outside the realm of specific assets, the liability of the fiduciary should not be transformed into a vehicle for the unjust enrichment of the plaintiff').

[121] Matthew Conaglen, 'Equitable Compensation for Breach of Trust: Off *Target*' (2016) 40 MULR 126, 129.

[122] Theobald (n 119) 52–53 (reviewing the relevant nineteenth-century judgments).

[123] (1878) 10 Ch D 377.

passed away. The trustees obtained a guardianship over the girl together with an order to pay the whole income to her mother for the girl's maintenance and education during her minority. The order ceased to be operative when the mother remarried. Without obtaining a new court order (ie proper prospective approval), the mother continued to receive the income until her daughter reached majority. The daughter later sought an account, aiming to recover any amount that was not spent on her personally. Any such amount had been applied towards household expenses, which benefited the daughter and the other members of the household. Ruling against the daughter, Jessel MR found that prospective approval would have been granted if it was sought. The Court of Appeal affirmed.[124]

Informed by cases like *Brown v Smith*,[125] Sir Owen Dixon took a flexible approach to formulating a guardian's duty to account. In *Countess of Bective v Federal Commissioner of Taxation* (*Bective*),[126] a case that was recently approved by a unanimous High Court of Australia,[127] his Honour stated 'a general rule' that guardians 'are not liable to account as trustees.'[128] '[T]he nature of the actual abode, the condition of the

[124] ibid 384–85 (Baggallay LJ), 386 (Brett LJ), 387 (Cotton LJ).

[125] ibid.

[126] (1932) 47 CLR 417, 420–23.

[127] *Clay v Clay* [2001] HCA 9, (2001) 202 CLR 410 [40].

[128] *Bective* (1932) 47 CLR 417, 420.

household and the state of the family of the [incapable person] or other person to be maintained' must be considered.[129] In agreement with Theobald, Dixon J emphasised the importance of considering the particular circumstances of the family:

> Often the person to be maintained is a member of a family enjoying the advantages of a common establishment; always the end in view is to supply the daily wants of an individual, to provide for his comfort, edification and amusement, and to promote his happiness. It would defeat the very purpose for which the fund is provided, if its administration were hampered by the necessity of identifying, distinguishing, apportioning and recording every item of expenditure and vindicating its propriety.[130]

However, the flexible duty to account is not so relaxed as to disregard the risk of financial abuse. In equity, a guardian owes a duty of loyalty to the incapable person. A guardianship is just 'a fiduciary relationship with particular characteristics.'[131] For instance, the outcome in *Brown v Smith* would have been different if the mother had '[made] up a purse' for herself with her daughter's income.[132] Thus courts of equity tend to lighten, but not eliminate, the burden of accounting on a guardian.

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[129] ibid 421.

[130] ibid 421.

[131] *Clay v Clay* [2001] HCA 9, (2001) 202 CLR 410 [40]. Also Theobald (n 119) 4, 51.

[132] (1878) 10 Ch D 377, 386 (Brett LJ), recently applied in *Woodward v Woodward* [2015] NSWSC 1793 [55]–[56] (White J).

2. Resurgence in New South Wales

'Times change, but relationships between family members over property raise issues that are similar from one decade or century to the next.' [133] In New South Wales, equity's flexible formulation of a guardian's duty to account now informs the exercise of judicial discretion retrospectively to exonerate guardians and attorneys from liability for breaches of fiduciary duty. The *best interests* of the incapable person determine whether to grant exoneration. For example, in *C v W (No 2)*, the sons of an elderly incapable woman who served as her guardians or attorneys committed various breaches of fiduciary duty.[134] Justice Geoff Lindsay of the Supreme Court of New South Wales relieved the sons of liability mainly because it was in the woman's best interests to bring an end to the litigation between her children.[135] Similarly, in *Ability One Financial Management Pty Ltd v JB*, Lindsay J relieved a professional guardian of any liability for potential breaches of fiduciary duty arising from receiving remuneration without proper prospective authorisation.[136] In so ruling, his Honour partly relied upon the finding that prospective authorisation would have been granted according to the best-interest

[133] *Crossingham v Crossingham* [2012] NSWSC 95 [33] (White J).

[134] [2016] NSWSC 945 [15], [48].

[135] ibid [12], [48].

[136] [2014] NSWSC 245.

standard if it was sought.[137] Such willingness to grant retrospective exoneration notwithstanding the guardian's failure to seek prospective authorisation is consistent with historical guardianship cases, such as *Brown v Smith*.[138]

Recent New South Wales decisions confirm that equity's flexible approach to regulating guardians also extends to attorneys who serve elderly incapable persons. The case for the imposition of fiduciary duty on an attorney is usually strong when he or she serves an incapable principal. The principal places a high level of trust on the attorney.[139] The extent of public monitoring and supervision of attorneys is weak compared to that of guardians.[140] Moreover, attorneys often undertake to comply with the terms and conditions of a prescribed form, which terms and conditions can include fiduciary duties.[141] Justice Richard White of the Supreme Court of New South Wales thus held that the attorney-incapable principal relationship is 'undoubtedly' fiduciary.[142] However, the relationship is 'not a relationship of trustee and beneficiary and the

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[137] ibid [12], [140], [328](a).

[138] (1878) 10 Ch D 377.

[139] Dal Pont (n 19) paras 6.50, 8.39.

[140] Eg *Re Joan Treadwell (Deceased)* (2013) EWHC 2409 (COP) [5]–[8] (*Treadwell*); *Smith* [2017] NSWSC 408 [92]–[94]; McCullagh (n 19) para [19.20].

[141] Eg *Powers of Attorney Regulation 2016* (NSW) sch 2, Form 1 s 6(c), Form 2 s 7(d).

[142] *Downie v Langham* [2017] NSWSC 113 [8].

law does not always impose an obligation on [the attorney] to account.'[143] Instead, Theobald's treatise and guardianship cases offer guidance on the rigour of an attorney's duty to account.[144]

As *Hanson*[145] and *Smith*[146] can illustrate, the flexible approach to fiduciary regulation tolerates some conflicts of interest within families. Unlike the strict approach, the flexible approach adopted in New South Wales would likely relieve Mrs Hanson from liability for breach of fiduciary duty. She could argue that it was in her incapable husband's best interests to live with her and be cared for by her in their habitual residence; the payments from her husband covered (in part at least) his living and care-taking expenses. The fact that Mrs Hanson enjoyed an unauthorised benefit from her position would not be fatal to her argument. On the other hand, the flexible approach would (and did) still hold Mrs Smith liable for breach of fiduciary duty. It would be a stretch to argue that it was in Mr Smith's best interests to be left in a nursing home while Mrs Smith spent his money to enjoy luxuries with her side of the family and buy real property for herself and her children from a prior marriage. Mrs Smith

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[143] ibid [8]. Also Dal Pont (n 19) paras 8.55-57, 8.62 (on the vagueness of an attorney's duty to account).

[144] Eg *Downie v Langham* [2017] NSWSC 113 [8]–[12]. Also *Crossingham* [2012] NSWSC 95 [18]–[25], [51] (applying guardianship cases to an attorney who enjoyed a personal benefit while living with and providing day-to-day care to his elderly, mentally-*capable* father).

[145] 682 NW 2d 207 (Neb 2004).

[146] [2017] NSWSC 408.

also made some of these expenses to devalue the property that the children from Mr Smith's first marriage were entitled to inherit under his will;[147] his wishes regarding succession planning were therefore undermined. The point is that the flexible approach is not fixated upon conflicts of interest; it aims to pursue the best interests of the incapable person.

B. Relaxation of Strict Fiduciary Law in England

While the English regime is heavily influenced by trust fiduciary law, the Court of Protection has shown some willingness to lighten the burden of fiduciary regulation on guardians and attorneys. In a small number of cases, the Court exercised a judicial discretion *retrospectively* to ratify breaches of fiduciary duty by an errant guardian or attorney.[148] The Court did so to advance the best interests of the incapable person — as defined by section 4 of the Mental Capacity Act 2005 (UK). These cases typically involved gifts made on behalf of the incapable person, requiring a close analysis of the gifting restrictions imposed by that Act.[149] In conducting statutory interpretation, the Court recognised that conflict of interest is the mischief that the legislature sought to remedy by restricting guardians and attorneys' gifting authority.[150] The Court's willingness to tolerate some

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[147] ibid [248]–[249].

[148] Eg *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [74]–[83], [93]; *Re PP* [2015] EWCOP 93 [121]–[123].

[149] Eg ibid. Generally Section III-C.

[150] *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [58]–[60].

conflicts of interest was in part driven by Theobald's treatise, the New South Wales decisions in point, as well as recent developments in international human rights law (which Section V-D-2 below will discuss).[151]

V. JUSTIFYING THE FLEXIBLE MODEL

Challenging the prevailing model of fiduciary regulation, the recent efforts to apply a flexible model in England and New South Wales leave important questions unanswered. As Part IV has explained, a small number of first-instance decisions in these jurisdictions are primarily responsible for applying the best-interests standard to govern retrospective scrutiny of fiduciary conduct; whether appellate courts should take a similar view is an open question. Another open question is whether the English and New South Wales view should be followed in other Anglo-Australian jurisdictions. This can be an open question even in jurisdictions where a guardian or an attorney's duty of loyalty is based on statute. For example, the Victorian power of attorney statute and the Queensland guardianship and power of attorney statutes expressly provide a discretion retrospectively to validate previously-unauthorised conflicts.[152] There is an open question as to whether Victorian and

[151] Eg *Re JW; GGW v East Sussex County Council* [2015] EWCOP 82, [2016] COPLR 36 [20], [30], [34]–[37], [42], [50](b).

[152] *Powers of Attorney Act 2014* (Vic) s 65(5); *Guardianship and Administration Act 2000* (Qld) s 58; *Powers of Attorney Act 1998* (Qld) s 105.

Queensland courts or tribunals should exercise that discretion in accordance with the best-interests standard.

This Part will offer normative grounds to explain and justify the flexible model of fiduciary regulation. The primary aim here is to persuade courts and tribunals to apply the flexible model to guardians and attorneys. Another aim is to persuade legislatures, law reformers and scholars of the merits of flexible fiduciary regulation.

To facilitate presentation, let the 'best-interests defence' refer to the retrospective application of the best-interests standard to exonerate a previously-unauthorised conflict of interest by a guardian or an attorney. The claim to be advanced is that the best-interests defence should be understood to have a *subjective* interpretation with logical implications:

(1) The subjective interpretation is that the best-interests defence excuses a conflict of interest in cases where the incapable person could have and would have authorised the conflict if he or she was mentally-capable and fully-informed;

(2) This interpretation logically implies that if a *mentally-capable* person cannot authorise a particular conflicted action or transaction, then the best-interests defence does not excuse such action or transaction.

The proposed subjective interpretation largely engages a 'substituted-judgment' analysis to respect the incapable person's own values and preferences whenever ascertainable. Section A will apply fiduciary doctrine and theory to explain and justify the proposed interpretation.

Building upon Part IV, Section B below will argue that the proposed interpretation correctly protects close family members who serve as guardians and/or attorneys. Section C will examine the main logical implication of the proposed interpretation: the best-interests defence does not excuse conflicted actions or transactions that amount to evasion of the applicable family provision statute. Section D will defend the flexible model against potential criticisms. All Sections will argue against the prevailing, strict model.

A. Approximation of a Private Individual's Power to Authorize Departures from Strict Fiduciary Law

1. Default Law versus Mandatory Law

When applied to protect mentally-capable persons, the strict model of fiduciary law primarily operates as *default* law that yields to party modification. The duty of loyalty can deter and sanction fiduciary conduct that actually benefits the beneficiary. To remedy such over-deterrence, fiduciary law generally permits the fiduciary to seek the fully-informed consent of the beneficiary to pursue personal gains.[153] The beneficiary is usually free to authorise departures from those aspects of fiduciary law that he or she finds undesirable. Moreover, fiduciary law generally does not ask hypothetical questions to excuse conflicts of interest;[154] if the

[153] Conaglen, Authorisation Mechanisms (n 62) 563–64 (citations omitted).

[154] *Murad v Al-Saraj* [2005] EWCA Civ 959 [76]–[77], [105]–[107] (citations omitted); *Ancient Order of Foresters in Victoria Friendly Society Ltd v Lifeplan Australia*

fiduciary commits a breach of fiduciary duty without the beneficiary's consent, then it is not a defence to prove that the beneficiary would have consented if consent was sought.[155] As Conaglen explained in another context, allowing retrospective approval would 'encourage[] fiduciaries to "chance it", on the basis that part of the profit they make from the infringing transaction might be able to be kept if the court is so minded.'[156] In other words, fiduciaries would have little incentive to obtain the actual consent of their beneficiaries if they were allowed to prove hypothetical consent at the time of adjudication.

In cases concerning mentally-incapable persons, however, fiduciary law tend to operate as *mandatory* law. '*Prima facie*, a person incapable of managing his or her affairs might reasonably be thought to be incapable of giving his or her fully-informed consent to a transaction otherwise in breach of fiduciary obligations.'[157] To be sure, guardians tend to face more challenges than attorneys in securing fully-informed consent from incapable persons. While the appointment of a guardian requires an

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Friendly Society Ltd [2018] HCA 43 [8] (Kiefel CJ, Keane and Edelman JJ) (citing, inter alia, Conaglen, Authorisation Mechanisms (n 62)).

[155] *Murad v Al-Saraj* [2005] EWCA Civ 959 [8], [32], [70]–[71].

[156] Conaglen, Authorisation Mechanisms (n 62) 576.

[157] Geoff Lindsay, 'Who Guards the Guardian? Incapacity in a Family Context' (*College of Law*, 15 June 2018) <http://www.supremecourt.justice.nsw.gov.au/Documents/Publications/Speeches/2018%20Speeches/Lindsay_20180615.pdf> accessed 17 October 2018 [21] (emphasis in original) (Incapacity in a Family Context). Also *Hartley v Woods* [2017] NSWSC 1420 [77]; Dal Pont (n 19) paras 8.38, 8.41, 8.78; McCullagh (n 19) paras [19.260], [19.290] (citations omitted).

official finding of mental incapacity,[158] no such finding is needed to appoint an attorney. Thus, in rare cases, attorneys had successfully defended consent obtained from elderly principals.[159] For example, in *Crossingham v Crossingham*,[160] Kimberley served as his elderly father Ernest's day-to-day carer and attorney. Ernest gave the PIN to his bank account to Kimberley and told him to 'look after yourself'.[161] Kimberley then withdrew moneys to pay household expenses and for his father's care. He also withdrew moneys for his own purposes, including gambling, alcohol and playing golf. After Ernest passed away, Kimberley's sisters sued Kimberley to recover the moneys withdrawn.[162] The New South Wales judge did not require Kimberley to repay the moneys withdrawn during Ernest's lifetime.[163] His Honour found that '[Ernest's] mental capacity was not disturbed. He must have known that giving his son the PIN to the account and telling him that he could use the moneys to look

[158] Generally Section II-A. Eg *Woodward v Woodward* [2015] NSWSC 1793 [12], [25] (White J).

[159] Eg *Day v Harris* [2013] EWCA Civ 191 [17]–[19], [30], [45]–[49] (Lloyd LJ); *Birch v Birch & Ors* [2018] QSC 289 [106]–[107], [124].

[160] [2012] NSWSC 95.

[161] ibid [41].

[162] ibid [2]–[13].

[163] Kimberley was nonetheless required to account for the moneys withdrawn after Ernest had pass away, because such moneys belonged to the estate. ibid [68].

after himself created a risk that the moneys might be dissipated.'[164] In other words, Kimberley had Ernest's fully-informed consent to withdraw moneys for selfish purposes. It would have been harder or impossible for Kimberley to secure such consent if a guardianship proceeding had determined that Ernest lacked mental capacity.

In typical cases, however, dementia (or a similar degenerative condition) is the reason for appointing the guardian or attorney. As the dementia progresses and worsens, it becomes harder for the guardian or attorney to argue that any consent given is fully-informed. Moreover, it can be very costly to 'litigation-proof' any consent given; there may be a need to engage the service of medical professionals. For instance, in succession cases involving assessment of mental ability, the 'golden rule' counsels that a medical professional should be engaged to verify and document the quality of consent in order to reduce the likelihood of a subsequent finding of testamentary incapacity.[165] The English Court of Protection has adopted an analogous rule that requires a medical professional to conduct assessment of mental ability.[166] Thus both guardians and attorneys tend to face significant challenges in securing and

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[164] ibid [51].

[165] *Banks v Goodfellow* (1870) LR 5 QB 549. Generally Ross Martyn and others (n 108) 3-012.

[166] Hale and others (n 14) para 10–041; HM Courts & Tribunal Services, 'Form COP 3: Make a Report on Someone's Capacity to Make Decisions' (*GOV.UK*, 1 December 2017) <https://www.gov.uk/government/publications/make-a-report-on-someones-capacity-to-make-decisions-form-cop3> accessed 11 September 2019.

‘litigation-proofing’ consent, even though such challenges are marginally more surmountable for attorneys.

Some law reformers argue that the incapable person could authorise departures from fiduciary law before losing mental capacity.[167] For example, principals who are only in the early stages of dementia often can make most decisions about their lives;[168] they can authorise departures in the power of attorney before they experience significant memory loss, cognitive difficulties, or other symptoms that tend to appear in the later stages of dementia.[169] This argument overestimates a person’s ability to anticipate future contingencies. Empirical research in behavioural economics and psychology consistently reveals that individuals tend to make systematic errors when making inferences about the future.[170] The cost of documenting all anticipated contingencies would also be prohibitively high. In fact, the need to respond to new circumstances as

[167] Eg ALRC Commonwealth Law Report (n 21) 172–74.

[168] Eg Harding, Duties to Care (n 15) ch 4 (discussing uses of powers of attorney in early stages of dementia).

[169] Generally ‘Symptoms and Memory in the Later Stages of Dementia’ (*Alzheimer’s Society*) <https://www.alzheimers.org.uk/about-dementia/symptoms-and-diagnosis/how-dementia-progresses/symptoms-memory#content-start) accessed 16 September 2019.

[170] Daniel Kahneman, ‘Maps of Bounded Rationality: a Perspective on Intuitive Judgment and Choice’ (Nobel Prize Lecture, Stockholm University, 8 December 2002) <https://www.nobelprize.org/prizes/economic-sciences/2002/kahneman/lecture/> accessed 17 October 2018 and the literature surveyed therein, especially Kahneman co-authored work with Amos Tversky; Daniel Kahneman, *Thinking, Fast and Slow* (Farrar, Straus and Giroux 2011) 129–36, 146–65.

they arise is often the very reason for engaging a fiduciary.[171] This is especially true when a guardian or an attorney is appointed to serve an elderly person; life expectancy is now higher than any generation before, thus the length of time for property-management services is also prolonged.

Textbook writers also tend to emphasise the availability of prospective authorisation by a court or tribunal.[172] Yet there are practical challenges for relying on this mechanism as the only (or the main) solution to the problem of over-deterrence arising from strict fiduciary law. First, widespread ignorance of fiduciary law within the community[173] implies that most lay guardians and attorneys are unlikely to know of the availability of court or tribunal approval, let alone the importance of seeking approval prospectively rather than retrospectively. Secondly, disputed cases often involve relatives of the elderly incapable person fighting over their expected inheritance. The adversarial nature of these disputes can generate high legal costs. In particular, inheritance disputes involving children from different marriages or cohabitation

[171] Scott and Scott (n 36) 2419–21; Sitkoff (n 36) 199.

[172] Eg Lush and Bielanska (n 30) paras 13.46, 13.53, 13.89; McCullagh (n 19) para [19.400].

[173] Eg ALRC Elder Abuse Report (n 3) 173 nn 62–64 and accompanying text; Victorian Parliament Law Reform Committee, *Inquiry into Powers of Attorney* (No 352, 2010) 175.

relationships are common;[174] animosity between these litigants can drive them to incur unnecessary legal expenses with the goal of harming the other side.[175] Moreover, limited funding, heavy caseloads and shortages in staffing can further undermine the effectiveness of the process for obtaining prospective court or tribunal authorisation.

2. A Solution to the Problem of Over-deterrence

Focusing on cases concerning mentally-incapable persons, Section V-A-1 above shows the ineffectiveness of the usual mechanisms for solving the problem of over-deterrence. It may be argued that two of these mechanisms also tend to be ineffective in respect of mentally-capable persons; powers of attorney granted by principals who never lose mental capacity may not account for all future contingencies, and the process for obtaining prospective court or tribunal approval may fail mentally-capable persons as well. Yet one mechanism tends to be ineffective only in respect of incapable persons: a private individual's power to authorise departures from those aspects of strict fiduciary law that he or she subjectively finds undesirable. In this light, the main function of the best-

[174] Generally O'Neil and Peisah (n 19) para 2.3.2; Rebecca Probert, 'Disquieting Thoughts: Who Will Benefit When We Are Gone?' in Häcker and Mitchell (eds) (n 48) 37–38; Prue Vines, *Bleak House Revisited? Disproportionality in Family Provision Estate Litigation in New South Wales and Victoria* (Australasian Institute of Judicial Administration 2011) 32.

[175] Eg *Wharton v Bancroft & Ors (Rev 1)* [2011] EWHC 3250 (Ch) [85] (describing claims by the deceased's children against his long-term partner as 'a cry of anguish dressed up in legal language'); *Wharton v Bancroft* [2012] EWHC 91 (Ch) [13], [27] (sanctioning these children with cost orders on the indemnity basis).

interests defence becomes apparent: it approximates the decision that the incapable person would have reached in a state of capacity if his or her fully-informed consent was sought by his or her guardian or attorney. This is the proposed subjective interpretation of the best-interests defence.

The best-interests defence tends to excuse a conflict of interest in cases where the incapable person would have permitted the conflict if he or she had capacity. This is partly because the best-interest standard has long been predominantly a subjective concept in cases concerning administration of property.[176] In the nineteenth century, the English Court of Chancery began to effectuate the incapable person's own wishes in the administration of his property.[177] The perspective of the incapable person was 'central', although not 'conclusive'.[178] After the Judicature Act reforms, courts exercising protective jurisdiction continued to consider what the incapable person would have wanted if he or she had capacity.[179] Recent applications of the best-interests standard in England and in New

[176] On the other hand, when applied in cases concerning medical decision-making, the best-interests standard tends to be an objective concept. Generally Louise Harmon, 'Falling Off the Vine: Legal Fictions and the Doctrine of Substituted Judgment' (1990) 100 Yale LJ 1; Hale and others (n 14) 1–9; Donnelly, The Evolution of Capacity Law (n 14).

[177] *Ex parte Whitbread* (1816) 2 Mer 99, 101–03 (Lord Eldon LC); 35 ER 878, 879, applied in eg *W v H* [2014] NSWSC 1696 [39]–[40].

[178] *W v H* [2014] NSWSC 1696 [45].

[179] ibid [44] discussing *In re Darling (a Person of Unsound Mind)* (1888) 39 ChD 209; *RL v NSW Trustee and Guardian* (2012) 84 NSWLR 263, 306–07 (Young JA, agreeing with Campbell JA); Theobald (n 119) 462.

South Wales focus on the elderly incapable person's subjective wishes.[180] Moreover, the hypothetical question regarding the incapable person's wishes in a state of capacity assumes that the person is fully-informed of the relevant conflict of interest.[181]

Evidence of an elderly incapable person's past conduct, relational norms and wishes tends to support inferences regarding what he or she would have wanted if he or she had capacity. The person may have expressed his or her wishes in succession-planning instruments, and even if not, he or she has had a lifetime to leave a 'memory trail … in the minds of family and friends'.[182] For instance, past gifting patterns can reveal whether the person would make a particular gift if he or she had capacity.[183] The person's will and wish letters can also reveal his or her gifting intentions.[184] The English Court of Protection tends to attach

[180] For England: *Aintree University Hospitals NHS Trust v James* [2013] UKSC 67 [45] (Lady Hale DPSC, with whom Lord Neuberger PSC, Lord Clarke, Lord Carnwath and Lord Hughes JJSC agreed), applied in *Meek* [2014] EWCOP 1, [2014] COPLR 534 [32], [34]; *Re PP* [2015] EWCOP 93 [98], [100]; *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [74]–[76]; *Suffolk County Council v JU* [2014] EWCOP 21 [46]. For New South Wales: *W v H* [2014] NSWSC 1696 [39]–[40].

[181] Eg *Meek* [2014] EWCOP 1, [2014] COPLR 534 [74].

[182] Carney (n 33) 5–6.

[183] Eg *Re PP* [2015] EWCOP 93 [101], [110].

[184] Eg ibid [105], [119]; *Re HH (Attorney's Application for Retrospective Approval)* [2018] EWCOP 13 [76].

'magnetic importance' to a will.[185] Gifts that are out of character would not be approved retrospectively.[186]

Hanson can illustrate how the best-interests defence can address the problem of over-deterrence.[187] The proposed subjective interpretation would direct a court to ask whether, if he had capacity, Mr Hanson would have authorised Mrs Hanson to receive payments from him according to their pre-existing agreement. It was likely beneficial for Mr Hanson to live with and receive care from Mrs Hanson in their habitual residence, and the payments to Mrs Hanson eased her financial burden of continuing that living and caring arrangement rather than moving him to a nursing home.[188] Mrs Hanson could also rely on the evidence that before Mr Hanson lost mental capacity, he had consented to the agreement with Mrs Hanson as well as 'family financial management in the family's accustomed manner[.]'[189] Moreover, there was an analogous Chancery decision concerning a married couple who had an arrangement to share household expenses before the wife became incapable. The Court made

[185] Eg *Re PP* [2015] EWCOP 93 [119]; *Treadwell* (2013) EWHC 2409 (COP) [27].

[186] Eg *Day v Harris* [2013] EWCA Civ 191 [47]; *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [95].

[187] 682 NW 2d 207 (Neb 2004).

[188] Also *Smith* [2017] NSWSC 408 [452] (holding that different accounting standards may apply to a guardian who lives with and provide day-to-day care to the incapable person and a guardian who places the incapable person in a nursing home).

[189] 682 NW 2d 207, 211 (Neb 2004).

provision out of her property to carry out the arrangement, because the evidence revealed that the wife would have done the same if she had capacity.[190] Supported by precedent, Mrs Hanson would likely succeed in establishing the best-interests defence. This outcome solves the problem of over-deterrence; Mrs Hanson would likely be protected from liability for breach of fiduciary duty because her conduct was subjectively beneficial to Mr Hanson.

In sum, strict prohibition of conflicts of interest can give rise to the problem of over-deterrence. A fiduciary who serves a mentally-capable beneficiary can solve that problem by obtaining the beneficiary's fully-informed consent, but a guardian or an attorney who serves a mentally-incapable person typically struggles to take advantage of that mechanism. The best-interests defence responds to the resulting problem of over-deterrence in cases concerning incapable persons. Under the proposed subjective interpretation, the best-interests defence aims to approximate, as closely as possible in the circumstances, for incapable persons the outcome that capable persons can obtain by giving fully-informed consent: departures from those aspects of strict fiduciary law that are subjectively undesirable. So understood, the best-interests defence merely functions to equalise the degree of protection for capable and incapable persons.

[190] *Re Hewson* (1852) 21 LJ Ch 825, approved in Theobald (n 119) 463.

3. *Exoneration rather than Ratification*

The proposed subjective interpretation of the best-interests defence follows the New South Wales view that breaches of fiduciary duty by guardians and attorneys may be *exonerated* rather than the view, proffered by the English Court of Protection, that such breaches may be *ratified*.[191] The analysis thus far does not depend on the exoneration-ratification distinction. It is now convenient to explain why that distinction may matter.

First, courts of equity may retrospectively exonerate breaches of fiduciary duty by guardians and attorneys,[192] while courts and tribunals vested with (statutory or inherent) protective jurisdiction may retrospectively ratify such breaches on behalf of incapable persons.[193] An implication of this distinction is that when the relevant incapable person dies, the protective jurisdiction to grant ratification seems to be lost,[194] while the equitable jurisdiction to grant exoneration remains intact.[195] As

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[191] Generally Sections IV-A-2, IV-B.

[192] *C v W (No 2)* [2016] NSWSC 945 [21]–[26].

[193] Eg *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [74]–[76] discussing the Mental Capacity Act 2005 (UK). On the English High Court's inherent jurisdiction over 'vulnerable' persons, which include incapable persons, see generally *In re L (Vulnerable Adults with Capacity: Court's Jurisdiction) (No 2)* [2012] EWCA Civ 253, [2013] Fam 1; Herring, Vulnerable Adults (n 46) ch 4.

[194] *Treadwell* (2013) EWHC 2409 (COP) [75], [78]. Cf *KS* [2018] WASAT 29 [20]–[27]; *IT and DN v MN* [2018] WASAT 117 [67]–[69].

[195] Eg *Downie v Langham* [2017] NSWSC 113 [11].

the previous (and subsequent) arguments in favour of flexible fiduciary regulation do not depend on whether the incapable person is alive at the time of adjudication, the best-interests defence should be understood to permit retrospective exoneration rather than ratification.

Secondly, adoption of the exoneration approach tends to avoid clashes with guardianship (and power of attorney) statutes that include non-subjective elements in their best-interests formula. For example, refusing to take a 'substituted-judgment' approach, Lewison J in *In re P (Statutory Will)* held that under the best-interests test formulated by s 4 of the Mental Capacity Act 2005 (UK), an incapable person's subjective wishes 'are to be given great weight' but not 'determinative'.[196] This and similar decisions may present statutory-interpretation challenges for those who prefer a purely subjective interpretation of best interests. Yet such challenges do *not* rise if the errant guardian or attorney seeks to invoke the equitable jurisdiction to grant retrospective exoneration rather than a statutory jurisdiction to grant retrospective ratification. Hence the exonerate approach tends to give more freedom to develop the equitable principles governing retrospective exoneration.

However, the exoneration-ratification distinction should not be exaggerated. The trend in law reform is against non-subjective

[196] *In re P (Statutory Will)* [2010] 1 Ch 33 [41] (Lewison J). For a criticism of ibid and similar decisions, see generally Harding, Statutory Wills (n 15).

formulations of best interests.[197] The UK Supreme Court now emphasizes the subjective elements in the best-interests test in the Mental Capacity Act 2005 (UK).[198] The Court of Protection also does not always follow *In re P (Statutory Will)*.[199] Moreover, Professor Rosie Harding's analysis of this case and similar cases shows that their outcomes would have been reached by applying a subjective, 'substituted-judgment' analysis.[200]

B. Close Families in the Protective Jurisdiction

This Section will argue that fiduciary regulation of guardians and attorneys ought to accommodate *families of affection and dependence*, to use Professor Lawrence Friedman's expression.[201] Such a family may or may not be based on formal marriage or bloodline.[202] As a shorthand, all discussions of 'close families' refer to families of affection and

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[197] See generally Section V-D-2 below.

[198] *Aintree University Hospitals NHS Trust v James* [2013] UKSC 67, [2014] AC 591 [45] (Lady Hale DPSC, with whom Lord Neuberger, Lord Clarke, Lord Carnwath and Lord Hughes JJSC agreed).

[199] [2010] 1 Ch 33, not followed in eg *Re Joan Treadwell, Deceased; Public Guardian v Lutz* (2013) EWHC 2409 (COP), [2013] COPLR 578 [95]. Also Harding, Statutory Wills (n 15) 959–60.

[200] Harding, Statutory Wills (n 15) 960.

[201] Lawrence M Friedman, *Dead Hands: a Social History of Wills, Trusts, and Inheritance Law* (Stan UP 2009) 11. Generally Elizabeth S Scott and Robert E Scott, 'From Contract to Status: Collaboration and the Evolution of Novel Family Relationships' (2016) 115 Colum L Rev 293, 305–06 (defining contemporary families based on adult relationships as those that exhibit the 'core qualities [of] a demonstrated, long-term commitment and the assumption of mutual care and financial responsibility').

[202] ibid 11; Rosalind Croucher and Prue Vines, *Succession: Families, Property and Death: Text and Cases* (4th ed, LexisNexis Butterworths, 2013) paras 2.17, 2.48–49 (citations omitted).

dependence. It will be argued that qualifying strict fiduciary duty with the best-interests defence appropriately accommodates the interests of guardians and attorneys who are in a close familial relationship with the elderly incapable person.

1. Cost-effective Regulation by Intrinsic Bonds and Informal Norms

Intrinsic bonds and informal norms in close families tend to be strong, and can often cost-effectively deter misconduct. In relation to close parent-minor child relationships, Professors Elizabeth Scott and Robert Scott argued that extra-legal mechanisms in the forms of biological and affective bonds, as well as social and moral norms, have a dominating effect in incentivising parents to fulfil their care-taking role.[203] Public humiliation is another form of sanction that discourages misconduct.[204] Limited legal regulation of close parent-child relationships recognises that extra-legal mechanisms can cost-effectively deter parental misconduct.[205] More recently, Elizabeth Scott and Ben Chen argued that extra-legal mechanisms can also deter misconduct when a spouse/partner or an adult child serves as guardian to an elderly incapable person.[206] To

[203] Scott and Scott (n 36) 2430, 2433.

[204] *Treadwell* (2013) EWHC 2409 (COP) [100]–[101]; *Meek* [2014] EWCOP 1, [2014] COPLR 534 [105].

[205] Scott and Scott (n 36) 2404, 2430–39.

[206] Elizabeth Scott and Ben Chen, 'Fiduciary Principles in Family Law' in Evan J Criddle, Paul B Miller and Robert H Sitkoff (eds), *Oxford Handbook of Fiduciary Law* (OUP 2019) ch 12.

be sure, affective bonds in such an adult guardianship tend to be less effective in deterring misconduct than in a close parent-minor child relationship; hence guardians of elderly incapable persons should be subject to more onerous legal regulation than the typical parent. Yet the presence of intrinsic bonds and informal norms can still partially offset the need for strict fiduciary regulation.

The available empirical evidence reveals the critical role of extra-legal mechanisms in close families. Based on empirical research involving carers of family members or friends with dementia in the United Kingdom,[207] Professor Rosie Harding recently reported that more than 90 percent of the respondents considered themselves responsible to provide care, but less than 40 percent considered themselves to be *legally* responsible.[208] These family-and-friend carers took on their role even though 'caring can be financially crippling, socially isolating and emotionally draining.' The Australian Bureau of Statistics also recently reported that almost 2.7 million Australians provided unpaid primary care to older people (aged 65 years and over) or people with disabilities.[209] The largest group of these primary carers were spouses/partners of the

[207] Generally Harding, Duties to Care (n 15) 50–74.

[208] ibid ch 4, 91 (Table 4.2).

[209] Australian Bureau of Statistics, '4430.0 – Disability, Ageing and Carers, Australia: Summary of Findings, 2015' (*Australian Bureau of Statistics*, 18 October 2016) <http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/4430.0main+features402015> accessed 19 October 2018.

care-recipient (40 percent), followed by adult children (25.7 percent).[210] Almost 80 percent of these primary carers resided with the care-recipient. Aside from not getting paid, these primary carers incurred substantial opportunity costs; '[t]he time taken to care for someone can impact on the carer's ability to remain engaged in the community, participate in the workforce and stay healthy.'[211] The most common reasons for taking on the care-taking role were 'a sense of family responsibility (66.9 percent)' and 'a feeling they could provide better care than anybody else (50.3 percent)'. Moreover, adult children who provided primary care to their aged parents were mainly driven by 'the responsibility of a family member to provide the care' (77.4 percent).[212]

Empirical findings regarding elder abuse therefore must be cautiously interpreted in the light of the prevalence of family carers. Surveys from Anglo-Australian jurisdictions consistently report that most alleged perpetrators of elder abuse are related to the victim. While the exact figures vary, adult children and spouses/partners are typically reported as

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[210] Australian Bureau of Statistics, '44300DO030_2015 Disability, Ageing and Carers, Australia: Summary of Findings, 2015' (*Australian Bureau of Statistics*, 18 October 2016) <http://www.abs.gov.au/ausstats/subscriber.nsf/log?openagent&44300do040.xls&4430.0&Data%20Cubes&4F8EE5AC6280C1C1CA25804F000F5D69&0&2015&18.10.2016&Latest> accessed 19 October 2018, Table_38.3.

[211] Australian Bureau of Statistics (n 209).

[212] ibid.

the largest groups of alleged perpetrators.[213] Yet these findings should not be interpreted to suggest that family members are prone to commit elder abuse.[214] Saying elder abusers are likely to be family members is not the same as saying family members are likely to be elder abusers. That family members are well-represented in elder abuse statistics may well be driven by the prevalence and frequency of dealings between the elderly and their family members. What would support strict fiduciary regulation is any empirical finding suggesting a strong tendency of family members to commit elder abuse. The author is unaware of any such finding.

Both theoretical considerations and empirical evidence thus offer reasons to doubt the extreme view that financial conflict in a close familial relationship is a necessary evil. Rather, 'Family and other caregivers are the cornerstone and default safety net system within the contemporary long-term-care system[.]' [215] There is then much to be said for the moderate view that fiduciary law should not inflexibly discount those family guardians and attorneys who provide valuable services *notwithstanding* their financial conflicts.

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[213] Generally Kaspiew, Carson and Rhoades (n 1) 8–11 (surveying empirical studies of elder abuse).

[214] Cf *Re PL* [2015] EWCOP 14 [31] (stating 'unfortunately, some [guardians] take advantage of their position, and family members are the worst offenders').

[215] Ann M Soden Ad E, 'Family Matters: Some Emerging Legal Issues in Intergenerational and Generational Relations' in Israel Dorn and Ann M Soden (eds), *Beyond Elder Law: New Directions in Law and Aging* (Springer 2012) 118.

2. *Ubiquity of Harmless Conflicts*

Another justification for flexible fiduciary regulation is the ubiquity of conflicts of interest within close families. Unless complex property management is required, courts and tribunals typically prefer to appoint close family members as guardians, and private individuals also tend to appoint their close family members as durable attorneys.[216] Empirical research reveals widespread conflicts of interest within families.[217] The sources of conflict include psychological involvements and intertwined financial interests. In particular, financial conflicts in close familial relationships often arise from joint property ownership, shared residence, and inheritance expectations.[218] Senior Judge Denzil Lush of the English Court of Protection thus stated that '[c]onflicts of interest are ubiquitous in any mental capacity jurisdiction and it would be unrealistic, if not impossible, to eradicate them entirely.'[219] Speaking extra-judicially, Justice Geoff Lindsay also took the view that community living and property sharing 'necessitate a relaxation of "the no profit" rule for the

[216] Eg Carney (n 33) 9; Harding, Duties to Care (n 15) 184 (citations omitted).

[217] Generally Harding, Duties to Care (n 15) 184 (citations omitted); ACT Guardianship Report (n 21) 85, 95, 98, 108 (citations omitted).

[218] Eg Harding, Duties to Care (n 15) 103; Queensland Guardianship Report (n 3) 239–41.

[219] *Re JW; GGW v East Sussex County Council* [2015] EWCOP 82, [2016] COPLR 36 [30]–[31].

purpose of serving the interests of the incapable person.'[220] The following will add that fiduciary regulation may affect whether well-intended family members would be willing to provide valuable property-management services.

The strict model of fiduciary regulation can discourage well-intended family members from taking on a fiduciary office. First, financial conflicts are ubiquitous in close families, yet compliance with the sole-interest duty of loyalty can require close family members to remove their conflicts. The costs of removing conflicts can deter close family members from serving as guardian or attorney. Secondly, in the strict model, the process for appointing a guardian can also deter close family members from seeking appointment as guardian. The majority of Australian jurisdictions have enacted statutory provisions that identify the presence of a conflict of interest as a factor against appointment as guardian.[221] The guardianship statute in the Australian Capital Territory disfavours conflicts of interest in general, but makes a narrow exception to accommodate conflicts between spouses.[222] Taking an extreme view, the

[220] Lindsay, Incapacity in a Family Context (n 157) paras 37–38.

[221] *Guardians of Adults Act 2016* (NT) s 15; *Guardianship and Administration Act 2000* (Qld) s 15; *Guardianship and Administration Act 1993* (SA) s 50; *Guardianship and Administration Act 1986* (Vic) s 23. These statutory provisions appear to be a modernised form of the medieval prohibition against appointing a ward's heir apparent as his guardian. Theobald (n 119) 44.

[222] *Guardianship and Management of Property Act 1991* (ACT) s 10(5).

Western Australian and Tasmanian guardianship statutes prohibit persons with conflicts of interest from serving as guardians.[223]

On the other hand, applying the best-interests defence partially to lift the prohibition against conflicts of interest, the flexible model recognises that close family members should not be discouraged from serving as guardian or attorney.[224] More precisely, the proposed subjective interpretation recognises that '[b]est interests is not synonymous with "self-interest"';[225] family members can benefit from their position to the extent consistent with what the incapable person would have wanted if he or she had capacity. Moreover, in New South Wales, the mere existence of a conflict of interest is often not a factor against appointment as guardian; the guardianship statute there recognises that conflicts are permissible unless they are 'undue'.[226] While some English cases suggest that having a conflict of interest is a factor against appointment as

[223] *Guardianship and Administration Act 1990* (WA) s 44(1)(b); *Guardianship and Administration Act 1995* (Tas) ss 21, 54. Cf NSW Guardianship Report (n 21) 99 n 37 and accompanying text (rejecting a proposal to prohibit persons with conflicts of interest from serving as guardians).

[224] Also Jonathan Herring, *Older People in Law and Society* (OUP 2009) ch 4 (arguing that promoting the best interests of an elderly incapable person requires taking into account the interests of his or her carer); Sloan (n 18) (arguing that various areas of private law should encourage and reward care-taking).

[225] *Re HH (Attorney's Application for Retrospective Approval)* [2018] EWCOP 13 [20] citing *Re G (TJ)* [2010] EWHC 3005 (COP).

[226] *Guardianship Act 1987* (NSW) s 17(1)(b); *IR v AR* [2015] NSWSC 1187 [35] ('A "conflict of interest" is "undue" … if it is reasonably likely, to an unacceptable degree, to impede the proposed guardian's performance of the duties of a guardian in the particular case.'). Also Ryan (n 3) 205–06 (surveying appointment cases that tolerated some degree of intrafamilial or personal conflict).

guardian,[227] the availability of retrospective ratification confirms that some degree of conflict is permissible.[228] Intrafamilial conflicts are to be managed or controlled, not prohibited.[229]

English and Australian courts recognise that fiduciary law can affect a family member's incentive to take on a fiduciary office. In *Bective*, Dixon J was lenient to family guardians in part to give them 'some inducement' for taking on their role.[230] 'Courts of equity have not disguised the fact that the [flexible duty to account] gives to a parent or guardian … an opportunity of gaining *incidental benefits*[.]'[231] Such incidental benefits must be 'small' and 'incidental to the incapable person's enjoyment of his or her own property[,]' as Lindsay J clarified.[232] Taking a similar view, Lush SJ introduced a de minimus rule to exempt guardians and attorneys from liability for small benefits arising from unauthorised conflicts.[233] Moreover, both the English Court of Protection

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[227] Eg *Suffolk County Council v JU* [2014] EWCOP 21 [40]–[41].

[228] Generally Section IV-B.

[229] *Re JW; GGW v East Sussex County Council* [2015] EWCOP 82, [2016] COPLR 36 [41], [44]–[50].

[230] *Bective* (1932) 47 CLR 417, 422.

[231] ibid 421 (emphasis added).

[232] *Smith* [2017] NSWSC 408 [103] (emphasis in original). Also Finn (n 17) paras 103–04.

[233] *Re Buckley: the Public Guardian v C* [2013] EWCOP 2965, [2013] COPLR 39 [43] (for attorneys); *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [87] (for guardians). Also Lush and Bielanska (n 30) para 13.45 (explaining the de minimis exception on practical grounds).

and the Supreme Court of New South Wales are willing retrospectively to authorise good-faith guardians and attorneys to receive remuneration for providing their services.[234] This responds to the fact that guardians and attorneys are typically relatives who do not seek prospective authorisation to receive remuneration.[235]

To be sure, the strict model gives courts a discretion to make allowances to good-faith fiduciaries for their efforts and expenses.[236] One may then argue that the availability of allowances as remuneration already provides enough incentives; family guardians and attorneys can 'get paid to care', so there is no need to relax the strict prohibition against conflicts of interest. This argument overstates the value of monetary reward in familial relationships. First, a familial relationship is largely private; services provided in such a relationship are difficult or impossible to describe and document.[237] Hence any allowance is likely to remunerate at most a proportion of the services provided. Secondly, in close familial relationships, over-reliance on monetary reward may 'crowd out' intrinsic

[234] Eg *Re HC* [2015] EWCOP 29 [26]; *Downie v Langham* [2017] NSWSC 113 [12].

[235] Queensland Guardianship Report (n 3) vol 3, 245; Victorian Guardianship Report (n 3) 412; Lush and Bielanska (n 30) para 13.53.

[236] Eg *Boardman v Phipps* [1967] 2 AC 46; *Warman International Ltd v Dwyer* (1995) 182 CLR 544.

[237] Elizabeth S Scott and Robert E Emery, 'Gender Politics and Child Custody: Puzzling Persistence of the Best-Interests Standard' (2014) 77 LCP 69, 74.

motivations.[238] Tying monetary reward to fiduciary service can commodify the voluntary nature of the underlying familial relationship.[239] Family guardians and attorneys who request an allowance also risk signalling that they are driven by money rather than intrinsic motivations.[240] Moreover, there is the risk of signalling that the incapable person or the court distrusts the family guardian or attorney;[241] the signal may be that the guardian or attorney would shirk his or her responsibilities without monetary reward.

C. Recognition of Inheritance Expectations

The proposed subjective interpretation of the best-interests defence logically implies that if a mentally-capable person cannot authorise a particular conflicted action or transaction, then the best-interests defence does not excuse such action or transaction. For example, the best-interests defence does not excuse a guardian or an attorney from non-compliance with any non-waivable core of fiduciary duty, which core prohibits bad

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[238] Empirical research shows that the likelihood of such 'crowding out' is increased when the monetary reward is small relative to the services provided. Eg Uri Gneezy and Aldo Rustichini, 'Pay Enough or Don't Pay at All' (2002) 115 Q J Econ. 791.

[239] Generally Melanie B Leslie, 'Enforcing Family Promises: Reliance, Reciprocity, and Relational Contract' (1999) 77 NC L Rev 551.

[240] Benjamin Ho and David Hoffman, 'Trust and the Law' in Joshua C Teitelbaum and Kathryn Zeiler (eds), *Research Handbook on Behavioral Law and Economics* (Edward Elgar 2018) 307–08 (explaining the likely causes of 'crowding out').

[241] Roland Bénabou and Jean Tirole, 'Intrinsic and Extrinsic Motivation' (2003) 70 Rev Econ Stud 489, 492.

faith and dishonesty;[242] capable persons have no power to authorise their fiduciaries to depart from any such non-waivable core, so the best-interests defence does not generate such a power for incapable persons. Similarly, in cases concerning transfers of property at or near death, the applicable family provision statute imposes outer limits on judicial willingness to respect subjective will and preferences. As these outer limits of testamentary freedom apply to *capable* persons, the best-interests defence does not generate a power to exceed such outer limits for incapable persons. This Section will argue that this logical implication is a virtue: it makes explicit the role of inheritance expectations whenever present, and partially mitigates the perverse incentives that may arise from any such inheritance expectations.

In theory, guardians and attorneys owe fiduciary duties only to the elderly incapable persons they serve. In reality, near the end of an incapable person's life, the conduct of his or her guardian or attorney, and how fiduciary law regulates such conduct, may affect the interests of persons who expect to inherit from the incapable person. The size and composition of the incapable person's estate at death depend on the outcome of any fiduciary claim against his or her guardian or attorney. A successful claim tends to enlarge the estate, and thereby benefits some persons who expect to inherit. For example, if the incapable person is

[242] Eg *Armitage v Nurse* [1998] Ch 241, 253–54 (Millett LJ).

alive, then a fiduciary claim can be a prequel to an application for the making of a statutory will.[243] In such a case, the elderly incapable person enjoys the fruits of a successful fiduciary claim only for the remainder of his or her lifetime. The claim also enlarges his or her estate at death, which will be shared by those with inheritance entitlements. Moreover, if the incapable person has passed away by the time of adjudication, then the fruits of a successful fiduciary claim exclusively accrue to persons who expect to inherit. For example, a fiduciary claim can be made at the same time as, or in anticipation of, an application for family provision relief.[244] In this scenario, a successful fiduciary claim enlarges the estate of the deceased incapable person. The estate will then be shared among those who are entitled to inherit, including by way of family provision relief. Figure 6 1 below depicts typical inheritance-driven fiduciary claims.

[243] Eg *Re GM* [2013] EWCOP 2966, [2013] COPLR 290 [103] and its sequel, *Meek* [2014] EWCOP 1, [2014] COPLR 534; *Re PP* [2015] EWCOP 93 [122]. A statutory will is made on behalf of a person who lacks testamentary capacity in anticipation of his or her death and on notice to persons who have inheritance expectations. Courts generally make a statutory will to effectuate what the incapable person would have intended if he or she had capacity. Generally Hale and others (n 14) paras 10–015, 10–016; Ross Martyn and others (n 108) para 3-013; Croucher and Vines (n 201) paras 6.11–6.19C. For criticisms of the law governing statutory wills, see especially Harding, Statutory Wills (n 15).

[244] Eg *Smith* [2017] NSWSC 408; *Reilly v Reilly* [2017] NSWSC 1419, appeal allowed in part on other grounds: *McFee v Reilly* [2018] NSWCA 322. Also *Alcazar-Stevens v Stevens* [2017] ACTCA 12 (deceased' son bringing a breach-of-fiduciary claim against deceased's daughter-attorney as prequel to his challenge against validity of deceased's will and his application for family provision relief from deceased's estate).

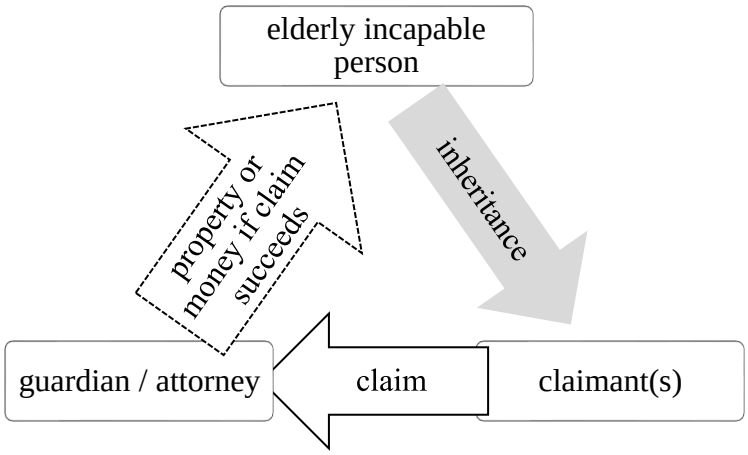

Figure 6: Breach-of-Fiduciary Duty Claims Driven by Inheritance Expectations

The preceding analysis suggests that in cases concerning inheritance, fiduciary law can potentially impact upon elderly incapable persons *and* persons who expect to inherit from them. It conforms with reality for lawmakers and adjudicators to consider the interests of both groups of persons. Recognising the implicit role of persons with inheritance expectations then enables an analysis of how best to respond to potential conflicts between their interests and the interests of incapable persons.

It is submitted that a defect of the strict model of fiduciary regulation is its tendency to ignore the possibility of conflicts between an elderly incapable person and claimants who expect to inherit from him or her. The elderly person may wish to benefit her guardian or attorney at the expense of others who have inheritance expectations. For example, in

Hanson,[245] the payments that the wife-guardian received from her incapable husband decreased the size of the husband's estate at death; these payments thus harmed the interests of his children from his first marriage, who had inheritance expectations. That the children succeeded in their fiduciary claim against Mrs Hanson illustrates that the strict model practically prioritises the interests of claimants with inheritance expectations over the incapable person's. Claims to avoid conflicted transactions tend to succeed without regard to the incapable person's own wishes. The 'real' beneficiaries of strict fiduciary regulation may well be claimants with inheritance expectations.

By introducing the best-interests defence, the flexible model of fiduciary regulation can recognise and balance potential conflicts between an elderly incapable person and claimants who expect to inherit from him or her. Anglo-Australian succession law and policy favour a *qualified* freedom of testation: a person's freedom of testation is qualified by a moral duty to provide for his or her family, the exact contour of which duty is defined by the applicable family provision statute.[246] In a similar vein, the flexible model of fiduciary regulation 'takes a large and liberal

[245] 682 NW 2d 207 (Neb 2004).

[246] Generally *Allardice; Allardice v Allardice* [1910] 29 NZLR 959, 972–73 (Edwards J), affd [1911] AC 730 (PC); *Vigolo v Bostin* [2005] HCA 11, (2005) 211 CLR 191 [15], [25] (Gleeson CJ), [73] (Gummow and Hayne JJ), [121]–[122] (Callinan and Heydon JJ); *Ilott v The Blue Cross* [2017] UKSC 17, [2018] AC 545 [49]–[52] (Lady Hale DPSC, with whom Lord Kerr and Lord Wilson JJSC agreed); Croucher and Vines (n 201) para 1.30.

view of what "benefit" is, and it will do on behalf of [the incapable person] not only what may directly benefit him or her, but what, if he or she were capable of managing their own affairs, he or she would as a *right-minded and honourable* person desire to do[.]'[247] The proposed subjective interpretation of the best-interests defence thus advances the incapable person's freedom of testation, while the logical implications of that interpretation mark the outer limits of that freedom. More precisely, inheritance expectations *legitimately* qualify the testamentary freedom of incapable persons to the extent that capable persons are subject to the *same* qualifications. (Section V-D-2 below will address the relationship between such equal restrictions of testamentary freedom and the CRPD.)

It is not beyond the permissible bounds of judiciary creativity to implement succession law and policy in the protective jurisdiction. From the Norman Conquest until the mid-sixteenth century, primogeniture was the underlying principle governing succession to land.[248] In that era, the wardship jurisdiction (one of the predecessors of the modern protective jurisdiction) aimed to 'prevent incapable people from alienating their

[247] *W v H* [2014] NSWSC 1696 [47] (quoting, inter alia, Theobald (n 119) 380 with minor amendments) (emphasis added). Also *Protective Commissioner v D* [2004] NSWCA 216, (2004) 60 NSWLR 513 [150] (McColl JA) (quoting Theobald (n 119) 380).

[248] GE Dal Pont and KF Mackie, *Law of Succession* (LexisNexis Butterworths 2013) paras 21.5–21.6. A testator had some degree of freedom to will his chattels subject to his widow and children receiving fixed shares. ibid.

lands and disinheriting their heirs[,]'[249] who were said to be chosen by God.[250] Testamentary freedom gradually expanded in the next three centuries.[251] Consistent with that development was Chancery's willingness to effectuate the incapable person's own wishes and its reluctance to interfere with inheritance expectations in his property.[252] In the early twentieth century, the excesses of testamentary freedom led Anglo-Australian legislatures to adopt New Zealand's innovative family provision statute.[253] Thus prevailing succession law and policy have long informed the administration of the protective jurisdiction.

It should be clarified that the outer limits of testamentary freedom are not uniform across Anglo-Australian jurisdictions. For instance, the family provision statutes in England and New South Wales have complex anti-evasion provisions.[254] Imposing restrictions on testamentary freedom,

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[249] Peter W Young, Clyde Croft and Megan Louise Smith, *On Equity* (Lawbook Co 2009) para 4.180.

[250] Watson (n 111) 137 (citations omitted).

[251] Dal Pont and Mackie (n 248) paras 21.9–21.14.

[252] Eg *In re Freer; Freer v Freer* (1882) 22 Ch D 622 (Ch), 624–25; *Attorney-General v The Marquis of Ailesbury* (1887) 12 AC 672 (HL) 688–89 (Lord Macnaghten) and the Chancery opinions summarised therein.

[253] Dal Pont and Mackie (n 248) paras 21.7, 21.29, 21.38, 21.51, 21.60, 21.82. Generally Rosalind Atherton (Croucher), 'New Zealand's Testators' Family Maintenance Act of 1900: the Stouts, the Women's Movement and Political Compromise' (1990) 7 Otago LR 202; Rosalind Atherton (Croucher), 'The Concept of Moral Duty in the Law of Family Provision – a Gloss or Critical Understanding?' (2000) 6 Aust J Leg Hist 5.

[254] Inheritance (Provision for Family and Dependants) Act 1975 (UK) ss 10–13, discussed in Ross Martyn and others (n 108) [271]–[276]; *Succession Act 2006* (NSW) pt 3.3, discussed in Dal Pont and Mackie (n 248) paras 20.58–78.

these anti-evasion provisions aim to nullify certain transactions, including lifetime dispositions of property, that the deceased made with the intention of defeating applications for family provision relief. When applied in England and New South Wales, the best-interests defence would not excuse guardians and attorneys from assisting incapable persons to make transactions that are captured by the applicable anti-evasion provisions. However, the best-interests defence would operate differently in jurisdictions that do not have similar anti-evasion provisions.[255] Thus, in general, the practical operation of the best-interests defence varies with the applicable family provision statute.

D. Common Criticisms

Supporting flexible fiduciary regulation of guardians and attorneys, the previous Sections argue that the best-interests defence qualifies the sole-interest duty of loyalty primarily to ameliorate the over-deterrence effect of that duty and to accommodate harmless conflicts in close families. Best-interests standards are commonly subject to two criticisms: indeterminacy, and discrimination against people with disabilities. This Section will argue that these criticisms should not lead to rejection of the proposed subjective interpretation of the best-interests defence, and that

[255] At the time of writing, New South Wales is the only Australian jurisdiction that has anti-evasion provisions, but there are calls for adoption of such provisions elsewhere. Dal Pont and Mackie (n 248) para 20.59 (citations omitted).

the strict model of fiduciary regulation can also be criticised on the same grounds.

1. Indeterminacy

Scholars have criticised best-interest standards for their indeterminacy. These standards tend to grant a broad judicial discretion to consider a range of incommensurable factors without provision of any guidance on how to weigh or rank them.[256] For example, the best-interest factors listed in the Mental Capacity Act 2005 (UK) include the incapable person's own wishes and feelings, beliefs and values, and an unenumerated class of 'other factors that he would be likely to consider if he were able to do so.'[257] Family life is also largely private; outsiders, such as courts and tribunals, often have no access to much of the information needed to apply many best-interest factors.[258] The breadth of judicial discretion and the resulting indeterminacy can impose substantial adjudication costs on courts. Such indeterminacy can further make it difficult and costly for private individuals to comply with their duties and resolve their disputes.[259]

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[256] Scott and Emery (n 237) 75. Also Herring, Vulnerable Adults (n 46) 54–58 (discussing the common criticisms of the best-interests standard and defending it).

[257] Mental Capacity Act 2005 (UK) s 4(6).

[258] Scott and Emery (n 237) 74.

[259] Generally Louis Kaplow, 'Rules versus Standards: an Economic Analysis' (1992) 42 Duke LJ 557.

This Section does not deny that adoption of the best-interests defence adds indeterminacy to the resolution of breach-of-fiduciary duty claims. Instead, it will argue that such additional indeterminacy is typically negligible. First, English and New South Wales case law now requires that predominance be given to one best-interest factor: what the incapable person would have wanted if he or she had capacity. This view reduces the range of best-interest factors to be considered and the costs of considering them. It also reduces the degree of indeterminacy.

Secondly, the proposed subjective interpretation of the best-interest defence primarily protects guardians and attorneys who are in a close familial or personal relationship with the incapable person. These guardians and attorneys have a strong case for family provision relief from the incapable person's estate,[260] regardless of whether the best-interests defence is available. Family provision law is already indeterminate.[261] When a dispute is viewed as a whole, introducing the best-interest defence adds little to the degree of indeterminacy already arising from the potential availability of family provision relief.

Thirdly, the strict model of fiduciary regulation is not necessarily more determinate than the flexible model. While a statutory duty of

[260] Generally Croucher and Vines (n 201) para 15.6; Ross Martyn and others (n 108) ch 11.3. Eg *Smith* [2017] NSWSC 408 [495](b).

[261] Eg *Ilott v The Blue Cross* [2017] UKSC 17, [2018] AC 545 [63], [66] (Lady Hale DPSC, with whom Lord Kerr and Lord Wilson JJSC agreed).

loyalty predictably prohibits conflicts of interest, the availability of vague statutory exemptions generate indeterminacy. The typical gifting exemption, for instance, permits gifts that reflect the incapable person's wishes and are 'reasonable' in the light of his or her financial circumstances.[262] Similarly, the typical exemption for provision to dependants requires such provision to be 'reasonable', and fails to delineate the degree of 'dependency' required.[263] Undermined by these vague exemptions, the strict model is also exposed to the indeterminacy criticism. Thus indeterminacy alone cannot explain or justify preferring the strict model over the flexible model.

2. Discrimination

Critical Legal Scholars have criticised best-interests standards as an extreme form of paternalism. The very notion of legal incapacity is said to facilitate paternalistic imposition of dominant societal values on people with disabilities, and thereby deprive them of their autonomy and dignity.[264] Recent efforts to promote the rights of people with disabilities

[262] Generally Section III-C.

[263] Generally Section III-C. Cf Inheritance (Provision for Family and Dependants) Act 1975, s 1(3) (defining a dependent of the deceased for the purpose of making a family provision claim), s 3(4) (the deceased's assumption of responsibility for the applicant's maintenance as a factor in assessing family provision claims on the dependent basis).

[264] Eg Duncan Kennedy, 'Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power' (1982) 41 Md L Rev 563, 633, 641–44; George J Alexander and Thomas S Szasz, 'From Contract to Status via Psychiatry' (1973) 13 Santa Clara Law 537.

culminated in the CRPD,[265] which the United Kingdom and Australia have ratified.[266] The CRPD marks a shift away from the 'medical' model of disability law and policy — in which people with disabilities are the subject of protection — towards a 'social' model that enshrines dignity, autonomy and equality before the law. This Section will argue that adoption of the flexible model brings fiduciary law closer to meeting the ideals of the CRPD.

The claim to be advanced is *not* that the flexible model 'perfectly' complies with the CRPD, but that the flexible model fares better than the strict model. This clarification matters because both the strict model and the flexible model assume the continuing existence of guardianships and powers of attorney. While CRPD-minded scholars and law reformers tend to accept powers of attorney,[267] they tend to reject guardianships (except perhaps as a last resort).[268] Similarly, both models of fiduciary regulation

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[265] n 13.

[266] 'Convention on the Rights of Persons with Disabilities' (*United Nations Treaty Collection*) <https://www.un.org/development/desa/disabilities/convention-on-the-rights-of-persons-with-disabilities.html> accessed 17 October 2018). Australia has made a reservation to preserve substitute decision-making arrangements, such as guardianship.

[267] Eg Anna Arstein-Kerslake and Eilionóir Flynn, The General Comment on Article 12 of the Convention on the Rights of Persons with Disabilities: a Roadmap for Equality before the Law' (2016) 20 Intl J Hum Rts 471, 476 (General Comment); Harding, Duties to Care (n 15) 91; Rosie Harding and Elizabeth Peel, Polyphonic Legality: Power of Attorney Through Dialogic Interaction (2019) 28 S & L S 675, 676.

[268] A large literature has developed to consider the extent to which guardianships are consistent with the CPRD. Eg Bartlett, The CRPD and Mental Health Law (n 14) 758–67; Amita Dhanda 'Legal Capacity in the Disability Rights Convention: Stranglehold of the Past or Lodestar for the Future?' (2007) 34 Syracuse J Int'l L & Com 429; Donnelly, Best Interests (n 14); Mary Donnelly, 'Deciding in Dementia: The Possibilities and Limits of Supported Decision-Making' (2019) Int'l J L & Psychiatry (forthcoming);

retain some concept of incapacity, which concept may sit uncomfortably with article 12(2) of the CRPD and the General Comment on that article (GC1).[269] Thus it is possible that both the strict model and the flexible model fail to comply with the CRPD. It is beyond the scope of this Chapter to explore that possibility because it advances a comparative rather than absolute claim.

The text of the CRPD tolerates both the strict model and the flexible model. Article 12(4) requires States Parties to ensure that safeguarding 'measures relating to the exercise of legal capacity respect the rights, will and preferences of the person, are *free of conflict of interest* and undue influence'.[270] The very same article also requires safeguarding measures to be '*proportional and tailored* to the person's circumstances' and '*proportional* to the degree to which such measures affect the person's rights and interests.'[271] Preamble (x) further recognises that 'the family is the natural and fundamental group unit of society', and envisages the contribution of families 'towards the full and equal enjoyment of the

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Eilionóir Flynn and Anna Arstein-Kerslake, 'The Support Model of Legal Capacity: Fact, Fiction, or Fantasy?' (2014) 32 Berkeley J Int'l L 124; Hale and others (n 14) paras I–008, I–009.

[269] Committee on the Rights of Persons with Disabilities, *General Comment No. 1: Article 12: Equal Recognition before the Law*, 11th sess, UN Doc CRPD/C/GC/1 (19 May 2014) 3.

[270] n 13 (emphasis added).

[271] n 13 art 12(4) (emphasis added). For other articles concerning safeguards, see generally Arstein-Kerslake and Flynn, General Comment (n 267) 479–80.

rights of persons with disabilities[.]' At the same time, the CRPD recognises that families could also be a source of abuse. Article 16(1) in particular requires States Parties to take 'appropriate' measures to 'protect persons with disabilities, both *within* and outside *the home*, from all forms of exploitation, violence and abuse'.[272] Perhaps as a result of such textual ambiguity, the English Court of Protection has used the CPRD to justify strict regulation of intrafamilial conflicts in some cases[273] and flexible regulation in other cases.[274]

Moreover, little guidance regarding fiduciary duty comes from the supported/substituted decision-making distinction. GC1 rejects systems of substituted decision-making under which a substituted decision-maker makes decisions based on *objective* best interests rather than subjective will and preferences.[275] Neither the strict model nor the flexible model permits the guardian or attorney to advance objective best interests in deciding whether to expose himself or herself to a conflict of interest. The strict model prohibits unauthorised conflicts of interest without regard to the incapable person's objective best interests or subjective will and preferences. This Chapter understands the flexible model to adopt a

[272] n 13 (emphasis added).

[273] Eg *Public Guardian v MP* [2015] EWCOP 21 [41]–[42].

[274] Eg *Re JW; GGW v East Sussex County Council* [2015] EWCOP 82, [2016] COPLR 36 [30]–[31].

[275] n 269 para 27. Generally Arstein-Kerslake and Flynn, General Comment (n 267) 475.

subjective interpretation of best interests, which interpretation respects the incapable person's own will and preferences whenever ascertainable. Thus, insofar as regulating conflicts of interest is concerned, neither model facilitates impermissible substituted decision-making as defined by GC1.

In addition, the flexible model and the strict model neither promote nor stultify efforts to provide supported decision-making systems as required by article 14(3) of the CRPD.[276] Both models lead to the same outcome in cases where what the incapable person would have wanted cannot be ascertained. In these cases, the guardian or attorney cannot successfully establish the (subjectively-interpreted) best-interests defence. Thus, just like the strict model, the flexible model does not excuse unauthorised conflicts of interest. At the same time, neither model precludes the guardian or attorney from seeking prospective judicial authorisation or, in rare cases, fully-informed consent from the incapable person. Both models thus equally leave room for the development of supported decision-making systems that may assist the incapable person to give the required consent on his or her own.

However, in cases involving sufficient evidence of what the incapable person would have wanted if he or she had capacity, the flexible model is less paternalistic than the strict model. The strict model largely disregards

[276] Generally Flynn and Arstein-Kerslake (n 268).

such evidence while the flexible model respects it.[277] In sufficient-evidence cases, the flexible model essentially facilitates a 'substituted-judgment' analysis that accords with the CRPD,[278] while the strict model paternalistically prohibits conflicts of interests even if the incapable person would have permitted such conflicts.

Empirical studies nonetheless have shown that those who make a best-interests decision on behalf of an incapable person frequently pay insufficient attention to the person's subjective values and wishes notwithstanding a legal obligation to do so.[279] Formal law thus seems to diverge from practical 'reality'. Yet any such divergence should not justify rejection of the flexible model in favour of the strict model. Focusing on health and social care matters, empirical studies tend to collect at most a small sample of property and financial matters.[280] Empirical claims regarding property and financial matters are thus statistically insignificant. Moreover, to the extent that formal law influences 'real' decision-making in property and financial matters, subjective values and wishes are more likely to be respected if their

[277] Generally Section V-A.

[278] Generally Harding, Statutory Wills (n 15) 968; Arstein-Kerslake and Flynn, General Comment (n 267) 477–78.

[279] Eg Williams and others (n 15) 7, 9. Also Select Committee on the Mental Capacity Act 2005 (n 15) paras 90, 104.

[280] Eg Williams and others (n 15) 5, 13, 45; Select Committee on the Mental Capacity Act 2005 (n 15) para 4.

consideration is permitted rather than prohibited by formal law. The flexible model permits judicial consideration of subjective values and wishes while the strict model prohibits such consideration to a great extent.[281]

The logical implications arising from the proposed subjective interpretation do not run afoul of the CRPD. 'Equality is the key' to achieving the ideals and aspirations of the CRPD.[282] As Arstein-Kerslake and Flynn explained, legal restrictions upon a person's decisions to self-harm or harm others must apply 'equally to persons with and without disabilities'.[283] Within the space of fiduciary regulation, the logical implications of the subjectively-interpreted best-interests defence do exactly that. These implications impose outer limits on the range of excusable conflicts of interest only to sanction those kinds of conflicts that *mentally-capable* persons would not have been permitted to authorise. Thus, for instance, the flexible model would impose the same outer limits on the testamentary freedom of incapable persons and capable persons.[284] Such equalisation of the outer limits of testamentary freedom is consistent with the requirement, under article 12(5) of CRPD, that States Parties are

[281] Generally Part III.

[282] Arstein-Kerslake and Flynn, General Comment (n 267) 485. Also ibid 477.

[283] ibid 483.

[284] Generally Section V-C.

to ‘ensure the equal right of persons with disabilities to own or inherit property, to control their own financial affairs…’, and to ‘ensure that persons with disabilities are not arbitrarily deprived of their property.’ If the outer limits of testamentary freedom discriminate against incapable persons, then it is the law of succession rather than fiduciary law that should be the subject of criticism.[285]

To recapitulate, in cases where there is sufficient evidence to ascertain what the incapable person would have wanted if he or she had capacity, the flexible model better achieves the ideals and aspirations of the CRPD than does the strict model. In other cases, both models fare equally with regard to the CRPD.

VI. CONCLUSION

This Chapter supports moderate and flexible fiduciary regulation of family guardians and attorneys who serve elderly incapable persons. The prevailing, strict model of fiduciary regulation assumes that the fiduciary can readily secure authorisation from the beneficiary to depart from default fiduciary law when it is harmless or beneficial to do so. Yet guardians and attorneys typically face significant obstacles to secure authorisation from elderly incapable persons and to ‘litigation proof’ any such authorisation. Moreover, in many cases, the strict model fails to

[285] Eg Harding, Statutory Wills (n 15) (arguing that the English law governing statutory wills contradicts the CRPD when applied to incapable persons who are unable or unwillingness to express their testamentary preferences). Also ibid 970 (suggesting to reform the English intestacy rules if they provide hardship or inequality).

recognise potential conflicts between elderly incapable persons and claimants who bring breach-of-fiduciary duty claims to increase their expected inheritance. The flexible model of fiduciary regulation that English and New South Wales courts have developed essentially approximates, for an incapable person, a capable person's power to authorise his or her fiduciaries to depart from those aspects of fiduciary law that he or she subjectively finds undesirable. It is suggested that the flexible model can alleviate the potential over-protectiveness of fiduciary law, accommodate harmless conflicts in close families and mitigate the perverse incentives arising from inheritance expectations whenever present.

Contradicting the prevailing view among Anglo-Australian legislatures and law reformers, this Chapter reaches the conclusion that strict fiduciary regulation is not the solution to the problem of financial abuse against the elderly. Such strict regulation inflexibly prohibits harmless conflicts with little regard for the elderly incapable person's own wishes and familial bonds. That inflexibility, I argue, tends to 'convert equity into an instrument of hardship and injustice in individual cases.'[286]

[286] *Chan v Zacharia* (1984) 154 CLR 178, 205 (Deane J).

Appendix A: Mental Capacity in American Transactional Law: Cases

This Appendix contains the two surveys of cases referred to in chapter 1 of this Dissertation. The Westlaw 2013-18 Survey in Table 2 below contains thirty cases decided in 2013-18 that are listed under Westlaw's West Key Number System, k-92. This table excludes cases that did not reach issues regarding mental capacity; and cases concerning a breach of fiduciary duty. The Restatement and Williston survey in Table 3 contains fifty-five cases decided after 1963 that appear in the case citations supplement to RESTATEMENT (SECOND) OF CONTRACTS § 15 (AM. LAW INST. 1981) or in the footnotes of 5 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 10:8 (4th ed. 1993 & Supp. 1999). This table excludes cases that did not reach issues regarding mental capacity.

Table 2: Westlaw 2013-18 Survey

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
E. D. N. Y.	2013	Rivera v. Sovereign Bank	Post-traumatic stress disorder, mild post-partum depression, adjustment disorder and pronounced anxiety	No	Release of liability	Self v. employer	Business	Yes	Yes	Yes	N.A.	N.A.	N.A.	No
D. C. Ct. App.	2013	Hernandez v. Banks	Old age, guardian and conservator appointed	Yes	Lease	Estate v. landlord	Business	Yes	No	Yes	N.A.	No	N.A.	Remanded
N. Y. App. Div.	2014	Thomas v. Gray	Alcoholism	No	Purchase option agreement in lease	Brother (landlord) v. tenant	Business	Yes	Yes	N.A.	N.A.	Fraud, duress, coercion, undue influence	No	No

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Miss. Ct. App.	2014	Legacy Hall of Fame, Inc. v. Transport Trailer Service. Inc.,	Extreme stress	No	Settlement	Employer v. contractor	Business	Yes	Yes	N.A.	N.A.	No	N.A.	No
Tex. Ct. App.	2014	ReadyOne Industries, Inc. v. Flores	No evidence	No	Arbitration agreement in employment agreement	Self v. employer	Business	Yes	Yes	N.A.	N.A.	Fraudulent inducement, procedural unconscionability, false misrepresentation	No	No

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Ky. Ct. App.	2014	Pikeville Medical Center, Inc. v. Bevins	Old age, poor health, end stage renal failure	Yes	Arbitration agreement in admission agreements	Estate v. hospital	Business	Yes	No	N.A.	N.A.	No	N.A.	Yes
N. D. Miss.	2014	Liberty Health & Rehab of Indianola, LLC v. Howarth	Old age, profound diminishment, significant disconnect from reality	Yes	Arbitration agreement in admission agreements	Estate v. nursing home	Business	Yes	No	N.A.	N.A.	No	N.A.	Yes
Mo.	2014	Ivie v. Smith	Old age, paranoia, dementia, cognitive impairment, Alzheimer's	Yes	Retitling bank accounts and vehicles, changes to beneficiary designatio	Half siblings v. husband	Family	Yes	No	N.A.	N.A.	Undue influence	Yes	Yes

Court	Year	Case name	Mental conditions	Old age?	Transactions in trusts	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
D.C.	2015	Renchard v. Prince William Marine Sales	Deaf	No	Purchase of yacht, charges for maintenance and upgrades	Self v. seller	Business	Yes	N.A.	N.A.	N.A.	Fraud, conspiracy, unjust enrichment	N.A.	Remanded
Alaska	2015	Erkins v. Alaska Trustee	N.A. (summary disposition on other grounds)	No	Loan	Self v. subsequent good faith purchaser bank	Business	Yes	N.A.	Yes	N.A.	Good faith	No	No

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
La. Ct. App.	2015	Noel v. Noel	Old age, stroke, confusion, lack of awareness and memory	Yes	Revocation of real estate transactions through power of attorney	Children v. spouse and child	Family	Yes	N.A.	No	N.A.	Fraud	N.A.	Remanded
Miss. Ct. App.	2015	In re Estate of Holmes	Old age, Alzheimer's	Yes	Health care necessaries	Estate (daughter) v. son's estate (grandson)	Family	Unclear	Incapacity assumed	Unclear	Incapacity assumed	No	N.A.	No (liability to pay for necessaries found but claim is time barred)
Ga. Ct. App.	2016	Kindred Nursing Centers Limited Partnership v. Chrza	Old age, dementia, chronic obstructive pulmonary disease, coronary artery disease, hypertension	Yes	Arbitration agreement in admission agreements	Estate v. nursing home	Business	Yes	N.A.	N.A.	N.A.	No	N.A.	Remanded

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
		nowski												
Ind. Ct. App.	2016	Maynard v. Golden Living,	Old age	Yes	Arbitration agreement in admission agreements	Estate v. nursing home	Business	Yes	Yes	N.A.	N.A.	No	N.A.	No
Ark. Ct. App.	2016	Black v. Duffie	Old age, mild mental retardation, artery disease, hypertension, infirmity, some amount of confusion	Yes	Transfers of land and share in hunting club	Guardian/nephew v. family friends	Social	Yes	No	N.A.	N.A.	Undue influence, inadequate consideration	Yes	Yes

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
N.D. Miss.	2016	Dalon v. Ruleville Nursing and Rehabilitation Center	Old age, depression, agitation, psychosis, confused, forgetful, suffering from either severe or moderate cognitive impairments and Huntington's Disease	Yes	Arbitration agreement in admission agreements (power of attorney)	Surviving spouse, estate v. nursing home	Business	Yes	N.A.	N.A.	N.A.	Procedural unconscionability (insufficiency of understanding is a factor)	Genuine issue	Remanded
M.D. Pa.	2017	Mony Life Insurance Company v. Snyder	Memory had been progressively declining, potential dementia	Unclear	Inter vivos transfer of insurance policy	Insurer v. insured's ex-wife, widow	Business	Yes	Yes	N.A.	N.A.	No	N.A.	No
Pa. Super. Ct.	2017	Cardinal v. Kindred Healthcare	Old age, physical infirmity, some amount of confusion	Yes	Arbitration agreement in admission agreements (power of attorney)	Estate v. nursing home	Business	Yes	Yes	N.A.	N.A.	Unconscionability, duress	No	No

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Tex.	2017	Kinsel v. Lindsey	Old age, macular degeneration, blind, inform, extremely frail, confusion and forgetfulness	Yes	Amendment to trusts, sale of family ranch	Step-children, step-grandchildren v. niece, nephew, attorney	Family	Yes	No	N.A.	N.A.	Undue influence, tortious interference with inheritances, fraud, conspiracy	Yes	Yes
N.D.	2017	Vig v. Swenson	Guardianship, declining medical condition, including chronic heart and kidney failure, macular degeneration, and diabetes	Yes	Quit claim deed to convey land, farm leases	Estate (children) v. son	Family	Yes	Yes	N.A.	N.A.	No	N.A.	No
Ohio Ct. App.	2017	In re Estate of Flowers	Alzheimer's dementia, memory issues	Yes	Change of beneficiary designation of annuity funds	Estate v. sibling & children	Family	Yes	No	N.A.	N.A.	Undue influence	Yes	Yes

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Kan. Ct. App.	2018	Moore v. Moore	Depleted physical and mental condition	Yes	Contracts to transfer land	Self, trustee established with spouse v. child & grandchild	Family	Yes	Yes	N.A.	N.A.	Undue influence	Remanded	Remanded
Nev.	2018	LaBarbera v. Wynn Las Vegas, LLC	Intoxication	No	Contracts to gamble at casino	Self v. Casino	Business	Yes	Remanded	Yes	Remanded	No	N.A.	Remanded
Tex. Ct. App.	2018	Anderton v. Green	Dementia	Yes	Change to bank accounts	Son v. grandchild	Business	Yes	No	N.A.	N.A.	No	N.A.	Yes

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Conn. App. Ct.	2018	Bassford v. Bassford	Conservatorship, severe anxiety, depression, post-traumatic stress disorder, mild to moderate dementia, impaired hearing, susceptible to frequent urinary tract infections, drug dependence	Yes	Revocation of trust	Children v. spouse	Family	Yes	Yes	N.A.	N.A.	Undue influence	No	No
Ky. Ct. App.	2018	Estate of Adams by and through Mitchell v. Trover	Low intellectual quotient limited abstract reasoning abilities, cancer, mental stress of dealing with cancer	Yes	Settlement of medical malpractice suit	Estate v. foundation & physician	Business	Yes	Yes	N.A.	N.A.	Duress	No	No

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
N.Y. App. Div.	2018	Matter of Estate of Bordell	Early dementia, cataract surgery	Yes	Election of spousal share in deceased's estate	Self v. estate of husband	Family	Yes	Yes	N.A.	N.A.	No	N.A.	No
Ohio Ct. App.	2018	Weinberg v. Weinberg	Alzheimer's dementia, guardianship	Yes	Assignments of partnership interests	Son v daughter	Family	Yes	Remanded	N.A.	N.A.	Undue influence	Pending	Remanded
Tex. Ct. App.	2018	Estate of Riefler	Tremor, influence of prescription medication	No	Settlement	Self v. relatives	Family	Yes	Yes	N.A.	N.A.	No	N.A.	No
Ala.	2018	Stephan v. Millennium Nursing and Rehab	Dementia	Yes	Arbitration agreement in admission agreements	Self v. nursing home	Business	Yes	No	N.A.	N.A.	No	N.A.	Yes

Court	Year	Case name	Mental conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
		Center, Inc.												

Table 3: Restatement and Williston Survey

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
N.Y. Sup. Ct.	1963	Faber v. Sweet Style Mfg. Corp.	Manic-depressive psychosis	No	Purchase of land	Wife v. seller	Business	Yes	Yes	Yes	No	No	N.A.	Yes
Wash.	1964	Harris v. Rivard	Stroke resulting in partial paralysis	No	Earnest money agreement to sell property	Self v. purchaser	Business	Yes	No	No	N.A.	No	N.A.	Yes

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Okla.	1964	Matthews v. Acacia Mut. Life Ins. Co.	hypertension, high blood pressure, brain tumor	No	Oral contract to confer ownership of property and insurance benefits	Widow v. children	Family	Yes	Yes	No	N.A.	No	N.A.	No
Colo.	1964	Davis v. Colorado Kenworth Corp.	Found not guilty by insanity, institutionalized	No	Purchase of tractor and goods	Wife v. seller	Business	Yes	Yes	No	N.A.	No	N.A.	No
N.Y.	1969	Ortelere v. Teachers' Retirement Bd. of City of New York	Involutional melancholiac in depression	No	Election to change retirement benefit	Beneficiary/widower v. government	Other	Yes	Yes	Yes	No	No	N.A.	Remanded
D.S.C.	1969	Humble Oil & Refining Co. v.	Mental retardation	No	Options for lease of service station site	Executor v. lessee	Business	Yes	Yes	No	N.A.	No	N.A.	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
		DeLoache												
Tex.	1969	Mandell and Wright v. Thomas	In shock	No	Contingent fee contract	Self v. lawyer	Other	Yes	Yes	No (contra. Edward D. Jones & Co. v. Fletcher)	N.A.	Fraud, misrepresentation	No	No
N.Y. Sup. Ct.	1971	Fingerhut v. Kralyn Enterprises, Inc.	Ailment manic depressive psychosis	No	Contract and binder to purchase golf club	Self v. seller	Business	Yes	Yes	Yes	Yes	No	N.A.	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Iowa	1971	Costello v. Costello	Old age, eccentric recluse	Yes	Contract and deed conveying half-interest in land	Nephew /beneficiary under will v. nephew/ beneficiary under will	Family	Yes	No	No	N.A.	No	N.A.	Remanded
Idaho	1972	McPheters v. Hapke	Old age, senile, undefined mental disability, guardian appointed post-contract	Yes	Sale of land	Executor v. purchaser	Business	Yes	No	No	N.A.	Unusual and financially disadvantageous	Yes	Yes
Kansas	1973	DeBaugue Bros., Inc. v. Whitsitt	Old age, infirmity	Yes	Sale of business	Self v. purchaser	Business	Yes	Yes	No	N.A.	No	N.A.	No
N.Y. Surr.	1974	In re Gebauer's Estate	Undefined mental illness	Yes	Deed for sale of land	Executor v. purchaser	Business	Yes	Yes	Yes	Yes	Fraud, overreaching, undue influenc	No	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Ct.												e, inadequacy of consideration		
Or.	1974	Gore v. Gadd	Psychotic agitated depression, psychotic depressive reaction, schizophrenia	No	Contract for sale of land	Self v. purchaser	Business	Yes	Yes	Yes (contra. Dillin v. Alexander, In re Marriage of Davis)	Yes	No	N.A.	No
Tex. Ct. App.	1974	Nohra v. Evans	Manic-depressive	No	Deed and other instruments for sale of land	Self v. purchaser	Business	Yes	N.A.	Yes	No	No	N.A.	Yes
Mass.	1974	Krasner v. Berk	Presenile dementia	Yes	Agreement to share rent and taxes	Self v. business partner	Business	Yes	No	Yes	No	No	N.A.	Yes

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Ill. Ct. App.	1975	Curry v. Curry	Auditory hallucinations, severe depression, suicidal thoughts	No	Divorce settlement	Self v. former husband	Family	Yes	Yes	No	N.A.	No	N.A.	No
Cal. Ct. App.	1977	Board of Regents v. Davis	Old age, arteriosclerosis	Yes	Donation to university	Estate v. university	Other	Yes	Yes	No	N.A.	No	N.A.	No
Or.	1978	Dillin v. Alexander	Depression, little paranoid	No	Deed granting interest in property in favor of sons by prior marriage	Self and former wife v. their sons	Family	Yes	Yes	No (contra. Gore v. Gadd)	N.A.	No	N.A.	No
Tex. Ct. App.	1978	Schmaltz v. Walder	Nervous tension and anxiety	No	Settlement of personal injury suit	Self v. insurance co.	Business	Yes	Yes	No (contra. Edward D. Jones & Co. v. Fletcher)	N.A.	Fraud, misrepresentation	No	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
N.Y. Sup. Ct.	1978	Pentinen v. New York State Emp. Retirement System	Psychosis	No	Election to change retirement benefit	Widow v. government	Other	Yes	N.A.	Yes	No	No	N.A.	No
N.C. Ct. App.	1982	Ridings v. Ridings	Headaches, anxiety and mild to moderate depression	No	Separation agreement	Self v. former wife	Family	Yes	Yes	No	N.A.	No	N.A.	No
Ind. Ct. App.	1983	Gallagher v. Central Indiana Bank, N.A.	Stroke	No	Note to secure son's mortgage	Self v. mortgagee and son	Business	Yes	Yes	No	N.A.	Undue influence	No	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Ariz. Ct. App.	1985	Golleher v. Horton	Chronic alcoholic, organic brain syndrome, delirium tremens	No	Termination of trust and transfer of land by attorney/sister	Executor/daughter v. attorney/sister	Family	Yes	Yes	No	N.A.	Undue influence, fraud	Remanded	Remanded
Pa.	1986	Estate of McGovern v. Com. State Employees' Retirement Board	Alcoholism and apparent distress	No	Election under retirement plan that reduces benefits to surviving beneficiary	Son/executor v. government	Other	Yes	Yes	No	N.A.	No	N.A.	No
N.Y. Sup. Ct.	1987	Blatt v. Manhattan Medical Group, P.C.	Major depressive illness	No	Settlement of employment dispute	Self v. former employer	Business	Yes	Yes	Yes	Yes	No	N.A.	No
Tex. Ct.	1988	Smith v. Christley	Unclear (issue not reached)	Unclear	Lease	Estate/sister v. businesses	Business	Yes	N.A.	Yes	N.A.	Unfair terms	No	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
App.														
Iowa Ct. App.	1988	Daughton v. Parson	Disoriented, old age	Yes	Deeds conveying land to son and wife	Guardian v. wife and son	Family	Yes	No	No	N.A.	Undue influence	Yes	Yes
Va. Ct. App.	1989	Drewry v. Drewry	Severe depression	No	Divorce settlement	Self v. former husband	Family	Yes	Yes	No	N.A.	Fraud, unconscionability	No	No
Idaho Ct. App.	1989	Knowlton v. Mudd	Parkinson's disease	Yes	Amendment of commercial real estate contract with son	Conservator/daughter v. son	Family	Yes	No	No	N.A.	No	N.A.	Yes
N.Y. Sup.	1989	Matter of Estate of Obermeier	Dementia	Yes	Contract for sale of land	Estate v. purchasers	Business	Yes	Yes	Yes	Yes	No	N.A.	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Ct.														
Mass. Ct. App.	1989	Farnum v. Silvano	Dementia and seizure disorder	Yes	Contract for sale of land	Guardian/nephew v. friend/purchaser	Social	Yes	No	Yes	No	Fraud, undue influence, constructive trust	Issue not reached	Yes
Va.	1989	Brown v. Resort Developments	Old age, great weakness of mind	Yes	Deed conveying land	Guardian/niece v. purchaser	Business	Yes	Yes	No	N.A.	No	N.A.	No
Ala.	1989	Lloyd v. Jordan	Mental instability and chronic dementia related to hypoxemia	Yes	Change of life insurance beneficiary	Widow v. children from former marriage	Family	Yes, statutory	Yes	No	N.A.	No	No	No
D.C Ct.	1990	Butler v. Harrison	Senile dementia	Yes	Quitclaim deed conveying interest to	Estate v. widower	Family	Yes	Yes	No (contra. Hernand	N.A.	Undue influence	No	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
App.					self and husband					ez v. Banks)				
Ala.	1991	Shoals Ford, Inc. v. Clardy	Manic-depressive	No	Purchase of truck	Conservator/wife v. seller	Business	Yes, statutory	No	No	N.A.	Wantonness	Yes	Yes
N.Y. Surr. Ct.	1992	Matter of Will of Goldberg	Organic brain syndrome related to stroke	Unclear	Instrument voiding antenuptial agreement	Widow v. estate	Family	Yes	Yes	Yes	Yes	Undue influence	No	No
Alaska	1993	Pappert v. Sargent	Transient ischemic attack	No	Exchange of land for mobile home	Estate v. friend	Social	Yes	No	No	N.A.	Unfair terms (low market value of mobile home)	No	Remanded
Bankr. D.M	1995	In re Hall	Depression	No	Note and mortgage	Guardian/brother v. lender	Business	Yes	N.A.	Yes	N.A.	No	N.A.	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
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Wis. Ct. App.	1995	Hauer v. Union State Bank of Wautoma	Brain injury, previous guardian appointment but terminated	No	Loan	Self v. lender	Business	Yes	No	No	N.A.	Bad faith	Yes	Yes
Me.	1995	Bragdon v. Drew	Flapping hands up and down, honking nose, banging head against wall	No	Deed for sale of land to neighbour	Siblings /guardian and conservator v. neighbour	Social	Yes	No, but unclear which test	Yes	No, but unclear which test	Overreaching, undue influence, fraud, inadequate consideration	No	Yes

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Tenn. Ct. App.	2001	Rawlings v. John Hancock Mut. Life Ins. Co.	Senile dementia and depression	Yes	Power of attorney, change of insurance beneficiary	Estranged husband v. brother/ beneficiary, insurer, employer,	Family	Yes	Yes	Yes	Yes	No	N.A.	No
Tex. Ct. App.	2001	Dubree v. Blackwell	Old age	Yes	Transfer of real and financial assets to lifelong friend	Nephew /estate/beneficiary v. lifelong friend	Social	Yes	Yes	Yes	Yes	Undue influence	No	No
Me.	2003	In re Estate of Marquis	Old age, dementia	Yes	Change of annuity beneficiary	Estate v. grandnephew	Family	Yes	No, but unclear which test	Yes	No, but unclear which test	Bad faith, undue influence	No	Yes

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Or. Ct. App.	2004	In re Marriage of Davis	Depression, post-traumatic stress disorder, battered woman's syndrome.	No	Stipulated marriage dissolution judgment	Self v. former husband	Family	Yes	Yes	No (contra. Gore v. Gadd)	N.A.	No	N.A.	No
Ala.	2008	Mason v. Acceptance Loan Co., Inc.	Mildly retarded	No	Arbitration agreement in insurance contract	Self v. insurance co.	Business	Yes, statutory	Yes	No	N.A.	Fraud, misrepresentation, negligence	Referred to arbitration	No
W.D. Wis.	2008	American General Life Ins. Co. v. Schreiber	Taking psychotropic medication	No	Change of insurance beneficiaries	Widow v. daughter from previous marriage	Family	Yes (citing In re Kringel's Estate, 144 N.W. 204 (Wis. 1913))	Yes	N.A.	N.A.	No	N.A.	No
D. Md.	2008	Biggs v. Eaglewood Mortg., LLC	Old age	Yes	Conversion of mortgage rates	Self v. lender	Business	Yes	Yes	Yes	Yes	Misrepresentation,fraud	No	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
D.D.C.	2010	Schmidt v. Shah	Severe depression, severe anxiety, obsessive-compulsive disorder	No	Settlement of employment discrimination complaint	Self v. government	Business	Yes	N.A.	Yes	No	Fraud, duress	No	Not reached (summary dismissal granted on other grounds)
Or. Ct. App.	2011	Drury v. Assisted Living Concepts, Inc.	Old age, dementia, chronic confusion, memory impairment	Yes	Arbitration agreement in admission agreements	Estate v. nursing home	Business	Yes	No	N.A.	N.A.	Unconscionability	No	Yes
Mass.	2012	Sparrow v. Demonico	Extremely upset and mentally distressed	No	Settlement of land ownership dispute	Self v. siblings	Family	Yes	Yes	Yes	Yes	No	N.A.	No
D.C. Ct. A	2013	Hernandez v. Banks	Old age, guardian and conservator appointed	Yes	Lease	Estate v. landlord	Business	Yes	No	Yes	N.A.	No	N.A.	Remanded

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
pp.														
D.C.	2015	Renchard v. Prince William Marine Sales	Deaf	No	Purchase of yacht, charges for maintenance and upgrades	Self v. seller	Business	Yes	N.A.	N.A.	N.A.	Fraud, conspiracy, unjust enrichment	N.A.	Remanded
Alaska	2015	Erkins v. Alaska Trustee	N.A. (summary disposition on other grounds)	No	Loan	Self v. subsequent good faith purchaser bank	Business	Yes	N.A.	Yes	N.A.	Good faith	No	No
N.D.	2017	Vig v. Swenson	Guardianship, declining medical condition, including chronic heart and kidney failure, macular degeneration, and diabetes	Yes	Quit claim deed to convey land, farm leases	Estate (children) v. son	Family	Yes	Yes	N.A.	N.A.	No	N.A.	No

Court	Year	Case name	Mental Conditions	Old age?	Transaction	Active parties	Identity of capable party	Cognitive test applied	Capable under cognitive test	Volitional test applied	Capable under volitional test	Inequitable conduct raised	Inequitable conduct found	Transaction avoided
Tex. Ct. App.	2018	Estate of Riefler	Tremor, influence of prescription medication	No	Settlement	Self v. relatives	Family	Yes	Yes	N.A.	N.A.	No	N.A.	No

Appendix B: Mental Capacity in American Transactional Law: Economic Model

This Appendix constructs a behavioral-contract-theoretic model to capture the transactions of potentially incapable individuals.[1] The numerical example introduced in Part IV of the Article uses the results of this model. Section B.1 below will set up the model. Assuming the absence of a power of avoidance, Section B.2 considers the equilibrium properties of the model. Section B.3 introduces a power of avoidance. Section B.4 permits the transacting parties to renegotiate.

B.1 The Model

The model has three players: an individual who may lack mental capacity, an actor who may transact with the individual, and a claimant who may challenge any transaction. The actor may take one of two actions—x_0 or x_1—pursuant to any transaction. Let $C(x) > 0$ be the actor's cost of taking action x.[2] Let $\widehat{B}(x) > 0$ be the individual's willingness to pay for action x at the time of

[1] The model set up in this Appendix builds upon the multi-selves model introduced by Kfir Eliaz & Ran Spiegler, *Consumer Optimism and Price Discrimination*, 3 Theoretical Econ. 459 (2008).

[2] All analyses remain valid under the more general assumptions that the actor's action space is a compact set X and $\widehat{B}, B, C : X \to \mathbb{R}$ are continuous functions. *See generally* Eliaz & Spiegler, *supra* note 1.

forming any transaction. If she has capacity at that time, then $\widehat{B}(x)$ is her benefit arising from x. If the individual lacks capacity, then her "true" benefit is $B(x)$.[3] Action x_0 is a "do nothing" option that costs the actor zero and gives the individual zero benefit; $\widehat{B}(x_0) = B(x_0) = C(x_0) = 0$. This action captures the actor's choice of not dealing with the individual. Action x_1 costs the actor less than the individual's willingness to pay; $C(x_1) < \widehat{B}(x_1)$.[4]

The timing and information structure of the model are as follows. The actor first designs the terms of a transaction comprising at least one action x and a corresponding price $p \in \mathbb{R}$, and offers these terms to the individual.[5] At this time, the actor knows the individual's willingness to pay ($\widehat{B}$), and holds the belief that the individual is incapable with probability μ and capable with complementary probability $1 - \mu$. With such knowledge and beliefs,

[3]The model's bifurcation of the incapable individual's benefit from transacting is not premised on, and does not support, a binary view of the manifestation of mental disorders or incapacities. For example, a mental disorder giving rise to transactional incapacity may manifest as a point in a continuum between a capable state and the most severe episode characterizing that disorder. The model captures such diversity. To see this, for each action x, let $B(x), \bar{B}(x)$ respectively describe the individual's willingness to pay in a capable state and in the state during which she is affected by the most severe episode. Suppose that at the time of forming the transaction, the individual's willingness to pay lies in the middle of these two extreme states. Then this model captures such intermediate state by defining the $\widehat{B}$ function by $\widehat{B}(x) = 0.5B(x) + 0.5\bar{B}(x)$; that is, the individual's willingness to pay for x in the legally-relevant incapable state is the average of her willingness to pay in a capable state and her willingness to pay in the most severe incapable state. This modeling technique captures any intermediate form of disorder or incapacity.

[4]If this assumption were violated, then the model becomes trivial because the actor would always choose to "do nothing" (x_0).

[5]Formally, the actor chooses a menu $\{(x, p)\} \subset \{x_0, x_1\} \times \mathbb{R}$.

Time 1	Time 2	Time 3	Time 4
The actor designs the terms of a transaction comprising a menu of action-price pairs.	The individual accepts or rejects the transaction, and chooses an action-price pair therein.	If a transaction was accepted, then the actor takes the chosen action and obtains the corresponding price from the individual.	The claimant chooses between avoiding or not avoiding any transaction.

Figure 7: Timing of the model

the actor designs the transaction to maximize her expected profits.[6] The individual then either accepts or rejects the transaction with the (possibly mistaken) belief that her benefit is $\widehat{B}$. She receives the outside payoff of 0 if she rejects the transaction. If she accepts the transaction,[7] then she chooses an action-price pair stipulated in the transaction to maximize her (perceived) payoff: her willingness to pay less the price she pays.[8] As Section B.3 will elaborate, if there is a power to avoid transactions for want of capacity, then a third player—the claimant—chooses whether to exercise that power. Figure 7 depicts the timing of the model.

Farnum v. Silvano can illustrate how the model captures the transactions of potentially incapable individuals.[9] Recall that in that case, an elderly woman who had dementia and seizure disorder made a cut-rate sale of her

[6]Formally, let the individual pay price p for action x if she lacks capacity, but $\widehat{p}$ for $\widehat{x}$ if she has capacity. The actor's expected profits are $\mu\,[p - C(x)] + (1 - \mu)[\widehat{p} - C(\widehat{x})]$.

[7]As a tie-breaking rule, assume that the individual accepts the transaction if she is indifferent between accepting or rejecting it.

[8]Formally, the individual's payoff is $\widehat{B}(x') - p'$ if she chooses the action-price pair (x', p').

[9]540 N.E.2d 202 (Mass. Ct. App. 1989).

house to a young friend in whom she had trust and confidence. The actor in the model represents the young friend, and his chosen action (x) captures the services (such as lawn-mowing) that he provided to the elderly woman. The transactional price (p) is the benefit that the young friend obtained from the woman—his profits from buying her house cheaply. The terms of the transaction in the model thus describe the young friend's services (the action) and the benefit (the price) that he obtained in exchange for providing these services. His cost of providing these services was $C(x)$. The elderly woman's willingness to pay for the young friend's services at the time of making the transaction was $\widehat{B}(x)$, while her "true" benefit was $B(x)$. The claimant in the model represents the woman's nephew (and expectant heir), who brought the claim to avoid the transaction.

The remainder of this Section will explain the key assumptions underlying the model. The critical assumption is that the actor is a sophisticated player who makes choices to maximize her own payoff and has superior bargaining power. While this assumption may appear cynical and unrealistic, it simplifies the model to focus on the problem of elderly financial abuse. This problem is most pronounced when the potential abuser—the actor here—is sophisticated, self-interested and superior in bargaining. Under this assumption, the normative case for maintaining a broad mental capacity doctrine is the strongest. As I propose to narrow the doctrine in Parts III and IV of the Article, I make this

assumption to "stack the cards" against me.

Another assumption is the claimant is also sophisticated and self-interested. This assumption aims to capture the potential misalignment of incentives between the potential incapable individual and her representative—the claimant. Being sophisticated and self-interested, the claimant may have an incentive to avoid a transaction even if the individual benefited from it. As Section III.A of the Article explains, this assumption captures typical transactional capacity cases in modern times.

A further assumption that by the time the claimant decides whether to seek avoidance, the transaction has been fully executed. This assumption aims to capture inheritance disputes over fully-executed contracts, irrevocable gifts and other lifetime transactions that transferred some property away from the potentially incapable individual's estate. That property is the price p in the model, and the recipient's conduct giving rise to the transfer is the action x. This assumption does not capture fully-executory or partly-executed contracts, for instance, a contract to refer any disputes to arbitration. Capturing fully-executory contracts, Section B.4 will modify the model to show that the normative arguments to be advanced are robust to the possibility of renegotiation. The author also has on file a modification of the model that captures partly-executed contracts. All these modifications lead to slightly different quantitative predictions regarding the exact transactional terms. As

the normative arguments to be advanced do not depend on the exactness of the predicted transactional terms, I keep the assumption of full execution to minimize technicality.

Moreover, there is an assumption that mental incapacity is the only potential basis of avoidance of any transaction. This assumption rules out alternative bases of avoidance, such as undue influence and unconscionability. There is no loss of generality in assuming away these alternative doctrines, because the subsequent formulation of the power of avoidance in Section B.3 is sufficiently flexible to cover all of them. Hence, to focus on mental incapacity and to minimize technicality, I assume away alternative bases of avoidance.

B.2 No Power of Avoidance

In this baseline scenario, suppose there is no power of avoidance. Proposition 1 below states the equilibrium properties of the model.[10] To facilitate presentation, define $\widetilde{B} = \widehat{B} - B$. If the individual initially lacks capacity, then $\widetilde{B}$ measures the change in her willingness to pay upon regaining capacity. Call $\widetilde{B}$ her *revaluation price*.

Proposition 1. *Without a power of avoidance, the actor offers an equilibrium transaction with terms that charge price $p = \widehat{B}(x_1)$ for action x_1. The individ-*

[10]The chosen equilibrium concept is the Bayesian Nash Equilibrium. A profile of choices is such an equilibrium if given the other player's choices, each player's choices maximize her payoff according to her contemporaneous beliefs whenever it is her turn to choose.

ual accepts the transaction and chooses this action-price pair, regardless of her state of capacity.

In equilibrium, the individual's "true" surplus from transacting is $-\widetilde{B}(x_1)$ *if she lacks capacity, and* 0 *if she has capacity. The actor's expected profits are* $\widehat{B}(x_1) - C(x_1)$.

Proof of Proposition 1

The absence of a power of avoidance implies the individual's state of capacity does not affect the actor's expected profits. To maximize her expected profits $p - C(x)$, the actor can charge the maximum $p = \widehat{B}(x_1)$ for x_1. □

Proposition 1 shows that in equilibrium, the actor may exploit the individual if she lacks capacity. Without a power of avoidance, the individual's "true" surplus from transacting is $-\widetilde{B}(x_1)$; she loses her revaluation price—the difference between her "true" benefit ($B(x_1)$) and her willingness to pay ($\widehat{B}(x_1)$) at the time of forming the transaction. Call a transaction *exploitative* if $B(x_1) < p$. The equilibrium transaction is exploitative whenever the individual's incapacity makes her *more* willing to pay: $\widehat{B}(x_1) > B(x_1) \Leftrightarrow -\widetilde{B}(x_1) < 0$. However, no exploitation takes place if $\widehat{B}(x_1) \leq B(x_1)$.[11]

[11] *See supra* Section III.B, Part IV of the Article (discussing the normative implications of these observations).

B.3 Power of Avoidance

This Section introduces a power of avoidance. Suppose that after full execution of the transaction, a third player—the claimant—may attempt to avoid the transaction.[12] The consequences of attempted avoidance depends on whether the individual (who transacted with the actor) was incapable at the time of forming the transaction:[13]

1. Suppose the individual was incapable. Then the claimant's avoidance attempt is successful. She recovers the transactional price p from the actor, and pays to the actor a *reasonable price* $R(x) \geq 0$ (where x was the action that the actor took pursuant to the terms of the avoided transaction).[14] Assume $R(x_0) = 0$: the reasonable price is zero if the

[12]The claimant may be the initially-incapable individual recovering from her incapacity, the initially-capable individual pretending to have been incapable, or a different person. In typical cases, the claimant is someone who expects to inherit from the potentially incapable individual. *See generally supra* Section III.A of the Article.

[13]The present specification of the consequences of attempted avoidance does not imply the absence of judicial errors or uncertainty in dispute resolution. To see this, consider an alternative formulation under which the claimant's avoidance attempt would be successful with probability $\underline{\theta}$ if the individual initially had capacity, and with probability $\bar{\theta}$ if the individual initially lacked capacity. Assume $\bar{\theta} > \underline{\theta}$, so being initially incapable increases the likelihood of successful avoidance. Let $b(x)$, $r(x)$ respectively denote the individual's willingness to pay at the time of forming the transaction and the claimant's reasonable price upon successful avoidance. Assume $r(x) \leq b(x)$ to ensure the claimant has an incentive to avoid. This alternative formulation is captured by the present model; just define $\widehat{B}(x) = \underline{\theta}r(x) + (1 - \underline{\theta})b(x)$ and $R(x) = \underline{\theta}r(x) + (1 - \bar{\theta})b(x)$.

[14]The value of R depends on those equitable considerations that control the power of avoidance and its remedial consequences, *see generally supra* Section I.A of the Article, and factors such as any transaction costs, litigation costs, as well as any imbalance between the claimant and the actor. Whether R is the result of settlement or litigation is immaterial to the subsequent analysis.

actor "did nothing".[15] Further assume $R(x_1) \leq \widehat{B}(x_1)$: the reasonable price is no greater than the maximum price that the individual was willing to pay at the time of forming the transaction.[16]

2. Suppose the individual was capable. Then the avoidance attempt fails.

The claimant decides whether to avoid with knowledge of the individual's true state of capacity at the time of forming the transaction. The actor continues to lack such knowledge.

A preliminary observation is that introducing a power of avoidance can encourage *opportunistic avoidance* in the following sense. Notice that the claimant's incentive to avoid any transaction does not depend on B—the potentially incapable individual's "true" benefit from transacting. Regardless of how much the individual would have valued the transaction, the claimant has an incentive to avoid it whenever doing so gives her a better outcome. In particular, the claimant has an incentive to avoid even if $B > R$: the benefit of the chosen action to the individual is greater than its reasonable price.

To facilitate presentation of the equilibrium properties, define *information rent* $I = \widehat{B} - R$ as the difference between the maximum price that the individual was willing to pay at the time of forming the transaction and the reasonable

[15] *See* Restatement Third of Restitution and Unjust Enrichment §§ 16 cmt. a, 33 cmt. a (Am. Law Inst. 2011).

[16] This assumption ensures that the reasonable price is effective in the sense that it would incentivize avoidance of a maximally-exploitative transaction. *See supra* Section B.2.

price.

Proposition 2. *With a power of avoidance, the equilibrium has the following properties:*

1. *In the event that the individual initially lacks capacity, the actor expects to receive the reasonable price for her action. In addition to the cost of acting, the actor's expected costs include a weighted amount of the information rent. The action taken maximizes the difference between such expected returns and costs.*[17] *Except the reasonable price, the actor does not obtain any of the joint surplus from transacting.*
2. *In the event that the individual initially has capacity, the actor expects to take action x_1. The actor expects to obtain the joint surplus from transacting less the information rent.*[18]

Proof of Proposition 2

The revelation principle implies that any equilibrium transaction that the actor can implement corresponds to one that induces honest reporting of the individual's "type"—her state of capacity. To apply the revelation principle, this proof will proceed as if the individual in a capable state is a different player from the individual in an incapable state.

[17] *See infra* equation (1) for a formal and precise description of the equilibrium action targeting the individual if she lacks capacity.

[18] Formally, the capable individual's transactional price is $\widehat{B}(x_1) - I(x)$, where x is the equilibrium action targeting the incapable individual.

Let (x, p) denote the action-price pair that at the time of forming the transaction, the incapable individual believes she would choose. The claimant's power of avoidance places an upper bound on the price that the actor can expect to receive:

$$p \leq R(x). \tag{LC}$$

The incapable individual accepts the transactional terms if and only if her participation constraint holds:

$$\widehat{B}(x) - p \geq 0 \tag{PC}$$

where 0 is her outside payoff. Implicit in the formulation of (PC) is that the incapable individual mistakenly believes her benefit is $\widehat{B}$ rather than B.

Let $(\widehat{x}, \widehat{p})$ denote the action-price pair that the capable individual believes she would choose. To ensure that the *incapable* individual chooses the action-price pair designed for her, the following incentive-compatibility constraint must hold:

$$\widehat{B}(x) - p \geq \widehat{B}(\widehat{x}) - \widehat{p}. \tag{IC}$$

The following participation constraint and incentive-compatibility con-

straint respectively ensure that the capable individual accepts the transactional terms and chooses the action-price pair designed for her:

$$\widehat{B}(\widehat{x}) - \widehat{p} \geq 0 \tag{$\widehat{PC}$}$$

$$\widehat{B}(\widehat{x}) - \widehat{p} \geq \widehat{B}(x) - p. \tag{$\widehat{IC}$}$$

The actor chooses (x, p), $(\widehat{x}, \widehat{p})$ to maximize her expected profits:

$$\mu\,[p - C(x)] + (1 - \mu)\,[\widehat{p} - C(\widehat{x})] \tag{Π}$$

subject to constraints (LC), (PC), (IC), $(\widehat{PC})$ and $(\widehat{IC})$.

For any choice of actions x and $\widehat{x}$, the actor can raise prices p, $\widehat{p}$ until (LC) binds without violating the other constraints.[19] This implies $p = R(x)$. The assumption $R \leq \widehat{B}$ then ensures the satisfaction of (PC): $\widehat{B}(x) - p = \widehat{B}(x) - R(x) \geq 0$.

The choice $p = R(x)$ implies (IC) and $(\widehat{IC})$ respectively become $\widehat{B}(x) - R(x) \geq \widehat{B}(\widehat{x}) - \widehat{p}$ and $\widehat{B}(\widehat{x}) - \widehat{p} \geq \widehat{B}(x) - R(x)$. These together imply

$$\widehat{B}(x) - R(x) = \widehat{B}(\widehat{x}) - \widehat{p}. \tag{$\star$}$$

[19]Except perhaps $(\widehat{PC})$. This step will ignore $(\widehat{PC})$, and a subsequent step will prove that it holds.

A rearrangement of ($\star$) gives $\widehat{p} = \widehat{B}(\widehat{x}) - \widehat{B}(x) + R(x)$. Using $R \leq \widehat{B}$ again ensures the satisfaction of ($\widehat{PC}$): $\widehat{B}(\widehat{x}) - \widehat{p} = \widehat{B}(\widehat{x}) - \widehat{B}(\widehat{x}) + \widehat{B}(x) - R(x) = \widehat{B}(x) - R(x) \geq 0$.

A substitution exercise using these prices transforms the actor's maximization problem into

$$\max_{x,\widehat{x}} \left\{ \mu \left[R(x) - C(x) \right] + (1 - \mu) \left[\widehat{B}(\widehat{x}) - C(\widehat{x}) - \widehat{B}(x) + R(x) \right] \right\}$$

Hence the equilibrium action targeting the capable individual is $\widehat{x} = x_1 \in \operatorname{argmax}(\widehat{B} - C)$, while that targeting the incapable individual is

$$x \in \operatorname{argmax}(\mu(R - C) - (1 - \mu)I), \tag{1}$$

where $I = \widehat{B} - R$ is the information rent. □

Proposition 2 shows the tradeoffs of introducing a power to avoid transactions for want of capacity. First, introducing a power of avoidance mitigates potential exploitation. With a power of avoidance, the claimant can reduce the price that the actor can impose on the incapable individual. However, in equilibrium, the actor only expects to receive the reasonable price (R) when transacting with the incapable individual. Moreover, transacting with the incapable individual would require the actor to pay information rent (I) to the

capable individual. This is because at the time of formation of the transaction, the actor does not know whether the individual has capacity; to obtain generous terms and conditions, the individual may pretend to be incapable even though she has capacity. Thus the actor needs to pay information rent in order to disincentivize the capable individual from so pretending. Such information rent adds to the actor's usual cost of taking actions (C). In sum, the power of avoidance reduces the actor's expected returns and increases her expected costs. These effects dampen the actor's incentives to transact in the first place.[20]

B.4 Renegotiation

This Section considers the implications of allowing renegotiation. As a modification of the model, suppose that after formation of the transaction but before the actor takes any action pursuant to the transactional terms, she and the individual may renegotiate. The individual now has capacity. If she initially had capacity, then her willingness to pay for action x remains $\widehat{B}(x)$. If she initially lacked capacity, then her willingness to pay is now $B(x)$—her "true" benefit. In renegotiation, the actor makes a take-it-or-leave-it offer, which the

[20]The actor's equilibrium transactional practice avoids dealing with the incapable individual if the reasonable price following successful avoidance is too small, or if the weighted information rent is too high. Formally, (1) shows the actor chooses $x = x_0$ if $R(x_1) - C(x_1) < \frac{1-\mu}{\mu} I(x_1)$. *See generally supra* Parts III, IV of the Article (discussing the normative implications of these observations).

individual may accept or reject.

Assuming the absence of any power of avoidance, Proposition 3 below characterizes the equilibrium. To facilitate presentation, let $\tilde{x}$ denote the action that induces the maximum revaluation price: $\tilde{x} \in \operatorname{argmax}(\widetilde{B})$. In other words, $\tilde{x}$ takes advantage of the maximum effect of incapacity on the individual's willingness to pay. Let x^* denote the efficient action when B is the individual's "true" benefit: $x^* \in \operatorname{argmax}(B - C)$.

Proposition 3. *Suppose renegotiation is permitted before the actor takes any action, and there is no power of avoidance. The equilibrium has the following properties:*

1. *If the individual is initially incapable, then she accepts a transaction with the mistaken belief that she would pay $\widehat{B}(\tilde{x})$ for action $\tilde{x}$. However, she ends up paying $\widetilde{B}(\tilde{x}) + B(x^*)$ for action x^*.*[21]

   The individual's "true" surplus is $-\widetilde{B}(\tilde{x}) \leq 0$. In addition to all the joint surplus, the actor extracts the maximum revaluation price from the individual; the actor's profits are $B(x^*) - C(x^*) + \widetilde{B}(\tilde{x})$.

2. *If the individual is initially capable, then she accepts a transaction with the correct belief that she would pay $\widehat{B}(x_1)$ for action x_1.*

   The individual obtains zero joint surplus from transacting. The actor

[21]Whether this is the result of renegotiation or initial transactional design is immaterial. As the proof of Proposition 3 will clarify, the initial transaction is renegotiation-proof.

obtains all the joint surplus; her profits are $\widehat{B}(x_1) - C(x_1)$.

Proof of Proposition 3

This proof first finds each equilibrium under the assumption that renegotiation does not take place, and then checks that the equilibrium transaction is indeed renegotiation-proof.

Let (x', p') denote what, at the time of formation of the transaction, the incapable individual believes she would choose. Her participation constraint is:

$$\widehat{B}(x') - p' \geq 0. \tag{PC'}$$

Implicit in the formulation of (PC') is that the incapable individual is naive at the time of contract formation; she mistakenly believes that her willingness to pay does not change to B later.

The actor may profit from the incapable individual's time-inconsistent willingness to pay. More precisely, the actor may design two possibility different action-price pairs, (x', p') and (x, p), and put them both in the terms of the transaction. This can exploit the incapable individual's initial belief that she would choose (x', p') instead of (x, p):

$$\widehat{B}(x') - p' \geq \widehat{B}(x) - p, \tag{C_1}$$

but she subsequently has the incentive to choose (x, p) instead of (x', p'):

$$B(x) - p \geq B(x') - p'. \tag{C_2}$$

To ensure the incapable individual chooses the action-price pair designed for her, the following incentive-compatibility constraint must hold:

$$\widehat{B}(x') - p' \geq \widehat{B}(\widehat{x}) - \widehat{p}, \tag{IC'}$$

where $(\widehat{x}, \widehat{p})$ is the action-price pair designed for the capable individual.

The following participation and incentive-compatibility constraints respectively ensure that the capable individual accepts the transactional terms and chooses the action-price pair designed for her:

$$\widehat{B}(\widehat{x}) - \widehat{p} \geq 0 \tag{$\widehat{PC}$}$$

$$\widehat{B}(\widehat{x}) - \widehat{p} \geq \widehat{B}(x) - p. \tag{$\widehat{IC}$}$$

The availability of (x', p') requires an additional incentive-compatibility constraint to ensure that the capable individual does not choose (x', p'):

$$\widehat{B}(\widehat{x}) - \widehat{p} \geq \widehat{B}(x') - p'. \tag{$\widehat{IC}'$}$$

The actor maximizes her expected profits (Π) by choosing action-price pairs (x', p'), (x, p), $(\widehat{x}, \widehat{p})$ subject to constraints (PC'), (C_1), (C_2), (IC'), $(\widehat{PC})$, $(\widehat{IC})$ and $(\widehat{IC}')$.

The following will find action-price pairs that maximize the actor's expected profits subject to constraints (PC'), (C_2), (IC'), $(\widehat{PC})$ and $(\widehat{IC}')$, and will conclude with showing that the chosen action-price pairs indeed satisfy the remaining constraints.

Some algebra reveals (IC'), $(\widehat{IC}')$ bind, implying

$$\widehat{B}(x') - p' = \widehat{B}(\widehat{x}) - \widehat{p}. \tag{2}$$

Holding the action choices and price p fixed, the actor can raise prices p', $\widehat{p}$ without losing any profit until (C_2) binds: $p' = B(x') - B(x) + p$.[22] A substitution exercise then transforms (2) to

$$\widetilde{B}(x') + B(x) - p = \widehat{B}(\widehat{x}) - \widehat{p}, \tag{$\star'$}$$

where $\widetilde{B} = \widehat{B} - B$.

Then, still holding the action choices fixed, the actor can increase prices

[22]Except perhaps (PC'), $(\widehat{PC})$. This step will ignore these constraints, and a subsequent step will ensure that they hold.

$p, \widehat{p}$ until each side of $(\star')$ drops to 0, when (PC'), $(\widehat{PC})$ bind:

$$\begin{cases} p &= \widetilde{B}(x') + B(x) \\ \widehat{p} &= \widehat{B}(\widehat{x}). \end{cases} \tag{3}$$

A substitution exercise using these prices transforms the actor's expected profits into:

$$\Pi = \mu \left[\widetilde{B}(x') + B(x) - C(x) \right] + (1 - \mu) \left[\widehat{B}(\widehat{x}) - C(\widehat{x}) \right].$$

Hence the action choices are characterized by $x' = \tilde{x} \in \operatorname{argmax}(\widetilde{B})$, $x = x^* \in \operatorname{argmax}(B - C)$, and $\widehat{x} = x_1 \in \operatorname{argmax}(\widehat{B} - C)$. Observe that x, x_1 are renegotiation-proof.

It remains to check that constraints $(\widehat{IC})$, (C_1) are satisfied. Some algebra using the actor's choices of prices and actions transforms both $(\widehat{IC})$, (C_1) into

$$\widetilde{B}(\tilde{x}) \geq \widetilde{B}(x^*),$$

which holds because $\tilde{x} \in \operatorname{argmax}(\widetilde{B})$. □

Proposition 3 shows the observations made in Section B.2 are robust to the possibility of renegotiation. The incapable individual's "true" surplus from transacting is $-\widetilde{B}(\widetilde{x})$; she loses her maximum revaluation price. This

transaction exploits her whenever her incapacity makes her more willing to pay: $-\widetilde{B}(\widetilde{x}) < 0$.

Proposition 4 below considers the equilibrium implications of introducing a power to avoid transactions for want of capacity when renegotiation is permitted.

Proposition 4. *Suppose renegotiation is permitted before the actor takes any action, and there is a power of avoidance. The equilibrium has the following properties:*

1. *In the event that the individual is initially incapable, the terms of the initial transaction include an action-price pair (x, p) that sets the actor's expected benefits as the reasonable price and her expected costs as the sum of the individual's "true" benefit and a weighted amount of the information rent.*[23] *Through renegotiation, the actor ends up taking action x^*.*

   The individual's "true" surplus from transacting is $B(x) - R(x)$. The remaining joint surplus goes to the actor, whose profits are $B(x^*) - C(x^*) - B(x) + R(x)$.

2. *In the event that the individual initially has capacity, the actor expects to take action x_1. The actor expects to obtain the joint surplus from*

[23] *See infra* equation (7) for a formal and precise description of the initial equilibrium action targeting the incapable individual.

transacting less the information rent.[24]

Proof of Proposition 4

This proof first finds the equilibrium terms of the initial transaction under the assumption that the initially-*capable* individual does not renegotiate, and then checks that her action-price pair specified by those transactional terms is indeed renegotiation-proof. This strategy allows the actor to design any renegotiated transaction with the knowledge that the individual who has the incentive to renegotiate was initially incapable.

When renegotiating with the initially-incapable individual, the actor offers new transactional terms comprising an action-price pair (x^R, P^R) to maximize her profits

$$P^R - C(x^R)$$

subject to the individual having the incentive to accept this new transaction:

$$B(x^R) - P^R \geq B(x) - R(x) \tag{4}$$

where (x, p) is the action-price provided by the initial transaction, and the right-hand side of inequality (4) is the individual's payoff from executing the

[24]Formally, the capable individual's transactional price is $\widehat{B}(x_1) - I(x)$, where x is the initial action targeting the incapable individual.

initial transaction and then avoiding it in order to pay the reasonable price rather than the agreed price. As the proof of Proposition 2 has explained, the power of avoidance prevents the actor from expecting to receive more than the reasonable price $R(x)$ for taking action x; that is, $p \leq R(x)$.

To maximize profits subject to (4), the actor chooses $x^R = x^* \in \text{argmax}(B - C)$ and

$$P^R = B(x^*) - B(x) + R(x). \tag{5}$$

At the time of designing the initial transactional terms, the actor can anticipate the possibility of renegotiation. She can choose action-price pairs (x, p), $(\widehat{x}, \widehat{p})$ to maximize the following objective function

$$\mu \left[P^R - C(x^*)\right] + (1 - \mu)\left[\widehat{p} - C(\widehat{x})\right]$$

which becomes the following after a substitution exercise using (5):

$$\mu \left[B(x^*) - C(x^*) - B(x) + R(x)\right] + (1 - \mu)\left[\widehat{p} - C(\widehat{x})\right]. \tag{6}$$

For reasons stated in the proof of Proposition 2, the actor's choices are subject to constraints (LC), (PC), (IC), $(\widehat{PC})$ and $(\widehat{IC})$. (Unlike in the proof of Proposition 3, the existence of a power of avoidance implies that the initially-

incapable individual is now no longer bound by any exploitative action-price (x', p'). Hence constraints (C_1), (C_2), (IC'), (PC'), $(\widehat{IC}')$ in that proof no longer apply here.)

For reasons stated in the proof of Proposition 2, holding the actions x, $\widehat{x}$ fixed, the actor chooses $p = R(x)$ and $\widehat{p} = \widehat{B}(\widehat{x}) - \widehat{B}(x) + R(x)$. A substitution exercise using these prices then transforms (6) into

$$\mu\left[B(x^*) - C(x^*) - B(x) + R(x)\right] + (1-\mu)\left[\widehat{B}(\widehat{x}) - C(\widehat{x}) - \widehat{B}(x) + R(x)\right].$$

Hence the actor chooses $\widehat{x} = x_1 \in \operatorname{argmax}(\widehat{B} - C)$ for the initially-capable individual, which is renegotiation-proof. The action chosen for the incapable individual under the initial transactional terms is

$$x \in \operatorname{argmax}\{\mu(R - B) - (1-\mu)I\} \tag{7}$$

where I is the information rent. Upon recovering from her incapacity and through renegotiation, the initially-incapable individual chooses x^*. □

Proposition 4 first confirms renegotiation does not affect the observations, made in Section B.3, that introducing a power to avoid transactions for want of capacity mitigates potential exploitation but encourages opportunistic avoidance. With a power of avoidance, the claimant can reduce the price that the

actor can impose on the initially-incapable individual. However, the actor's expected returns are reduced to the reasonable price. Moreover, transacting with the initially-incapable individual would require the actor to pay information rent to the initially-*capable* individual. In sum, the power of avoidance reduces the actor's expected returns and increases her expected costs. These effects dampen the actor's incentives to transact in the first place.[25]

[25]The actor's equilibrium transactional practice avoids dealing with the initially-incapable individual if the reasonable price following successful avoidance is too small, or if the weighted information rent is too high. Formally, an application of (7) shows the actor chooses $x = x_0$ if $R(x_1) - B(x_1) < \frac{1-\mu}{\mu} I(x_1)$.