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Fiduciary Duties as Default Rules

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CONCEPTS that are useful for analysis often can do great mischief if taken as accurate descriptions of reality or as broad and universal normative principles. Such mischief is currently done by the indiscriminate use of the concept "contract" to describe various relationships. In recent years innovative legal scholars have adopted a view of fiduciary relationships as contracts.[1] Thus, "contractarians" define corporations as criss-crossing contracts among the different actors, including shareholders and management,[2] and propose to reclassify partnership relation-

* Professor of Law, Boston University School of Law. For insightful and enriching comments I thank Dean Ronald Cass, Professors Randy E. Barrett, Lisa Bernstein, Michael Harper, Richard Painter, David Phillips, and Alan W. Vestal and members of the Boston University Workshop. I thank Jason Vargalis and Andrew Pitts, graduates of Boston University Law School, for comments and editorial assistance.

[1] *See, e.g.*, Victor P. Goldberg, *Price Adjustment in Long-Term Contracts*, 1985 WIS. L. REV. 527; *see also* Alison Grey Anderson, *Conflicts of Interests: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 756 (1978); Mark P. Gergen, *The Use of Open Terms in Contract*, 92 COLUM. L. REV. 997 (1992) (dealing with agency relationship and compensation terms to meet the difficulties that they pose but describing them as contract relationships; and citing numerous articles dealing with fiduciary relationships, but identifying them as contracts). *But see* Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, HARV. BUS. SCH. RES. COLLOQUIUM—PRINCIPAL AND AGENTS: THE STRUCTURE OF BUSINESS 55 (1984) (responding to the view, described by many of the colloquium participants, that fiduciary relationships equal "agency relationships" in economic parlance and that corporations constitute a conglomeration of contracts, and convincingly arguing that neither the language of the economists nor their focus on individual contract relationships are adequate to theorize about fiduciary duties of corporate management to the corporation).

[2] These scholars follow the characterization of corporations by economists, although the definition of "contract" in economics differs from the legal definition. For economists, "contract" means any agreement or obligation by economic actors. For lawyers, "contract" refers to particular types of legally enforceable obligations. As I argue later, fiduciary relationships can give rise to legal obligations that are not contractual. Recent legal literature, however, makes little distinction between the two. *See* Lucian Arye Bebchuck, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1397 (1989); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). *See generally* William J. Carney, *The ALI's*

ships as contracts, switching to the language and jurisprudence of contract.[3]

This reclassification has far-reaching practical implications for fiduciaries and for those they serve (entrustors). Behind it lurk drastic and fundamental changes in the current law and a substantial reduction in entrustors' protection such that fiduciary duties would be grounded in express or implied provisions of the agreements among the parties and enforced as contract obligations.[4] This reclassification reverses traditional default rules.

Under current law, fiduciaries owe entrustors both a duty of care—to act carefully and not negligently—and a duty of loyalty—to perform their services in the interest of their entrustors and not in conflict of interest. In most cases fiduciaries can be

Corporate Governance Project: The Death of Property Rights?, 61 GEO. WASH. L. REV. 898, 904, 910, 916, 950-51 (1993) (asserting that (1) property rights are explicit whereas fiduciary rules are open ended and costly; (2) market prices are sufficient to fill any gap in the contract between investors and management; (3) "the default rule is freedom of action in the absence of prohibition or effective constraint through incentive or governance provisions, not the imposition of fiduciary duties;" and (4) judges suspicious of the efficacy of markets in providing either efficient contract terms or appropriate pricing of inefficient ones "ignore the powerful evidence in support of the Efficient Capital Markets Hypothesis"); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Gergen, *supra* note 1 (examining incentive systems for agents to develop assets for the principal by gain-sharing arrangements, showing the limitations of such systems and proposing tests borrowed from the rules of negligence in tort law).

[3] REVISED UNIF. PARTNERSHIP ACT (1994), *reprinted in* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT 205 (1995); *see* Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 537-64 (1993) (asserting that rather than maintaining the traditional classification of partnership as a fiduciary relationship designed to promote the collective interest of partnership, the RUPA classifies partnership as contractual, focusing on the short-term interest of the individual partner and failing to impose adequate standards in the arrangement. The RUPA is statutory and exclusive (limiting the types of fiduciary duties), restrictively defined (pronouncing partnerships subject to the fiduciary duty of loyalty and of care only), and broadly amendable (parties can agree to modify provisions, even identify in advance categories of activities that do not violate the duty of loyalty). The author argues against this shift from the fiduciary to contract view of the partnership relation under the RUPA because it will create an inflexible legal regime incapable of adapting to new situations, evolving business practices, and changing social beliefs).

I beg to differ with Vestal's criticism of the RUPA design of partnerships as "temporally limited," where fiduciary duties arise mostly within the period of conduct and wind up, but not in formation. As I argue in part I, fiduciary law does not regulate the formation of the relationship.

[4] I presume that "contract" would include an agreement among the fiduciary and other parties, such as the trustor, the maker of a will, or voters in an election.

relieved of these duties only if entrustors expressly or impliedly waive these duties; in some cases the duties are non-waivable.

Fiduciaries will be permitted to act negligently and in conflict of interest, unless expressly or impliedly prohibited from doing so, or if they fulfill certain conditions, such as disclosure. Further, courts would exercise less discretion in fashioning fiduciary duties. Rules regulating fiduciaries would be far more specific and dependent on the terms of the arrangement among the parties.

Some contractarians do not go so far as to completely eliminate fiduciary law. They are ready to recognize fiduciary duties, but would impose the contract regime to allow entrustors to waive duties owed to them. These waivers would be enforced like the waiver or bargaining around of contract obligations.

The consequences of reclassifying fiduciary law as contract law are not necessarily ordained and do not logically follow the contractarian approach. We could, after all, import fiduciary rules into contract law regulating special types of contracts. Yet, in terms of both psychological fact and organization of the law, a name is important and reclassification can be treacherous.[5] When we blur the distinctions between fiduciary and contract relationships, calling them by the same name, we tend to disregard the reasons for the different rules that govern them. Having forgotten these reasons, we are proposing seriously flawed rules that could come back to haunt us.

This Article examines the status of fiduciary rules as default rules: whether, and how, entrustors can waive fiduciary duties owed to them.[6] Contractarians argue that fiduciary rules constitute default rules around which the parties can bargain.[7] Anti-contractarians argue that at least some rules are mandatory and cannot be waived.[8] In my opinion, most fiduciary rules consti-

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[5] *See, e.g.*, Tamar Frankel & Francis H. Miller, *The Inapplicability of Market Theory to Adoptions*, 67 B.U. L. REV. 99, 101 (1987) (arguing that the use of the terms "market," "commodity," and "supply and demand" for babies creates a fundamentally different model of parent-child relationship).

[6] I define default rules as rules that would replicate efficient, frictionless, voluntary decisions for classes of cases. For a discussion of "bargain" and "waiver," see *infra* note 60.

[7] Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 29-30 (1990).

[8] John C. Coffee, Jr. *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1661-64, 1671-74, 1689 (1989) [hereinafter Coffee, *Judicial Role*]; *see also* John C. Coffee, Jr., Lecture, *No Exit?:*

tute default rules. However, entrustors may only waive fiduciary duties owed to them if they follow a two-step procedure.

First, entrustors must be put on clear notice that, with respect to the particular duties that they waive, they can no longer rely on their fiduciaries; instead, the entrustors must fend for themselves. Second, the fiduciaries must provide entrustors with information acquired by virtue of their position as fiduciaries to enable entrustors to make an informed independent decision regarding the waiver.

The reasons for this procedure stem from the unique nature of fiduciary relationships and the law governing them. In varying degrees the relationships expose entrustors to extraordinary risks. Entrustors must entrust power or property to the fiduciaries because the fiduciaries could not perform their services effectively otherwise,[9] yet this exposes entrustors to the risk that the fiduciaries will appropriate the entrusted property or interest, or misuse the power entrusted to them. The appropriation or abuse of power can result in a loss that far exceeds the potential gain from the fiduciaries' services.

In addition, entrustors become dependent on their fiduciaries and may not be able to monitor the quality of their services because: (1) the skills involved are not easily acquired or understood; (2) the cost to entrustors of monitoring and evaluating such services would undermine the utility of the arrangement; and (3) there exists no other effective alternative monitoring mechanism. In sum, fiduciary rules reflect a consensual arrangement covering special situations in which fiduciaries promise to perform services for entrustors and receive substantial power to effectuate the performance of the services, while entrustors cannot efficiently monitor the fiduciaries' performance.[10]

Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies, 53 BROOK. L. REV. 919 (1988) [hereinafter Coffee, *No Exit*].

[9] For example, unless a trustee is vested with title of trust property, he cannot perform trust services, and unless corporate management is vested with control of the corporate enterprise, it cannot manage. Many fiduciary relationships involve services requiring these kinds of entrustments.

Such power may be entrusted by law, as in the case of non- elected public officials and corporate officers, or by election of entrustors, as in the case of elected public officials and corporate directors. Alternatively, the power can be vested by the entrustor, as in the case of agents, or it can be vested by a third party, as in the case of trustees under a trust or a will.

[10] Arguably, some contract situations pose similar problems, such as franchises, construction agreements, and so-called "relational contracts" (long term agreements). I argue that although some elements of these contracts are similar to fiduci-

Fiduciary law addresses the unique aspects of this relationship. First, the law vests in entrustors the *legal right to receive quality fiduciary services*. It imposes on fiduciaries a duty to exercise care and skill, akin to the tort of negligence. Second, the rules vest in entrustors the *legal right to rely on the honesty of their fiduciaries* by imposing on fiduciaries a duty of loyalty, as well as other specific duties, in order to deter fiduciaries from misappropriating the entrusted property or interests. This part of fiduciary law is akin to the crime of embezzlement[11] and the tort of conversion.[12]

The status of fiduciary rules as default rules conflicts with the fiduciaries' duties of loyalty and reliability. While bargaining with their fiduciaries on the issue of waiver, entrustors must fend for themselves as independent parties. Their right to rely on their fiduciaries must be eliminated. In fact, during the bargaining, the *entire relationship* must be terminated.

Fiduciary law allows such termination of the relationship with respect to specified transactions only if the parties follow a specific procedure. This procedure is designed to ensure an effective transition from the fiduciary mode in which entrustors rely on their fiduciary, to a contract mode in which parties rely on themselves. That is why fiduciaries must put entrustors on notice that, in connection with the specified transaction, entrustors cannot

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ary relationships, they are distinguishable. In general, even if contracts and fiduciary relationships overlap at the fringe, the basic prototypes of these relationships are very different.

[11] WAYNE R. LAFAVE & AUSTIN W. SCOTT, JR., SUBSTANTIVE CRIMINAL LAW § 8.6 (2d ed. 1986 & Supp. 1995).

[12] WILLIAM L. PROSSER & W. PAGE KEETON, PROSSER & KEETON ON THE LAW OF TORTS § 15 (5th ed. 1984). For an example of characterizing conversion and breach of fiduciary duty as inter-changeable, see Moore v. Regents of the Univ. of Cal., 793 P.2d 479 (Cal. 1990), *cert. denied*, 499 U.S. 986 (1991) (rejecting conversion claim by a patient against his physician for taking, without the patient's consent and converting to his own research and commercial use, the patient's blood, skin, and sperm, but allowing a claim of breach of fiduciary duty and lack of informed consent to the taking); *see also* Recent Developments, 104 HARV. L. REV. 808 (1991).

The prevailing misunderstanding of the nature of fiduciary relationships and the purpose of fiduciary law may be due to the fact that most, though not all, fiduciary relationships involve agreements between fiduciaries and entrustors, some of which can constitute binding contracts. However, fiduciary relationships can arise: (1) without agreements; (2) by agreements that do not constitute enforceable contracts; or (3) by other legal arrangements, such as trusts, wills, agencies, elections, and statutory empowerment. Fiduciary law applies to, and is superimposed on, all other legal arrangements, just as criminal law and tort law are imposed on legal arrangements.

rely on their fiduciaries.[13] That is why entrustors must be capable of bargaining independently with their fiduciaries and have the capacity to enter into bargains. That is also why, to allow entrustors to make informed decisions, fiduciaries must provide them with information regarding the transaction, especially when the fiduciaries acquired this information in connection with the performance of their services to the entrustors. This procedure is, and should remain, mandatory.[14]

In addition, circumstances exist where fiduciary duties are not waivable for reasons such as doubts about the quality of the entrustors' consent (especially when given by public entrustors such as shareholders), and the need to preserve institutions in society that are based on trust. Further, non-waivable duties can be viewed as arising from the parties' agreement *ex ante* to limit their ability to contract around the fiduciaries' duties.[15] Under these circumstances fiduciary rules should generally be mandatory and non-waivable.

This Article consists of four parts. Part I draws a profile of fiduciary relationships. It also explains the different responses of fiduciary and contract rules to the different problems that the relationships pose regarding: (1) the right of one party to rely on the other and the specific duties of loyalty and care, which mirror these rights; and (2) the events that trigger the application of fiduciary rules. Finally, it compares contract with fiduciary rules. The reasons for the existence of fiduciary rules suggest that, when in conflict, they trump the rules governing other parallel relationships, including contracts.

Part II describes the characteristics and boundaries of fiduciary rules as default rules and demonstrates the required process for waiver of fiduciary duties. Part III discusses limitations on entrustors' waivers of their rights under fiduciary law relating to specific transactions, and waivers of their rights under fiduciary

[13] Arguably, the very notice by a fiduciary seeking to transform the relationship from fiduciary to contract constitutes breach of his or her fiduciary duties. The notice declares that the entrustor can no longer rely on the fiduciary. I reject this argument because the notice is conditioned on the entrustor's consent, and because the entrustor can refuse consent. The notice need not constitute a violation of a fiduciary duty.

[14] Not all fiduciary rules are default rules, however, subject to the consent procedure. Some are mandatory. For example, classification is a mandatory rule that precludes the parties from contractually classifying their relationships. Courts assert the final power to make the final classification. *See infra* part III.

[15] I owe this idea to Professor Alan Wertheimer, The University of Vermont.

law generally. Part IV distinguishes between private fiduciary relationships, discussed in the former three parts of this Article, and public fiduciary relationships, i.e., mass-produced relationships with numerous entrustors such as shareholders of corporations. From these distinctions I conclude that public fiduciaries possess more power than private fiduciaries, and that the self protection afforded to numerous entrustors is less effective than that afforded to private entrustors. I also question the effectiveness of public entrustors' consent to conflict of interest transactions and other bargaining around fiduciaries' duties. I believe such consents are often imaginary and empty.

I then examine three possible solutions to public entrustors' protection. One is the proposed contractarian view which would eliminate fiduciary law and lead to the creation of property rights for corporate management in its office. The second solution is to impose all or most fiduciary rules as mandatory rules and ignore so-called consents by public entrustors. The third is to establish a government office as surrogate for consent by public entrustors, along the scheme established in the Investment Company Act of 1940.[16] There are, no doubt, other solutions as well. I conclude that private and public fiduciaries should be subject to a separate body of rules and reject the contractarian view.

I

Fiduciary Relationships

A. *The Main Features of Fiduciary Relationships*

To show why waiver rules of fiduciary duties and waiver rules of contract obligations differ, I start by discussing the main features of fiduciary relationships.

1. *Risk of Misappropriation*

In most fiduciary relationships, fiduciaries cannot perform their services without receiving power over the entrustors, their property, or their interests. This power is vested in fiduciaries solely in order to perform their services for the entrustors.[17] Fiduciary relationships seem like executory contracts because entrustments to the fiduciaries must be made at the outset, before

[16] 15 U.S.C. §§ 80a-1 to 80a-64 (1994).

[17] *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. Rev. 1045 (1991).

they perform their services. Unlike executory contracts, these entrustments are not part of the bargain to which fiduciaries are entitled. The entrusted powers are simply a necessary condition for the performance of the fiduciaries' service; the powers therefore vary, depending on the nature of the fiduciaries' services and the extent to which they are needed in order to perform those services efficiently.[18] Entrustment exposes entrustors to the risk that the fiduciaries will appropriate the entrusted property or interest, causing entrustors a loss that far exceeds their potential gain from fiduciaries' services. Even entrustors who are in a strong bargaining position before they enter the relationship become vulnerable immediately after they entrust power or property to their fiduciaries.[19]

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18 For example, a trust arrangement is used to provide expert and reliable property management for beneficiaries, usually long-term. Some beneficiaries, such as children, can neither manage the property themselves nor appoint others to do so. Therefore, to perform his duties, a trustee must take title and control of the trust assets. Bailment of goods is another example. Bailees, required to guard property (e.g., in a parking lot) must receive possession of the property. Bailees required to use the customers' materials (e.g., dressmakers) must be entrusted with possession of these materials. For a discussion of entrustment in the commercial fiduciary context see *infra* part IV.A.1.

In contrast, if entrustors promise the fiduciaries fees for their services, payment of the fees in advance would constitute an executory contract.

19 Entrustors expose their assets to two kinds of risks. One risk involves the investment of assets. For example, if entrustors buy shares in an enterprise, they take the risk that the enterprise will experience losses for whatever reasons, such as a downturn in the economy. For this investment risk entrustors receive a return. The entrustors' other risk involves the entrustment of their assets to the fiduciaries. For this risk, entrustors receive benefits from the fiduciaries' services. Both risks can result in total loss of the entrusted assets, and both risks must be adequately compensated.

The potential benefits from the fiduciaries' services must either match or exceed the investment benefits, which they rarely do. If the benefits are lower, the entrustors' risk of loss through the fiduciaries' misappropriation must match or fall below the potential benefits from the fiduciaries' services.

Thus, an entrustor may entrust $100,000 to a fiduciary for investment. The investment will bear a return that compensates the entrustor for his investment risk. The value of the fiduciary's services consists of expert investment management, freeing the entrustor from the burden of managing the portfolio, and, in some cases, offering the entrustor diversification to reduce his investment risk. Assuming that the value of these benefits is five percent of the value of the portfolio, or $5000, the entrustor may be willing to pay the fiduciary a fee up to something below the value of the benefits (e.g., three percent of the value of the portfolio, or $3000).

However, the expected benefits from the fiduciary's services must be discounted by the risk that the fiduciary will misappropriate the entrusted $100,000. If the entrustor values the net benefits from the relationship (the benefits minus the fiduciary's fees of $3000) at two percent of the portfolio, or $2000, the entrustor will not enter into the relationship if the probability of loss of the whole portfolio by misap-

Fundamentally, the risk to entrustors from fiduciaries' misappropriation of entrusted power is similar to the risk to property owners from stealing.[20] The entrustors' risk may be even greater. Thieves can be discovered when attempting to obtain the property of others, but fiduciaries cannot be discovered at this stage; the owners hand the property to them, and they may possess or own it legitimately, so long as they make the proper use of it. Misappropriation will occur when fiduciaries use the property for a purpose other than the purpose for which they were entrusted with the property.[21] Because conversion to an improper use is

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propriation is higher than that benefit of two percent. The entrustor might be willing to pay the fiduciary an additional fee for a lower probability of misappropriation, but that fee plus the remaining lower probability of misappropriation cannot exceed $2000. Additionally, the entrustor must be assured that the risk will indeed be lower. If the costs to the entrustor are higher, a rational and wise entrustor will not enter the relationship.

Similarly, when an agent is authorized to bind the principal to legal obligations and is granted broad discretion to do so, the misappropriation of the power can result in substantial losses to the principal. Thus, if the agent receives kickbacks to enter into a transaction on behalf of his principal on terms less favorable to the principal, the principal's loss may be at least the amount of the kickback and often more than that amount. These losses may far exceed the benefits to the entrustor from the agent's services.

Potential losses decrease when the fiduciary's discretion is lower, such as when the entrustor engages an investment adviser but retains the investment decision. If the adviser, in conflict of interest, suggests less than the best investment, and the entrustor follows the advice, he will sustain a loss. He has, however, the opportunity of checking the adviser's suggestion, although the cost of checking the advice reduces its benefits to the entrustor.

20 The magnitude of the entrustors' risk from misappropriation parallels that from stealing; in both cases the entrustors' loss is difficult to predict but can amount to the total value of what is entrusted.

21 That is why at common law a fiduciary's misappropriation is called embezzlement, or cheating, rather than stealing. However, the Model Penal Code makes no such distinction. Indeed, in the Code, misappropriation falls within the definition of the crime of theft. MODEL PENAL CODE § 223.1 (Supp. 1995).

Perhaps in one aspect, misappropriation may be less risky to the entrustor than stealing. In most situations, an entrustor can choose his fiduciary and can prevent misappropriation by choosing a trustworthy fiduciary. The thief, however, is self-chosen. Yet the entrustor's cost of preventing his loss of entrusted power or property or insuring the loss is relatively high for three reasons. First, for many fiduciary relationships, evaluating the probability of misappropriation is difficult and costly. Often, entrustors lack information about the fiduciaries; they certainly lack information about the future behavior of their fiduciaries. Second, usually entrustors do not consciously engage in measuring the probabilities of misappropriation. They follow intuitively or consciously the experience of others, demonstrated in general tradition, or in the stories about particular persons and experiences. Such following of tradition or anecdotal experiences creates a "snowball" effect generally augmenting a trend. Under these circumstances, both trust and mistrust are unreliable as they can be far more deeply rooted than the facts warrant. Thus, the entrustors' evaluaoften costly to discover and prove, entrustors' cost of detecting fiduciaries' misappropriation could be much higher than the cost of detecting theft. Further, theft is usually a single occurrence; conversion may occur over a long period and be discovered only much later.[22] In addition to, or perhaps because of, low probabilities of detection, fiduciaries face great temptations to convert. Fiduciaries in the business of controlling other people's money long-term are more likely than others to succumb to temptations.[23]

We expect fiduciaries to exercise self-control; to forego immediate pleasure from misappropriated property for long-term benefits of honesty. In the words of James Q. Wilson: "It is a remarkable characteristic of human society that most of the things that are best for us—that is, most likely to produce genuine and enduring happiness—require us to forgo some immediate pleasure."[24] Most fiduciaries would agree to refrain from

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tion of fiduciaries could be unreliable. Third, entrustors with small investments are unlikely to diversify their risk of misappropriation. A one-time entrustment, for example, writing a will or performing surgery, cannot be diversified. The diversification of the misappropriation risk will make it more costly.

[22] The cost of discovering the whereabouts of the fiduciaries is lower than the cost of discovering the whereabouts of thieves, unless the fiduciaries abscond with the property. While the cost of locating fiduciaries may be lower, the difference may not be enough to cover the related costs.

[23] *See, e.g.*, Robert L. Rose, *After Turning Around Giddings & Lewis, Fife Is Turned Out Himself*, WALL ST. J., June 22, 1993, at A1, A8 (the story of an able and aggressive company president, who had turned his company around, but was finally ousted by the board of directors because: (1) he "had begun to treat [the company] as if it was his own" [sic] by engaging in transactions that benefitted himself without reporting to, or seeking authorization from, the board; and (2) he "'was micromanaging, more for today than for tomorrow.'" *Id.* at A1. In that case, temptation increased with greed. In other cases, it increases when the fiduciary is under financial pressures: he sincerely hopes merely to borrow rather than misappropriate. The likelihood that the fiduciary will succumb to temptation also increases if his risk of detection is low. This danger has long been recognized by the courts and demonstrated in empirical studies. *See* James Shanteau, *The Perceived Strength of an Implied Contract: Can It Withstand Financial Temptation?*, 49 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 1 (1991) (experiment showing that when business management students were given a choice to switch mid-summer to a more lucrative job the students gave greater weight to nonfinancial incentives such as commitment, yet when the students received specific financial statements, they seemed to change to a business context and gave higher priorities to financial incentives); Ephraim Yuchtman-Yaar & Giora Rahav, *Resisting Small Temptations in Everyday Transactions*, 126 J. SOCIAL PSYCHOLOGY 23 (1986) (examining misappropriation of extra change given to bus passengers "by mistake." When the group that was tested was more homogeneous as to age and sex the differences in misappropriated amounts were reduced).

[24] JAMES Q. WILSON, THE MORAL SENSE 81 (1993). "Inside every person there is

misappropriation and meet the entrustors' expectations, but may find it difficult at times to do so. Fiduciary rules are mainly designed to help them overcome these difficulties. Therefore, waivers of these rules expose entrustors to possible losses of their properties and, if made without consideration, are tantamount to gifts.

2. *Risk of Low-Quality Services*

In addition to the risk of misappropriation, fiduciary relationships expose entrustors to the risk of careless performance by fiduciaries. Entrustors may lack the expertise to monitor particular services. The cost of monitoring the quality of fiduciary services can be very high—so high as to eliminate the benefits of the services to entrustors. For example, monitoring the performance of attorneys is costly because it requires legal education, and because the quality of the services may not be readily or immediately apparent.[25]

The potential losses from careless performance of fiduciary services can be extremely high, resulting in injury to entrustors' persons (e.g., eviction, incarceration) and to their property (e.g., loss of a court claim, a deficiently drafted will).[26]

The extent of the losses might differ, depending on the particular circumstances. The classification of fiduciaries reflects the anticipated monitoring costs of the entrustors. The variety and strictness of the rules governing each class may depend on the relative weight which courts assign to these costs. In each class, if the entrustors' cost of monitoring the fiduciaries' performance is relatively high, the rules governing the fiduciaries are likely to be

found a 'parliament of instincts' . . . . Self-control does battle with self-expression; the seductiveness of immediate pleasure competes with the attraction of more distant ones; the lure of what is novel contends with the comfort of what is familiar." *Id.* at 91.

[25] For example, one might discover that a negligently executed will lacked a legally binding effect only after the testator dies, many years after its execution. On the other hand, physicians' services may be performed very well and yet the patient may die. *See* Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 814 (1983).

[26] If entrustors' time is valuable then monitoring their fiduciaries will be very costly. The higher the parties' expertise (entrustors or fiduciaries), the greater the parties' and society's interest will be in discouraging them from "doing it themselves." Surgeons should be encouraged to hone their skills rather than become experts in portfolio management or lawyering. Lawyers should resort to surgeons for surgery. The higher the costs of learning to "do it myself," the higher is society's interest in fostering delegation of services to others and promoting specialization in those services.

stricter.[27]

3. *Costly Self-enforcement*

Although some fiduciary relationships are not as risky to entrustors as others,[28] entrustors' risks from the relationships remain higher than those of contracting parties. However, if entrustors could reduce their risks by enforcing their fiduciaries' obligations, no legal intervention beyond contract law would be necessary. Numerous techniques for self-enforcement are available to parties in different relationships,[29] although most do not help entrustors. Examples of various self-enforcing techniques are self-enforcing agreements, "hands-tying," self-bonding, hostage-taking, collateral-taking, and union (identity of interest among the parties, including altruistic habits of subordinating individual welfare to that of others).[30]

In contrast to contract, self-enforcing agreements are not generally possible in fiduciary relationships.[31] If parties entrust the enforcement to a third party, such as an escrowee, the arrangements also create fiduciary relationships that lead to entrustors' problems. In addition, usually entrustors cannot transfer the entrusted power or property to third parties; if they do, they defeat the purpose of the relationship. For example, if an entrustor wishes to receive the services of a very gifted lawyer, he cannot entrust the power to make decisions to a third party whom he might trust more, but who may not possess the expertise. Although entrustors' and their fiduciaries' interests may be

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27 *See* Frankel, *supra* note 25; Tamar Frankel, *Fiduciary Law: The Judicial Process and the Duty of Care* X-1, 1993 Isaac Pitblado Lecture, University of Manitoba Law School, *in* FIDUCIARY DUTIES/CONFLICTS OF INTEREST (1993); *see also* Tamar Frankel, *Fiduciary Relationship in the United States Today*, *in* EQUITY, FIDUCIARIES AND TRUSTS 173, 191-93 (Donovan W.M. Waters ed., 1993) [hereinafter Frankel, *Fiduciary Relationship*].

28 For a discussion of agency in the context of public fiduciary relationship, see *infra* part IV.

29 *See, e.g.*, Jensen & Meckling, *supra* note 2; *see also* Cooter & Freedman, *supra* note 17; Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5, 11-12 (1985); Saul Levmore, *Commissions and Conflicts in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters, and Other Agents' Rewards*, 36 J.L. & ECON. 503 (1993).

30 *See* Kronman, *supra* note 29, at 11-12, 23.

31 For example, contracts that involve performance stages, such as the sale or construction of a house, usually contain simultaneous exchanges at each stage. The parties attempt to provide no more than they receive at each stage.

sometimes aligned, such as by profit sharing, the alignment is not perfect and does not protect entrustors fully.

Hands-tying may not be an effective technique where the fiduciaries' services require discretion. In addition, fees do not necessarily relate to the risk of misappropriation. Honest and fair fiduciaries do not necessarily command higher fees. This may be because it is hard, ex *post facto*, to evaluate the performance of fiduciaries. Many fiduciary services cannot be tested for quality because faulty performance may not be discovered at all, or may appear only after a very long time. Furthermore, quality may gradually erode, and it may take years for the markets to evaluate quality and for entrustors to learn of any changes in it. When markets for fiduciary services exist, however, they can provide more credible and better information.[32]

Yet, not every market price reduces particular information cost. If the prices are a "black box" affected by numerous types of information, as stock prices are, then prices do not provide evidence of the quality or honesty.

Self-bonding, hostage-taking and collateral-taking are not likely to protect entrustors effectively. Fiduciaries could, and indeed do, provide assurance to entrustors by self-bonding. However, if the cost of providing such assurance exceeds the benefit to fiduciaries from the relationship, the fiduciaries would not engage the relationship.

To convince entrustors to entrust their property, fiduciaries can invest in establishing and maintaining a reputation of trustworthiness.[33] This may be effective in a stationary society, in which everyone knows the fiduciary, his history, and his family. Social and collegial pressures on the fiduciary would reduce the potential losses to the entrustor. The fiduciary's family members or members of his professional club who seek to maintain their collective reputation will monitor his performance. As these sources of information and monitoring disappear in a mobile society, however, fiduciary relationships with strangers become far more risky to entrustors.

Further, impressing people with one's honesty is not so easy:

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32 *See e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 18-19 (1991).

33 For fiduciaries, the costs of creating and maintaining such a reputation are much higher than similar costs to the parties in "spot" contract situations. Parties to long-term "relational contracts" face a similar problem as that facing fiduciaries.

> For people to be impressed by your honesty, you must either be honest all of the time (in which case you will have to stop taking selfish advantage of the many opportunities for cheating, and so you might as well stop being greedy altogether), or you will have to be honest in some very conspicuous, highly dramatic fashion, such as telling the truth even when it costs a lot of money to do so. . . . [P]eople will accept your behavior as a sign of honesty or duty only when it would be costly to fake it. If it is costly to fake it, you can't fake it; the reputation you then earn for honesty or duty corresponds exactly to reality. You *are* dutiful.[34]

In such cases, the imposition of legal rules is more cost-effective, although the rules may impose added burdens on those fiduciaries who can rely on community reputation. But as more impersonal fiduciary relationships occupy the field, the social benefits of institutionalized rules increase.

Finally, third-party insurance of fiduciaries is highly problematic and costly. It is difficult to determine the level of coverage or range of potential loss. It is also difficult for the fiduciary to obtain coverage. Insurance companies will not bond fiduciaries for intentional violations, such as embezzlement, and third-party insurers certainly will not allow fiduciaries to benefit from their own misappropriation. Further, unless mandatory government insurance is imposed, the practice of fiduciaries obtaining private third-party insurance could give rise to free-riding fiduciaries who would not insure and would benefit from the reputation of those who do insure. Since the assurance to entrustors must cover the full amount entrusted to the fiduciaries (minus the entrustor's potential benefits and discounted by the probability of that loss), the cost is likely to exceed the benefits to the fiduciaries from the relationship, or the benefits to the entrustors (if the costs were passed on to them).

Arguably, fiduciaries will pass their bonding costs to entrustors in the form of fees and costs of litigating claims. However, so long as fiduciaries compete for entrustors' business, it is unlikely that all the fiduciaries' private insurance costs could be passed on in such a way. If fiduciaries could indeed transfer all their costs of private insurance to their entrustors, their bonding would become ineffective because the fiduciaries would not suffer from, or be deterred by, the prohibition. In addition, the entrustors would not be fully compensated by the insurance; in fact, they

[34] WILSON, *supra* note 24, at 102 (citing ROBERT H. FRANK, PASSIONS WITHIN REASON 99-102 (1988)).

would self-insure. Thus, self-help by entrustors is far more costly to them than the cost of self-help to contracting parties. Special rules of fiduciary law are needed to reduce these costs.

4. *Inadequate Market Discipline*

In the past thirty years, numerous scholars, especially those dealing with the duties of corporate management, have argued that the invisible hand of the market serves as a regulatory alternative to the visible hand of fiduciary law enforceable by the courts.[35] Therefore, if shareholders desire to waive the fiduciary duties that management owes to them, they ought to be allowed to do so. Because this argument is made especially with respect to public fiduciaries, it is discussed in part IV below.

B. *The Law's Response*

1. *Purposes, Policies, and Coverage of Fiduciary Rules*

Fiduciary rules address the unique problems posed for entrustors. In light of the social benefits from fiduciary relationships and the high risk of these relationships to entrustors, entrustors must be induced to enter the relationship by assurances that overcome their concern for the safety of their assets. They must be convinced that the relationship is likely to bring them net economic benefits. In other words, the opportunities for gains from expert services must in all probability outweigh the risks of loss from entrustment. Thus, the main purpose of fiduciary law is to reduce entrustors' risk from embezzlement of their entrusted property or interests, and to reduce the costs of monitoring fiduciaries.[36]

If we view fiduciary law as a prohibition against taking what is not one's own and against acting negligently, then the duties that the law imposes arise when a person undertakes to perform a service effectively and takes property, or accepts power solely for that purpose.[37] That is why it does not matter whether the rela-

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[35] For a discussion of public fiduciaries including corporate management see *infra* part IV. These markets include the market for corporate control, the market for corporate financing, the market for executives, and the market for the products of the particular corporations. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

[36] In contrast, the main purpose of contract law is to provide a regime for enforcing and sometimes modifying mutual obligations to which the parties agreed in contract.

[37] The less important issue is whether he performs his services well. This may be

tionship arose in connection with other legal arrangements or in isolation. The relationship may arise as an incidence of contract, trust, will, statute, charter, election, or without any legally binding arrangement.[38] Fiduciary law is triggered merely by the fiduciary's consent to provide services, coupled with entrustment.[39] If my friend Smith agrees to represent me in a legal transaction without remuneration, he becomes my fiduciary and fiduciary law is triggered by his consent.[40] If he is negligent in his representation, he will be liable to me for my losses; if he uses for his own benefit the information that I had given him, he will be both liable for my losses and accountable to me for his profits. What is necessary to trigger fiduciary law is the entrustment of power or property in connection with his services: this is precisely the situation that poses risks for me which the law is designed to reduce.

Furthermore, Smith's right to payment for his services must be

because carelessness is less intentional, and the potential losses from it are lower than those from embezzlement. The main thrust of fiduciary law is therefore to prevent him from misappropriating another person's valuables.

[38] Fiduciary rules do *not* cover the process by which a fiduciary relationship is established. For example, a trust can arise by a will or a trust instrument. An agency can arise in connection with an employment contract, but not every agency is accompanied by an employment contract and not every employment contract constitutes an agency. An office and its attendant fiduciary relationship can arise from election or appointment, by private parties or by law; it can be accompanied by an employment contract, but need not be. *See* Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 290 (Minn. 1981) ("In order to create an agency there must be an agreement, but not necessarily a contract between the parties."). In contrast, contract rules determine conditions under which contract relationships are established.

[39] Like a party to a contract for service or labor, a fiduciary can always resign and decline to serve, even in breach of contract. It is unclear to what extent the party will be liable for the breach. *But see* Investment Company Act of 1940, 15 U.S.C. § 80a-26 (1994) (prohibiting trustees of unit investment trusts to walk away from such trusts unless the trusts are managed by alternate trustees). Section 26 of the Investment Company Act of 1940 was necessary because some trustees walked away from the trusts and caused losses to investors by leaving the funds without management. *See* S. Rep. No. 1775, 76th Cong., 3d Sess. 8 (1940); *see also* H.R. Rep. No. 2639, 76th Cong., 3d Sess. 22 (1940). In addition, under this section, the trustee must be an incorporated bank rather than an individual. 15 U.S.C. §80a-26(a)(1).

The consent of the entrustor to the relationship is usually required, but not always. For example, in the case of executor and administrator services of a trust, the consent of the fiduciaries, but not the entrustors, is required. Fiduciary relationships can arise even if the fiduciary's promise to serve is made to a third-party other than the entrustor. This may be one reason why fiduciary duties must be established by law.

[40] Although both contract and fiduciary relationships require at least two parties, contract requires mutual promises and a measure of reciprocity that fiduciary law does not require.

derived from some other legal source, such as a contract or statute or the doctrine of *quantum meruit*. Fiduciary law properly offers no right of payment, just as the torts of fraud and negligence do not entitle people to payment for acting honestly (not fraudulently) or carefully.[41]

In light of those policies and purposes, it is not surprising that the breach of the fiduciary duty of loyalty almost always constitutes fraud and that the remedies for breach of this duty are both compensatory and punitive.[42] Because, as pointed out earlier, fiduciary law is akin to the criminal law of embezzlement and the tort of conversion,[43] the dividing line between mandatory and default rules, as well as the treatment and policy underlying default rules in embezzlement and conversion, could help guide the treatment of fiduciary rules.

2. *Reasons for the Differences Between Contract and Fiduciary Rules*

The numerous differences between fiduciary law and contract law can be explained in a number of ways. First, because fiduciary law is aimed at reducing the entrustors' risks, the law regulates mostly the fiduciaries. Contract law regulates both parties equally.[44]

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41 Once he consents to act, a fiduciary is bound by fiduciary duties even though he was promised nothing in return. A fiduciary is not entitled to any consideration, except perhaps quantum *meruit*. *See, e.g.*, AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 174, at 466 (4th ed. 1987):

> The trustee is held to the standard of a man of ordinary prudence, *whether he receives compensation or whether he acts gratuitously*. . . . [T]he courts have ordinarily fixed a higher standard for bailees and agents who are compensated than they have fixed for those who act gratuitously. There is no similar distinction, however, as to trustees. (emphasis added).

Similarly, if directors agree to serve, their role does not entitle them to any consideration. They must find another legal basis for this entitlement.

42 *See, e.g.*, Ong Int'l (U.S.A.), Inc. v. 11th Ave. Corp., 850 P.2d 447, 453 (Utah 1993) (finding that a release will be voidable if it is part of a scheme to defraud). In fiduciary relationships silence may constitute fraud. In contrast, deterring breach of contract is not the primary purpose of contract law, especially not with respect to breaches of contract that are economically efficient. E. ALLAN FARNSWORTH, CONTRACTS § 12.3 (2d ed. 1990). Remedies for contract breaches are compensatory, rather than punitive. *Id.* § 12.8. Breaches of contract per se do not constitute fraud. Lavery v. Kearns, 792 F. Supp. 847, 864 (D. Me. 1992).

43 *See supra* text accompanying notes 11-12.

44 Therefore, a relationship can consist of both contract and fiduciary law, and to the extent that fiduciary relationships are also contractual, both sets of rules will apply to them. However, when the two regimes conflict, fiduciary rules will prevail in order to protect the entrustor.

Second, although most types of fiduciary relationships are grounded in the consent of both parties, fiduciary law is triggered primarily by the consent of the fiduciary to serve. Trusts, for example, require the consent of the trustee and trustor only, but not of the beneficiary. Contracts require, in all cases, the consent of all parties.

Third, fiduciary law is easily applicable because entry into fiduciary relationships involves low costs, requiring no formalities or special conditions.[45] These requisites are far less formal than the requisites for contract.

Fourth, because fiduciary law addresses the entrustors' risks from relationships, the rules dictate how fiduciaries should behave. Contract rules are far less intrusive.

Fifth, because entrustors' risks from the relationship vary, fiduciary rules that address these risks vary more than contract rules.

Sixth, the focus on the entrustor's potential harm from the relationship explains the ascendancy of fiduciary rules over other legal arrangements. Because the private arrangements and other rules that govern the relationships are not deemed sufficient to protect entrustors, fiduciary law is superimposed on the other rules.[46]

In sum, contract and fiduciary regimes are triggered in different ways. Fiduciary rules are triggered upon the fiduciary's consent to serve and acceptance of property or power, or solely upon his consent to perform fiduciary services. The rules apply regardless of other applicable legal relationships, and are appended to any other such relationships. In contrast to contract, there are no formalities for establishing fiduciary relationships. Whether and what formalities apply depend on other areas of the law.

3. *Entitlement to Trust and Rely*

The two building blocks of fiduciary law—the duty of loyalty

[45] If real estate is transferred to the fiduciary, the transfer may require formalities under the law governing real estate transfers. If a trust or guardianship or executorship is established by will, certain formalities must be observed. But these formalities relate to the kind of property that is transferred or to the writing of a will, not to the fiduciary relationship that is established.

The policy of encouraging people to interact within fiduciary relationships may be stronger than the policy of encouraging people to interact within contracts or relationships that require even greater formalities, such as marriage.

[46] Analogously, the rules prohibiting larceny and negligence are superimposed on rules governing the legal relationships in which larceny and negligent behavior may arise.

and the duty of care—constitute "reliance rules."[47] They entitle entrustors to trust and rely on fiduciaries' honesty.[48] The very word "trust" means a *justifiable belief without need of proof*, including a belief in the existence of affection and commitment on the part of another person.[49] Although courts sometimes describe entrustors as persons who actually trust their fiduciaries, courts have not required such actual trust as a basis for finding

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[47] Another group of fiduciary law rules implements the two duties. This group imposes on fiduciaries specific duties designed to reduce the temptation to misappropriate. *See, e.g.*, SCOTT & FRATCHER, *supra* note 41, § 170, at 311 ("[the fiduciary] is not permitted to place himself in a position where it would be for his own benefit to violate his duty to the beneficiaries."). At section 170.2, the commentators state, "Courts of equity have felt that it is only by imposing a strict rule like this that all temptation to the trustee to act in his own interest . . . can be removed. The same rule is applied to other fiduciaries." *Id.* at 323.

The rule that requires the trustee to segregate trust property from his own and earmark the property as trust property is designed to give notice to the trustee's creditors that the property is not available to pay his bills. I believe that these rules also serve a psychological function, to remind the trustee whenever temptation arises that the property is not his.

[48] The nature of reliance in fiduciary duties, particularly in the advisory context, is not simply a "wholesale substitution of decision-making power from the investor to the advisor . . . [but rather whether] the decision is effectively that of the advisor . . . ." The former is too restrictive whereas the latter admits the peculiar potential for overriding influence of the advisor to the entrustor. The law's intervention, among other things, "foster[s] the fair and proper functioning of the investment market . . . ." Hodgkinson v. Simms, 117 D.L.R. 4th 161 (1994).

See, e.g., Bassan v. Investment Exch. Corp., 524 P.2d 233, 238 (Wash. 1974):

> The articles give the general partner the authority to conduct 'any and all of the business of the Partnership . . .' Once the limited partner has joined the partnership he has no effective voice in the decision-making process. *He must, then, be able to rely on the highest standard of conduct from the general partner.* Any deviation from this must be clearly stated in terms that would give the limited partner the option of deciding whether or not, in the first instance, to join the partnership. (emphasis added).

[49] *See* THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 1378 (1969) (trust means "firm reliance on the integrity, ability, or character of a person or thing"); RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 2031 (2d ed. unabridged 1987) (trust implies "reliance on the integrity, strength, ability, surety, etc., of a person or thing"). Trust, therefore, implies that it is wrong to hide facts that make these beliefs untrue. The features common to the synonyms for "trust" are: (1) justifiable assumption without proof (acceptance, belief, and faith); (2) assumption that there are no hidden facts that must be discovered; (3) certainty: confidence and conviction describe both a belief and a certainty in that belief; and (4) assumption of devotion on the part of another: loyalty, allegiance, constancy, and devotion, fealty, and fidelity (devotion includes affection, adoration, and commitment). The antonym of "trust" is treachery: betrayal, disloyalty, and falseness (the opposite of truth and genuineness). A treacherous person is a person, justifiably assumed trustworthy, who wrongfully and secretly renders this assumption false. *See id.* at 2015.

fiduciary relationships and attendant duties. Fiduciaries should be *trustworthy*, not necessarily *trusted*. Even distrustful and sophisticated entrustors, who can fend for themselves, should be entitled to rely on their fiduciaries.[50] The extent of the justifiable trust depends on the extent to which the particular relationship requires reliance, and not on the state of mind of the particular entrustors. Because courts require fiduciaries to perform their services in the interest, and for the benefit, of the entrustors,[51] judicial decisions give the impression that fiduciaries are required to deny their own interests and at their own expense to benefit others. Thus, in *Meinhard v. Salmon*, Justice Cardozo said: "[the defendant] had put himself in a position in which thought of self was to be renounced, however hard the abnegation."[52] The language of the decision may suggest that fiduciaries must be *altruistic*.[53] A closer look at the substance of the duties, however, suggests otherwise.

By "altruistic" I mean: persons who (1) willingly and without compulsion (2) give their entitlements to others, or (3) give up the entitlements by denying themselves. Fiduciary law is replete with images of truly altruistic and trusted persons, such as priests and parents. The images are comforting to entrustors. Both priest and parent are committed to giving. The parent is committed to give to, rather than take from, the child. The priest has renounced worldly goods, that are usually at stake, and adopts the paternal image, even calling his parishioners "children." This language and the mantle of sacrifice in which the courts wrap fiduciaries may have a salutary effect on the cost of enforcing fiduciary duties.

Yet fiduciaries occupy neither the position of parents nor that

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50 Bennett v. Newark Milk & Cream Co., 156 A. 4, 6 (N.J. Ch. 1931), *aff'd*, 162 A. 580 (N.J. Eq. 1932).

51 *See* Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928). Judge Cardozo, then Chief Justice of the New York Court of Appeals, declared:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Id. at 546.

52 *Id.* at 548.

53 In a 1983 article, I used the language of altruism perhaps too broadly to describe substantive fiduciary duties, not merely image. Frankel, *supra* note 25, at 830. Upon reflection, I would limit this statement.

of priests. Fiduciaries are required to identify with the interests of entrustors *only to the extent that the fiduciaries exercise dominion over the entrustors or their property*, and to a lesser extent, with respect to the quality of their services. The starting point of the fiduciary relationship is the vesting in a fiduciary someone else's property or power for a defined purpose (to enable the fiduciary to perform his service to the entrustor). The "goodness" expected of fiduciaries consists of refraining from taking what is not theirs, without permission. Fiduciaries must meet the obligations even if the entrustors do not police their activities. This is *honesty, not altruism*.[54]

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[54] Sometimes commentators and courts seem to meld the distinct aspects of "good faith" embodied in fiduciary duties and contract. Indeed, the two concepts rub shoulders. *See* A. Brooke Overby, *Bondage, Dominion, and the Art of The Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation*, 61 FORDHAM L. REV. 963 (1993) (reviewing judicial decisions and literature on lenders' liabilities). Examining the relation between the two, Overby wrote:

> A contractual moralist would assert that good faith and principles of contractual morality preclude[ ]. . . abuse of [lenders'] power . . . . Interpretivists would look deeply into the parties' agreement and the term[s] . . . to assess whether . . . [the] behavior contravened . . . the parties' reasonable expectations . . . . Relationists would examine the parties' relationship . . . to determine the normative framework governing the relationship. Yet, the law and economics approach focuses on issues that more concisely identify where [the defendant] went wrong . . . . [T]he effectiveness of express terms approach to good faith, which gives terms in lending agreements their commonly understood meaning and prohibits only opportunistic behavior, protects borrowers from egregious lender behavior while also providing standards which lenders can conform their actions. Beyond that, other legal protection to parties in lending agreements ought to be furnished by traditional contract law doctrines such as modification, estoppel, waiver, and unconscionability rather than the noble, yet unworkable, concept of good faith.

Id. at 1028.

Indeed, "good faith and fair dealing" can be expanded to include all fiduciary duties whenever contract vests power in one party over another. The duty of fair dealing and fiduciary duties are similar. In each case the parties receive powers or property for a limited purpose. The duties differ, however. The duty of fair dealing aims at curbing abuse of power that the contract relationship can create *for each party* to *protect the interests of, and benefitting, the empowered party*. Fiduciary duties aim at curbing abuse of power and misappropriation of property that *one party* to the relationship (the fiduciary) receives for the purpose of *enabling the fiduciary to perform its services* for the other party (the entrustor). A contract party abuses its powers not by extracting benefits for itself but only by extracting unreasonable additional benefits. A fiduciary abuses its power by appropriating any benefit for itself.

As of the late 1960s, courts imposed upon lenders liabilities for breach of contract for not dealing fairly with borrowers, and tended to expand the concept. *See generally* HELEN DAVIS CHAITMAN, THE LAW OF LENDER LIABILITY (1990); DENNIS M. PATTERSON, GOOD FAITH AND LENDER LIABILITY: TOWARD A UNIFIED THEORY

Arguably, honesty and altruism overlap. Fiduciaries are required to be altruistic because they must abide by their promises under all circumstances,[55] denying themselves benefits that contract parties have, including the right to efficient breach. Even so, the fiduciaries' altruism is rather "thin." They enter the relationship willingly subject to a regime different from contract. Second, even if they do give up something, they give up little. Both fiduciaries and contract parties are prohibited from misappropriating what does not belong to them. The main difference between the two regimes is therefore in policing enforcement. As compared to contract parties, fiduciaries must impose more rigorous self limitations.

The entrustors' entitlement to trust their fiduciaries is crucial to understanding the rules and the process governing bargaining around, and waiver of, fiduciary duties. The distinction between entitlement to trust in fiduciary law and *caveat emptor* in contract law explains the different processes governing waiver of obligations. Contracting parties expect to be on their guard when the other parties seek waivers of obligations; justifiably, entrustors have the opposite expectation. They must therefore be disabused of the notion that their fiduciaries are trustworthy in bargaining with them for changes or waivers of the fiduciaries' duties.

Arguably, the very request by a fiduciary for waiver of his duties could constitute a violation of these duties. Even if fiduciaries may make such requests, the nature of the relationship requires that the parties follow a unique procedure when they bargain around these duties, particularly when the entrustors waive the duties. This procedure differs from a contract bargain.[56]

(1990). We can test the lenders' status by asking whether the powers entrusted to the lenders in the loan agreements were given for the purpose of enabling them to serve the borrowers. If that purpose was to protect the lenders' interests rather than facilitate their services to borrowers, the lenders are not fiduciaries, and their abuse of contract powers should be more limited than those of fiduciaries.

55 For example, under fiduciary law, fiduciaries may not claim "efficient breaches." Even if they could use the money entrusted to them in a more productive manner than the way in which their entrustors may use this money, they are not entitled to misappropriate this money and compensate the entrustors according to the lower return. Contract parties may do so, at least according to the theories of efficient breach. *See* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW & ECONOMICS 31-34 (2d ed. 1989); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 117-18 (4th ed. 1992).

56 *See infra* part III. Of course, if we understand "contract" to include all con-

II

FIDUCIARY RULES AS DEFAULT RULES

A. Characterization

At first blush, fiduciary rules appear to be essentially mandatory rules, similar to criminal and many tort rules, aimed at deterring fiduciaries from violating their duties to their entrustors.[57] The timing and manner of articulating the rules support this first impression. The rules are varied, fact-specific, and developed at the adjudication stage, and that makes it more difficult for the parties to bargain around the rules. A closer examination, however, suggests that under certain circumstances fiduciary rules serve both as default terms for the parties and as deterrence against misbehavior.

There are good reasons for viewing fiduciary rules as default rules and for enforcing the parties' bargain around them. We should start with a presumption that rules are default rules. This presumption is based on our philosophy that people ought to be free to govern their relationship unless good reasons exist to impose mandatory rules on them. Default rules can be justified also as reducing the parties' costs of planning and transacting by providing a measure of uniformity and stability, and by filling gaps that the parties failed to address in their initial bargain. The rules are presumed to represent the terms to which most parties

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sents, promises, and agreements, then fiduciary relationships will constitute "contracts." Contractual relationships are usually consensual, requiring at least the fiduciary's consent to serve. Yet, regardless of definition, contractarians argue for the application of the law of contracts to fiduciary relationships. Therefore, I take contractarians at their word, and define "contract" in its legal sense.

Classification can become smoke and mirrors. Arguably, the prohibition on misappropriation of entrusted property and power constitutes an implied contractually binding promise. Theft can also find itself in the contract category as an implied social contract by each member of society not to take another's property without permission. Clearly, contract rules could be similar to, or include, fiduciary rules in situations in which fiduciary rules ought to apply. Then we would include under contract a subcategory of rules applicable to fiduciary relationships. The reason we do not is that fiduciary law applies to relationships that need not constitute contracts, such as the occupation of an office or trust law.

Similarly, the expectation of high quality fiduciary services can constitute an implied contract promise by the fiduciary. The entrustor's risk from misappropriation and his high monitoring costs will then become a risk of breach of a contract. Such a construct would not entitle the entrustor to trust the fiduciary, and would offer the entrustor fewer and weaker remedies than fiduciary law currently affords him.

[57] *See* Frankel, *supra* note 25. Fiduciary law more nearly resembles tort law than contract law with its focus on duties and balancing.

would agree had they negotiated the terms. If the particular parties wish to deviate from the default rules, they should be free to bargain around them.

There is a special reason for allowing the parties to bargain around the prohibition on a fiduciary from dealing with his entrustor's property in conflict of interest. This reason parallels the reason for recognizing the parties' bargain around the prohibition on larceny, embezzlement, and conversion. A taking of property is a wrong if, and only if, the owner does not consent to the taking.[58] Lack of the owner's consent constitutes an element of the wrong, be it larceny or a fiduciaries' misappropriation of entrusted property and power. Thus, fiduciaries accused of misappropriation can plead the entrustors' consent to the taking as a defense to liability for breach of a duty of loyalty.[59]

B. *Boundaries*

Part of the confusion and disagreement about bargains around fiduciary duties can be eliminated by distinguishing between (1) the regulation of the *initial establishment* of fiduciary relationships—ascertaining the fiduciaries' functions, and the powers with which they must be entrusted in order to perform these functions; and (2) the regulation of fiduciaries *once they acquire the powers*, designed to reduce the entrustors' risks from the

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[58] If the entrustor consented before the fiduciary took the property, the entrustor has not committed a wrong. If the entrustor's consent was obtained after the taking, it is not clear whether the consent cured the wrong or merely eliminated the consenting party as plaintiff. This distinction may have practical implications if, for example, the consenting entrustor transferred the property by sale or operation of law to a nonconsenting party and the court determined that the transferor's consent was not binding on the transferee. *See* SCOTT & FRATCHER, *supra* note 41, § 216, at 330:

> The consenting beneficiary cannot complain even of acts that would constitute a violation of the duty of loyalty . . . although in such cases the transaction will be set aside not only if the trustee fails to disclose all relevant facts but also where the transaction is not in all respects fair to the beneficiary.

[59] *Cf.* LAFAVE & SCOTT, *supra* note 41, § 5.11, at 687 ("Consent of the victim is a defense only when it negatives an element of the offense or precludes infliction of the harm to be prevented by the law defining the offense."); SCOTT & FRATCHER, *supra* note 41, § 170.13, at 357. On this point contract and fiduciary rules coincide. Because contract rules aim to bring the terms of the agreement to closure, a change in the explicit or implicit default terms requires the consent of both parties. Because fiduciary rules aim to reduce the entrustors' risks of fiduciaries' misappropriation, by definition, the entrustors' consent is required to permit the fiduciaries from appropriating what was entrusted to them. Thus, in both situations, a change in the "rules of the game" or waiver of these rules requires the affected parties' consent.

relationship.[60]

Fiduciary law does not regulate the parties' behavior in establishing the terms of the relationship. A would-be fiduciary does not owe a would-be entrustor any fiduciary duties. If the fiduciary relationship arises in conjunction with another legal relationship, the bargain concerning these functions and entrusted powers is governed initially by the law governing that legal relationship. A will establishing a trust must conform to the laws governing the establishment of wills. If real estate property is transferred in trust, the formalities of real estate transfer must be satisfied. However, the rules applicable in all cases of fiduciary relationship whether or not other relationships are involved, are the rules governing consent, including rules on capacity, undue influence, mistake, fraud, and duress.

In one respect fiduciary law governs the establishment of the relationship. While the parties set forth the terms of the relationship, the courts classify the relationship as fiduciary, following definitions of the classification and subclassifications (e.g., agency, trust, directorship). This is similar to the classification of enforceable contracts.[61]

Once the relationship has been established and the power has been entrusted, fiduciary rules apply. They can serve as default

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60 At the outset, a clarification is in order. Is it accidental that contract default rules are viewed as rules around which contracting parties may *bargain*, while fiduciary duties are viewed as duties toward entrustors that the entrustors may *waive*? Are these rules the same? "Bargain" implies active negotiations between the parties culminating in a contract of mutual exchange with consideration. The outcome of a bargain is not necessarily identical to the initial offer. A "waiver" implies a gift and a one-sided consent to give up something that is due—a unilateral release by one party upon the request of another. Waiver of a right is not negotiable—it is either granted or denied.

In fact, however, a waiver may be compensated and a contract under seal may be a binding one-sided waiver. The two are the same, for our purposes. Presumably, in most cases, a party will not waive its rights without being asked and without some expectation of benefits. In any event, parties can bargain around fiduciary duties both by mutual exchanges and by uncompensated waivers, both before and after a breach, much as an owner's consent to the taking of his property by another may be binding as a sale, a lien, a lease, or a gift. *See* SCOTT & FRATCHER, *supra* note 41, § 170.1, at 319-20 ("A gift of trust property by the beneficiaries to the trustee is . . . not necessarily voidable by them, but will be set aside if the gift was induced by the exertion by the trustee of influence arising by reason of the trust relationship.").

One caveat is in order, however. The difference between waiver and bargain suggests a difference in emphasis and image. An entrustor is not invited to negotiate a bargain; he is asked to waive a right.

61 On whether the classifications are default rules, see *infra* part IV.

rules only if the process by which the parties bargained around them satisfies specific conditions unique to this area of the law.

C. *Conditions for Bargaining Around Fiduciary Rules*

A bargain around fiduciary default rules consists of not one, but two bargains. The main one is the bargain around the rules. The other, however, must precede it: it is the bargain around the right of the entrustor to rely on and trust his fiduciary. To bargain with his fiduciary, the entrustor must fend for himself rather than rely on his fiduciary. Thus, the first bargain will change the relational mode in which the parties operate. If the conditions for the change are met, then, and only then, can the entrustor bargain as a contracting party.[62]

In order to transform the fiduciary mode into a contract mode, four conditions must be met: (1) entrustors must receive notice of the proposed change in the mode of the relationship; (2) entrustors must receive full information about the proposed bargain; (3) the entrustors' consent should be clear and the bargain specific; (4) the proposed bargain must be fair and reasonable.[63]

Thereafter, two other general bargaining conditions apply. One relates to consenting parties: entrustors must be capable of independent will.[64] The other relates to the subject matter of the

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62 *See infra* part III for a discussion on mandatory fiduciary rules. For instance, lawyers cannot disclose confidential client information "unless the clients consent *after consultation*." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983) (emphasis added). Lawyers cannot represent clients whose interests would be adverse to other clients "unless each client consents *after consultation*." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 (1983) (emphasis added). This consent is not fully operative, however. Lawyers, even with both clients' consent, should not act on such consent if a disinterested lawyer would conclude that the client should not agree to representation. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 cmt. 2 (1983).

63 The rationales for this requirement are discussed *infra* parts II.C.1.a-.d.

64 SCOTT & FRATCHER, *supra* note 41, § 170.1, at 317-18:

> Where the beneficiaries are all sui juris and consent to the sale, it cannot be set aside if the trustee made a full disclosure and did not induce the sale by taking advantage of his relation to the beneficiaries or by other improper conduct, and if the transaction was in all respects fair and reasonable. On the other hand, the sale can be set aside if the trustee did not make a full disclosure, or if he improperly induced the sale, or if the transaction was not fair and reasonable.

Id. § 216, at 326-31, 344-48 (footnote omitted).

My analysis in this Article is very similar to that used previously by Professor John C. Coffee, Jr. *See* Coffee, *Judicial Role*, *supra* note 8, at 1661-64, 1671-74, 1689; *see also* Coffee, *No Exit*, *supra* note 8.

bargain: the proposed bargain must not cover non-waivable duties. These duties are discussed in part III.

1. Changing the Relational Mode

a. Notice

Because entrustors are legally entitled to trust and rely on their fiduciaries, fiduciaries who seek waivers of their fiduciary duties must put entrustors on notice that the entrustors can no longer rely on them in the matter, and that the entrustors must assume full responsibility for defending their own interests. In their notice, fiduciaries must identify the proposed waiver of duties about which the parties will bargain.[65] Notice may consist of words or actions.[66]

b. Information

Fiduciaries must provide entrustors material information necessary for the entrustors to make an informed decision regarding the waiver.[67] This is necessary because, in contrast to contract law, there is no assumption in fiduciary law that the parties' information about the proposed waiver or bargain is symmetrical. Asymmetrical information among the parties to a fiduciary relationship results both from the nature and from the purpose of the relationship. Fiduciaries possess far more information about their own activities. Entrustors and fiduciaries are not equally equipped to make a cost-benefit analysis of the contemplated change in their relationship. In reality, entrustors can seldom perform such an analysis because they lack accurate information to make it.[68] Therefore, when the fiduciaries possess information

[65] SCOTT & FRATCHER, *supra* note 41, § 170, at 312.

[66] Thus, although partners are fiduciaries of each other, when their relationship becomes adversarial and they deal with each other at arm's length, the fiduciary duties they owe each other are deemed extinguished. Ong Int'l (U.S.A.), Inc. v. 11th Ave. Corp., 850 P.2d 447, 454-55 (Utah 1993).

[67] *See* SCOTT & FRATCHER, *supra* note 41, § 170.1, at 318-19 ("The trustee owes a duty of disclosure even though the relations between him and the beneficiary are such that the beneficiary is not likely to repose confidence in him."); *id.* § 496, at 500 (stating that when a trustee purchases trust property with the beneficiary's consent:

> [T]he transaction cannot be set aside by the beneficiary if he was not under an incapacity, and the trustee made a full disclosure to him, and did not induce the sale by taking advantage of his position or by other improper conduction, and if the transaction was in all respects fair and reasonable.).

[68] *See Ong Int'l*, 850 P.2d at 454-55 (finding that a partner who has decidedly more information than the other owes the other a fiduciary duty of disclosure, and his silence under these circumstances constitutes fraud). If a physician prescribes

in connection with the bargain, and especially if the information has come to them by virtue of their position as fiduciaries, the change of the relationship mode must be accompanied by the fiduciaries' disclosure of this information to the entrustors.[69]

c. *Clarity of Consent and Specificity of the Bargain*

The entrustors must clearly consent to waive or bargain around the fiduciaries' duties towards them, and their awareness must be sharper than contract parties' awareness when they waive contract obligations owed to them.[70] That is because, by waiving fiduciary duties, entrustors always give fiduciaries something of value. For example, consent to breach the fiduciary duty of loyalty (misappropriation) can provide a defense for fiduciaries—negating a necessary element of a wrong, and the existence of a wrong.[71] Whether entrustors receive something in return is less clear and depends on their ability to sever the umbilical cord

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drugs to a patient and directs the patient to a pharmacy owned by the physician, the physician might be posing unknown health risks and secret economic injury to the patient-entrustor by prescribing a more costly drug. If a director robs his corporation of a business opportunity, it is difficult for the affected shareholders to evaluate their loss before the fact.

One should note that disclosure in the process of bargaining around fiduciary rules is not identical to the rule that fiduciaries must report on their activities to entrustors. A duty to report is a preventive duty, similar to the duty to earmark trust property. A duty to report may be statutory or implied from the parties' relationship. A duty to disclose conflicts of interest relates to the parties' bargain around the rules and the entrustors' waiver of their rights against their fiduciaries.

69 Clearly, the information should be disclosed in a reasonably objective format to reduce the risk that the entrustor's consent will be provided because of the biased format.

70 *See, e.g.*, Public Serv. Co. v. Chase Manhattan Bank, 577 F. Supp. 92, 102-03 (S.D.N.Y. 1983):

> New York courts construe exculpatory provisions narrowly to avoid erosion of the fiduciary duty . . . . [A] trustee will be 'relieved of liability . . . only to the extent to which it is clearly provided that he should be relieved.' . . . Cases finding a contractual waiver of the prudent investor standard have typically relied on contractual language . . . that the trustee shall not be liable for losses resulting from the imprudent exercise of that discretion (citations omitted).

See also Cincinnati Ins. Co. v. Gill Erection Co., Nos. 92 C.A. 162, 165, 166, 1993 WL 428679, at *2 (Ohio Ct. App. 1993) (in upholding the contract parties waiver of rights to damages covered by insurance, the court emphasized that the waiver was "clear, concise and in no way ambiguous."). *But see* Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986).

71 LAFAVE & SCOTT, *supra* note 11, § 5.11.

with their fiduciaries, as well as on their bargaining capabilities.[72] The requirement of clarity relates to the condition that the bargain be fair and reasonable. This condition, in turn, is grounded in a rationale, derived from contract law, suggesting that if the bargain is highly unfair and unreasonable, the consent of the disadvantaged party is highly suspect. Experience demonstrates that people rarely agree to terms that are unfair and unreasonable with respect to their interests.[73] Because the bargain or waiver is more likely to be in the fiduciaries' interests, but less likely to be in the entrustors' interests, the consent, by entrustor's action or inaction, must be clear.[74]

To ensure clarity, default rules should be as specific and precise as possible. Fiduciary duties of loyalty and care, however, are broad standard rules. Therefore, the bargain around these duties must carve out explicit and specific situations. A number of reasons can be offered for requiring specificity. First, specific rules are efficient for the parties' planning and for bargaining around the rules. Second, specificity is necessary to avoid misunderstandings among the parties. Third, in many cases, a broad waiver of duties is bound to be uninformed and speculative.[75] Waivers of specific claims or level of losses will be more readily upheld. For example, if the fiduciary relationship is an escrow, waiver of particular conditions in advance would likely be upheld because the conditions of the initial relationship are fairly specific, and the waiver will be specific. Fiduciaries may also have better luck enforcing waivers of specific fiduciary duties *after* vio-

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72 Rules in fiduciary law, such as the business judgment rule, shield fiduciaries from liability. However, the parties rarely, if ever, bargain around this rule.

73 Another rationale on which the requirement of fairness and reasonableness is grounded relates to consent given by surrogates for entrustors, such as the courts, or fiduciaries subject to judicial supervision, such as independent directors or the majority of the disinterested shareholders. In this case the standard of fairness and reasonableness is necessary because, unlike the entrustors, courts and fiduciaries subject to judicial supervision cannot consent arbitrarily. All these surrogates must be accountable and must give reasons for their consent. Reasons require standards and criteria by which they will be judged. *See infra* part II.C.1.d.

74 *See, e.g.*, State *ex rel.* Gozenbach v. Eberwein, 655 S.W.2d 794, 796 (Mo. Ct. App. 1983) (stating that a binding implied waiver of a statutory physician-patient privilege requires that the party be clear, unequivocal, and decisive regarding the waiver); Industrial Loan & Inv. Co. v. Superior Ct., 209 P. 360 (Cal. 1922) (finding that a waiver of privilege under the bankruptcy statute cannot be effectuated by prospective contractual stipulations); Victor Brudney & Robert Charles Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981).

75 Therefore, a broad waiver of fiduciary duties *ex ante* in the trust instrument, or thereafter, is likely to be struck down as uninformed. *See infra* part IV.

lations have occurred. Their chances are improved because the nature and extent of the violation are easily ascertainable, and because the entrustors' bargaining position is stronger. Similarly, waivers of bonding requirements by executors, especially family members or friends of the testator, are likely to be upheld because the testators presumably knew the executors well, and because the waivers are specific and limited to a particular function. A broad waiver of the underlying duties of the executors, however, might not be enforced.[76] Similar reasons apply to waivers of the duty of loyalty in other contexts.[77] Overall, the courts are not likely to uphold bargaining around the *broad duties* of fiduciaries far *in advance* when the fiduciaries have substantial discretion over the entrustors' power or property.

In sum, if the specific procedures and conditions of fiduciary law are followed and entrustors consent to the bargain, the fiduciaries' duties will be changed or eliminated pursuant to the bargain. There should be no objection to the contractarian argument for opting out of fiduciary duties in these circumstances.

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[76] Presumably, if asked, entrustors would have waived their rights to sue their fiduciaries for negligent services that caused a loss of one dollar, but would hesitate to waive if the negligence were to cause losses of a substantial amount of assets, and would probably refuse to waive their rights on a loss of all the entrusted assets.

If the waiver related not only to mere negligence but to gross negligence as well, the legal effect of this waiver would be even more questionable. It would be extremely doubtful that the beneficiary would have contemplated all the situations and rights that he had so broadly waived. *Cf.* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1921 (1991) (making a similar point with respect to tort claimants).

[77] *See, e.g.*, Bassan v. Investment Exch. Corp., 524 P.2d 233 (Wash. 1974) (en banc) (holding that a general partner who sells real estate that he owns to the limited partnership must notify the limited partners to whom he owes a duty of loyalty of the particular property he sold and the profits he made on the sale, despite the fact that the limited partners had agreed to such sales in conflict of interest in the past with respect to particular properties). *But see id.* at 239 (Rosellini, J., dissenting) (finding that the pattern of consents by the limited partners was sufficient to cover this particular sale: Because "[n]o authority is cited" for the propositions that (1) partners are not bound by an agreement, (2) the general partner "may make a fair and reasonable profit on a transaction with the partnership unless the agreement spells out the method of determining the amount of such profit," and (3) the terms of an agreement may not be established by the course of dealing between the parties, and "if any such authority exists, it is contrary to the general principles of contract law").

In my opinion, the facts of *Bassan* might fail to support a contract because of lack of specificity. In any event, the dissent looked to the wrong body of law (contract) to resolve the issue. For a marvelous discussion of the different views of effective shareholders' consent, see Coffee, *No Exit*, *supra* note 8, at 933-36, 950-53.

d. A Fair and Reasonable Bargain

Even if above requirements are met, courts will generally not enforce an unfair or unreasonable bargain, but will require a showing that the transaction is fair and reasonable.[78] Although this requirement appears to be grounded in the reality that courts will not enforce unfair deals between fiduciaries and entrustors, the requirement is often based on a general presumption that entrustors' consent to unfair or unreasonable terms is uninformed or not independent.[79] Similar presumptions operate in other areas. Consents to tortious acts have been struck down because their substance indicated the likelihood that they were not voluntary.[80]

A second reason for doubting the voluntariness of an apparent consent to an unfair transaction could be a lingering suspicion that generally, when entrustors consent to waive fiduciary duties (especially if they do not receive value in return) the transformation to a contract mode from a fiduciary mode was not fully achieved. Entrustors, like all people, are not always quick to recognize role changes, and they may continue to rely on their fiduciaries, even if warned not to do so.[81] Lack of fairness may also signal the absence of more or less equal bargaining power by the

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[78] *See* SCOTT & FRATCHER, *supra* note 41, § 170.1, at 317-18. The fairness requirement is a new requirement that substituted the court's decision for the consent of the entrustors. Before the courts acted as surrogates for the entrustors, no such requirement was imposed because the entrustors may give consent arbitrarily, while the courts may not. *See, e.g.*, Stewart v. Lehigh Valley R.R. Co., 38 Court of Errors & Appeals 505, 523 (N.J. 1875), *reprinted in* DETLEV F. VOGTS, BASIC CORPORATION LAW 241 (1979) ("It matters not that the contract [entered into in conflict of interest] seems a fair one. Fraud is too cunning and evasive for courts to establish a rule that invites its presence."); *see also* Harold Marsh, Jr., *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966).

[79] *See, e.g.*, *In re* Boone, 83 F. 944, 957 (N.D. Cal. 1897) (it is "grossly improbable" that a client would fully understand a consent releasing his attorney from all of his fiduciary duties). In the corporate context courts might ask: Why would shareholders consent to pay corporate directors or officers more than the market price for property that the directors desire to sell to the corporation? Does the higher price represent a saving of intermediation costs, and if so, is the saving equally or fairly divided among the parties? Why would a shareholder consent to the directors' use of corporate information to enrich themselves without compensating the shareholders?

[80] *See, e.g.*, Robinson v. Moore, 408 S.W.2d 582, 583 (1966); *see also* RESTATEMENT (SECOND) OF TORTS § 61 (1965).

[81] This is the underlying assumption in the cases. *See* SCOTT & FRATCHER, *supra* note 41, § 170.1, at 315 (stating that the trustee "must not take advantage of his position as trustee by failing to make a full disclosure, by exerting improper influence because of his position, or by failing to pay an adequate price for the property.").

entrustor.[82] When the parties are sophisticated, however,[83] courts are likely to refrain from examining the content of the transactions and uphold consents, as tort cases have demonstrated.[84]

A third reason for the requirement that the bargain between fiduciaries and their entrustors be fair and reasonable relates to the role of the courts. When the courts, rather than the entrustors, determine on the merits the validity of transactions made in conflict of interest or when the courts pass on the validity of waivers by representatives or surrogates of entrustors, the courts need such standards by which to make the judgments. If the entrustors themselves consent to bargain around fiduciary duties or waive them, the courts need not pass judgment on the substance of the transaction; they only examine the quality of the consent. Although entrustors are entitled to give their fiduciaries gifts, or consent to transactions on the basis of a whim, the entrustors' surrogates and the courts cannot make decisions without standards against which their decisions (to approve the transactions or the approval of other surrogates for the entrustors) will be tested.[85]

It should be noted that even though the rules governing con-

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[82] *See* Anderson, *supra* note 1, at 760 ("Where bargaining power is roughly equal, specific fiduciary duties can be waived by the parties on the basis of full disclosure and consent by the client.").

[83] Many of the conditions for consent to the tortious behavior of another are similar to those that apply to consent to the breach of fiduciary duties of loyalty and care. *Cf.* Martin Marietta Corp. v. International Telecom. Satellite Org., 763 F. Supp. 1327, 1331-33 (D. Md. 1991), *aff'd in part, rev'd in part*, 991 F.2d 94 (4th Cir. 1992) (finding no tort liability for negligence based purely on contract—especially if the parties were equally sophisticated; and finding no duty of care absent a special relationship of trust because an existing statute demonstrates that "public policy strongly favors . . . waivers of all tort claims, including those for gross negligence"). *Id.* at 1333.

[84] *See* Hudson v. Craft, 204 P.2d 1 (Cal. 1949) (holding that consent to an unlicensed boxing match does not relieve the participant from liability); Williams v. Cox Enters., Inc., 283 S.E.2d 367 (Ga. Ct. App. 1981) (holding that an entrant who waived the right to claim injuries as a result of a footrace after being informed of all hazards in connection with the race could not sue for subsequent injuries); Hart v. Geysel, 294 P.2d 570 (Wash. 1930); Tynes v. Bankers Life Co., 730 P.2d 1115, 1123-25 (Mont. 1986) (finding that fiduciary relationship existed between an insurance company and its insured, and stating that sufficient evidence existed for jury to find that insurer waived its rights to deny coverage on grounds that insured was not an employee eligible for group health plan coverage, where insurer had made independent investigation of insured's employee status and had found insured to be eligible employee); SCOTT & FRATCHER, *supra* note 41, §§ 892, 892A.

[85] *See infra* part IV.

sents may be similar in contract and fiduciary laws, the burdens of proof regarding flawed consents differ. In contract law, the burden of proving that a transaction is unfair and unreasonable is on the party asserting that its consent to the transaction is unenforceable. In contrast, the burden of proving that the transaction in conflict of interest is fair and reasonable and therefore binding the entrustors is usually on the fiduciaries.[86]

2. *The Bargain: Entrustors' Independent Will*

To bargain in the contract mode, entrustors must be capable of independent will. If their dependence on their fiduciaries is chronic, no bargain can be reached and no waiver of fiduciary duties will be recognized. For example, if entrustors who are minors or who act under the undue influence of the fiduciaries[87] bargain around fiduciary rules, the bargains will be unenforceable. If the parties act under a mistake of fact the bargains also will be flawed.[88] Further, courts generally will not enforce waivers that are so open-ended as to suggest either fraud or lack of informed or independent consent.[89]

One may criticize this legal scheme of waivers as imposing on fiduciaries much of the cost of contracting around fiduciary rules. However, the costs are lower to the fiduciaries than to the en-

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86 The fiduciaries' burden of proving the fairness of the transaction may differ depending on the extent of their power and entrustment and the nature of the entrustors' consent. Trustees have a greater burden than agents, and agents may have a lower burden than corporate directors. *See* SCOTT & FRATCHER, *supra* note 41, § 496, at 501.

87 *Id.* § 496, at 500 (stating that when a trustee purchases trust property with the beneficiary's consent,

> the transaction cannot be set aside by the beneficiary if he was not under an incapacity, and the trustee made a full disclosure to him, and did not induce the sale by taking advantage of his position or by other improper conduct, and if the transaction was in all respects fair and reasonable).

See also FARNSWORTH, *supra* note 42, § 4.20, at 444 (stating that undue influence renders a contract voidable and may serve as a defense or as a basis of a claim in restitution); *id.* § 4.4 at 379 ("a minor's contract is "voidable" at the instance of the minor").

88 FARNSWORTH, *supra* note 42, § 9.3, at 509 (paraphrasing RESTATEMENT OF CONTRACTS (SECOND) § 152) (parties may avoid legal consequences of a contract if it can be shown that the mistake upon which both parties made the contract constituted a basic assumption, that the basic assumption had a material effect on the agreed exchange of performances, and that the party seeking avoidance of contract did not bear the risk of the assumption).

89 CORBIN ON CONTRACTS, vol. 1. § 95 (1963) (stating that "indefiniteness and uncertainty as to any of the essential terms of an agreement, have often been held to prevent the creation of an enforceable contract").

trustors because, notwithstanding the uncertainty about the rules, fiduciaries have better information about fiduciary law, about the cost (to them) of the rules that they wish to avoid, and about the transaction with respect to which they seek the waiver or consent of the entrustors. In addition, some rules reduce the fiduciaries' cost of obtaining consent.[90] In some circumstances entrustors' silence or inaction after the fiduciaries' disclosures will be deemed binding and enforceable consents.[91]

In sum, if the procedures of fiduciary law are followed, its conditions are met, and the entrustors consent to the bargains, the fiduciaries' duties will be changed or eliminated in accordance with the bargain.

III

FIDUCIARY RULES AS MANDATORY RULES. LIMITATIONS ON WAIVERS OF RIGHTS TO FIDUCIARY DUTIES

A. *Rationales for Limitations*

Even if the procedures described above are followed, and even if entrustors' consents are informed and independent, courts and legislatures might refuse to enforce entrustors' waivers, fully or conditionally. Thus, Professor Scott states:

> [E]ven where the beneficiaries consent, the transaction is not like one between persons dealing with each other at arm's length, which can be set aside only for fraud, duress, undue influence, or mistake.
>
> In a number of states there are statutes that expressly prohibit self-dealing by fiduciaries [and by] corporate fiduciaries. By the Uniform Trusts Act § 5, it is provided that "[n]o trustee shall directly or indirectly buy or sell any property for the trust from or to itself or an affiliate; or from or to a director, officer, or employee of such trustee or of an affiliate; or from or to a relative, employer, partner, or other business associate."[92]

[90] For a discussion of entrustor consent in the commercial fiduciary context, see *infra* part IV. Another example is a corporation. The corporation is the entrustor and its board of directors owes it a duty of loyalty. Therefore, the corporation's consent must be obtained for any violation of that duty. Corporate law provides for various representatives of the corporation to express the consent when the corporate statutory agent (the board of directors) is disqualified because of conflicts of interests with the corporation. The independent or disinterested directors or the majority of the disinterested shareholders can constitute such representatives. *See* JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS 415-17 (1995).

[91] *See infra* part IV.

[92] *See* SCOTT & FRATCHER, *supra* note 41, § 170.1, at 312-13.

The Act allows some waivers of fiduciary duties ex ante, and some, such as conflict of interest transactions, only after violations have occurred. Under section 18 of the Uniform Trusts Act a beneficiary

> if of full legal capacity and acting upon full information, by written instrument delivered to the trustee [can] relieve the trustee as to such beneficiary from any or all of the duties, restrictions, and liabilities which would otherwise be imposed on the trustee . . . except as to the duties . . . imposed by Sections 3, 4 and 5. . . . Any such beneficiary may release the trustee from liability to such beneficiary *for past violations* of any of the provisions of this Act.[93]

Similarly, the Model Rules of Professional Conduct regulating lawyers do not permit lawyers to opt out of certain fiduciary duties, such as (1) the prohibition on preparing instruments under which the client is granting them or their close relatives a legacy; (2) the prohibition on negotiating an agreement for literary or media rights based on information relating to representation, prior to concluding representation; (3) the prohibition on acquiring proprietary interests in a cause of action or subject matter of litigation (except for lien for fees or contingent fee); and (4) the duty of keeping clients' property separate from their own.[94]

Denial of entrustors' waivers can be based on a variety of reasons.

1. *Paternalistic Protections*

Paternalistic protections, that is, protections of members of a class regardless of their own express and clear intent, are not limited to fiduciary law. Such protections are grounded in many and diverse principles, and exist in the law of contracts as well.[95] Paternalistic attitudes can derive from the observation that most members of a particular class lack competence or sufficient bargaining power and are therefore incapable of independent consent to waive their legal protections or bargain around them.[96]

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93 UNIFORM TRUSTS ACT, §18, 7B U.L.A. 790 (1985) (emphasis added).

94 MODEL RULES OF PROFESSIONAL CONDUCT, Rules 1.8(c) (1983).

95 For a wonderful discussion of the subject, see Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983). For a discussion of waiver of consent of statutory protections in the Securities Acts, see *infra* part IV.A.1 and n.144.

96 Presumably, people who need money to survive but have no job options or few job options will agree to waive their claims against an employer for work-related accidents, no matter how dangerous the work and the machinery that they will oper-

Further, members of a protected class may be "rationally apathetic" and fail to protect themselves.[97] If the disappointment of members of a class, such as investors, can affect the system, for example, by a "run" on the financial markets, the investors' waivers may be ignored. Similarly, there is an exception to the rule that, if a crime constitutes a tort, the victim's consent to the commission of the crime is an effective bar to recovery in tort (on the assumption that the victim should not be allowed to claim compensation for the commission of a wrong to which he consented). The rule will not apply if the purpose for "criminalizing" the wrongful action was to protect the class of persons to which the consenting person belongs.[98] Courts may also refuse to enforce agreements whose substance conflicts with the fundamental protection of all members of society, such as agreements to enslave oneself, or the protection of a group of persons, such as agreements to refrain from bringing a divorce suit or a petition in bankruptcy.[99] In such cases, the consenting persons' waivers of their rights are not enforceable.

In contract law there are non-waivable rules as well. These rules can be deemed efficient because they provide standard terms;[100] those terms help prevent fraud, where the parties' information is asymmetric and the remedy of avoiding the binding relationship upon the discovery of the fraud is inadequate.[101] Similarly, in fiduciary law, the duty of loyalty is grounded in asymmetric information. Indeed, upon discovering the fraud entrustors may terminate the relationship. However, termination is less valuable for entrustors than such a remedy is for contract

ate. The wealthy can afford to place a higher value on their lives. There is also a question of whether those fortunate enough to pick safe jobs wish to live in a society in which the poor bargain their safety cheaply. *See, e.g.*, *Ex parte* Southeastern Homes, Inc., 374 So. 2d. 344, 346 (Ala. 1979) (holding that a union contract cannot operate as a waiver of unemployment benefit rights in light of a statute that avoids such a waiver); *In re* Boone, 83 F. 944, 954-57 (C.C. Cal. 1897) (finding it grossly improbable that a client would fully understand a consent releasing his attorney from all of his fiduciary duties); *see also* Securities Act of 1933, § 14, 15 U.S.C. § 77n (1994) ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."); Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a); Investment Company Act of 1940, § 48(a), 15 U.S.C. § 80a-47(a).

[97] *See infra* part IV.

[98] RESTATEMENT (SECOND) OF TORTS § 496F (1965).

[99] *See* Kronman, *supra* note 95, at 786.

[100] *Id.* at 765-67.

[101] *Id.* at 767.

parties, because under fiduciary law each party to a fiduciary relationship, except the beneficiary of a trust, can *always* terminate the relationship. By the time the fraud is discovered and losses incurred, termination is rarely a remedy. Furthermore, in fiduciary relationships fraud cannot easily be proved. In such situations, it may be more efficient to make the terms of the arrangement, such as the duty of loyalty, mandatory. Arguably, it is reasonable to assume that by their very entry into fiduciary relationships the parties have agreed in advance to limit their power to waive fiduciary duties. To the extent that we believe rational entrustors would not otherwise enter the relationship, it is important to make mandatory the fiduciary duties protecting them.

2. *Level Playing Field for Fiduciaries*

Another reason for mandatory fiduciary duties is the policy to provide fiduciaries with a level playing field, and to deter them from competing by dishonest treatment of entrustors or by providing less-than-acceptable quality of services. For example, the Securities Acts put market fiduciaries and contract actors on such a level playing field by prohibiting waivers of rights under the Acts.[102]

3. *Fundamental Tenets of Society*

The mandatory effect of some rules can be grounded in fundamental tenets of our society. Courts refuse to enforce waivers of such legal rules, regardless of the parties' desires.[103] For exam-

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102 Securities Act of 1933, § 14, 15 U.S.C. § 77n ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."); Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a); Investment Company Act of 1940, § 37(a), 15 U.S.C. § 80a-47(a).

103 For examples of congressional public policy guiding a court in evaluating the waiver of claims for tort liabilities, see Martin Marietta Corp. v. International Telecom. Satellite Org., 763 F. Supp. 1327 (D. Md. 1991), *aff'd in part, rev'd in part*, 991 F.2d 94 (4th Cir. 1992); New York State Urban Dev. Corp. v. Marcus Garvey Brownstone Houses, Inc., 469 N.Y.S.2d 789 (N.Y. App. Div. 1983) (holding, over a very strong dissent, that even though a homeowner was aware that the plaintiff had no license and can be presumed to have waived the requirement of the license, public policy requires that the waiver be ignored, and that the plaintiff be entitled to assert legal protections against unlicensed construction companies); Moore v. Regents of the Univ. of Cal., 793 P.2d 479 (Cal. 1990), *cert. denied*, 499 U.S. 936 (1991); *see also* Recent Developments, *supra* note 12, at 812-13 (stating that *Moore* involved conflicting public policy considerations, including the policy of providing in-

ple, waivers of rights for the purpose of facilitating illegal acts are unenforceable.[104] No person, whether or not compensated, may consent to enslave himself or to be hunted and killed to amuse another person.[105] In such cases, peoples' freedom of choice is curtailed to further the protections of peoples' other fundamental freedoms. Similarly, courts should not enforce waivers of fiduciary duties that result in fraud on entrustors. More importantly, I believe that like every civilized society, we must provide a legal model of a trust relationship. Broad and sweeping waivers of fiduciary duties that could undermine such a trust model should not be enforced. This notion is discussed more fully in part V of this Article.

B. *Carrying the Concept of Waivers to Its Logical Conclusion: The Parties' Choice of Legal Classification*

Until now, I discussed waivers of fiduciary duties with respect to *particular transactions*. The question is whether the concept of default rules should be expanded to cover the whole set of rules that would apply to their relationship: under what conditions, if any, should courts defer to the parties' legal classification of their relationships?[106] Allowing people to classify their actions and

centives for medical research and the policy of protecting patients; criticizing the scope of the court's view of a patient autonomy and dignity; noting that a physician need not disclose to the patient future research interests that are insignificant to the decision to recommend medical treatment; and arguing that a patient's rights should include not only the right to proper treatment but also to dignity).

104 FARNSWORTH, *supra* note 42, § 8.5; *see, e.g.*, 47 E. 74th St. Corp. v. Simon, 69 N.Y.S.2d 746, 748 (N.Y. App. Div. 1947) (per curiam) (holding that a landlord cannot waive his right to remove a tenant for conducting a business in violation of the zoning laws).

105 For an explanation of judicial refusal to enforce the party's consent in such cases, see Kronman, *supra* note 95, at 774-75 (1983).

106 For example, parties could agree that instead of fiduciary law, another body of law would govern their relationships. If they do so clearly and explicitly, courts would enforce the parties' choices. Under such a regime courts would enforce corporate charters which specify that managements will be subject to contract law and to any prohibition such as embezzlement or duty such as disclosure of conflict of interest transactions expressly provided for in the charter, but to no other fiduciary rule. Courts would also enforce charters that allow corporate management to act as they wish, and *only* be liable in tort with respect to some activities, and in criminal law with respect to other activities. Needless to say, any proposal allowing the parties to apply default rules of their choice must exclude third-party rights, unless the third parties agreed to this choice or at least were put on notice and acted to show their consent. To the extent that their choice of default rules will affect the rights of others, their choice must be subject to principles other than mere choice. *See* Kronman, *supra* note 95, at 764-65.

determine the rules applicable to them is not a revolutionary idea. Except for mandatory laws, most people do establish and live by their own rules and their own classifications of the rules. Many people do not even know, and do not care to know, what the legal rules are.[107] Further, people should be free to design their relationships as they wish, unless there is a good reason to prevent them from doing so. I believe that there are good reasons for the courts to insist that they have the last word on legal classifications.

A rule that treats a *legal classification* as a default rule and requires the courts to enforce the classification for which the parties bargained raises a fundamental question about the role of the courts in designing a legal system. Similar issues arise in cases of choice of law in contracts, but in the context of fiduciary law, the impact of the parties' choice of law on the legal system would be even greater. The parties' freedom of choice would be broader (because fiduciary law imposes greater constraints on fiduciaries than does contract law) and the impact on judicial discretion would be greater (because fiduciary law vests broader discretion in the courts than does contract law).

The default rule that we discuss here would allow people to establish a legal system under which they would relate, and would require the courts and the state to enforce this legal system. If we accept the proposed expanded default rule, the parties could trump the courts' current powers.

Presently, the courts determine the class to which legal rules, particular activities, and relationships belong, taking into account what the parties intend to do, and sometimes how the parties perceive their relationship in legal terms.[108] For example, if a trust instrument allows the trustee to do with the trust property as he wishes (e.g., give it away to whomever he wishes) and relieves him from accounting to the beneficiary, a court is likely to

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[107] *See, e.g.*, ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (describing how neighbors settle some disputes pursuant to legal rules and others pursuant to differing, non-legal rules).

[108] Emle Indus., Inc. v. Patentex, Inc., 478 F.2d 562, 574 (2d Cir. 1973) (a private party may not limit the court's power to regulate an attorney's conduct); *see* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); SCOTT & FRATCHER, *supra* note 41, at §187.4 ("Even if the settlor does intend to confer upon . . . [the trustee] power to act in bad faith, the trustee will not be permitted to do so."); *see also* Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 HASTINGS L.J. 621 (1992-93).

reclassify the relationship as a gift, notwithstanding the parties' use of the term "trust." If the broad waiver of fiduciary duties is part of the original agreement creating the trust, the court may avoid the trust as inchoate, because the agreement is not sufficiently instructive to the fiduciary. The trust will be dissolved, and the assets will revert to the estate of the trustor.[109] As one court stated in the context of determining whether a partnership exists:

> Assuming some written contract between the parties, the question may arise whether it creates a partnership. If it be complete, if it expresses in good faith the full understanding and obligation of the parties, then *it is for the court to say whether a partnership exists*. It may, however, be a mere sham intended to hide the real relationship. Then other results follow . . . . Mere words will not blind us to realities. Statements that no partnership is intended are not conclusive. If as a whole a contract contemplates an association of two or more persons to carry on as co-owners a business for profit, a partnership there is.[110]

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[109] Morice v. Bishop of Durham, 32 Eng. Rep. 947, 947 (1805) (where testator left remainder in trust "for such objects of benevolence and liberality as the trustee in his own discretion shall most approve," trust classification failed because the court could not exercise supervisory power, and remainder passed intestate); SCOTT & FRATCHER, *supra* note 41, § 125; *see also* Anderson, *supra* note 1, at 756 (arguing that the extent of nonwaiver rules may depend on the evaluation of the benefits that the entrustor may gain from the fiduciary's self dealing, and the costs of ensuring that there actually will be benefits).

Facially, this example can be explained by the theory of penalty default rules in which the courts penalize parties for failing to specify terms of their agreements when the costs of such specification are far below the costs to the courts of determining the terms *ex post facto*. *See* Ayers & Gertner, *supra* note 108, at 91-93. *But see* Kostritsky, *supra* note 108. This explanation, however, does not comfortably fit the trust situation discussed above because the parties did not omit from their agreement a provision that the courts were required later to fill in at higher costs. In this case, the parties stated explicitly the rules of behavior which apply to the fiduciary-trustee, and the rules relieved from his accountability. The question here is whether the courts should trump this express choice of the parties.

[110] Martin v. Peyton, 158 N.E. 77, 78 (N.Y. 1927) (emphasis added). While Professors Bromberg and Ribstein describe the economic realities of arrangements as the parties' "objective intent," they admit that "[e]ven where the parties explicitly and intentionally characterize their relationship as a partnership or nonpartnership, . . . this characterization may be disregarded where the indicia of objective intent clearly point in the opposite direction." 1 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 2.05, at 2:37 (1991). The authors, however, hasten to add that the cases in which the courts ignored the parties' subjective intent all involved the rights of third parties. *Id.* at 2:38. Presumably the rights of third parties would justify judicially overruling the parties' characterization of the relationship. But the authors also add: "[E]ven in cases wholly among . . . partners, the courts have held that the characterization was not controlling where the facts

To some extent courts allow the parties to establish the law that governs their agreements,[111] arbitration,[112] and judicial settlement. Even so, the final decision on legal classification is with

indicated a contrary intent." *Id.* at 2:39. Yet, here the authors offer a criticism: the courts should have held that "the parties did not intend the particular consequence at issue rather than that they did not intend partnership at all." *Id.* at 2:39-:40. In fact, the whole discussion and structure of the treatise is built on the parties' intent, both subjective and objective. I question the authors' conceptual structure and analysis of judicial decisions. In my opinion the courts meant what they said both in cases that involved third parties and in cases that involved the partners only: courts, not parties, determine the characterization of the relationships, based on what the parties said and did and on their subjective and objective intents. In short, the model of the relationship is designed by law and interpreted by the courts, not by the parties.

[111] *See, e.g.*, Hellenic Lines Ltd. v. Rhoditis, 398 U.S. 306, *reh'g denied*, 400 U.S. 856 (1970) (holding that despite the contract provision that the contract will be enforced under Greek law, the Jones Act applied where the transaction involved United States contacts); Exxon Corp. v. Burglin, 4 F.3d 1294, 1298 & n.5 (5th Cir. 1993) (while sitting in diversity, following "Texas choice of law rules," which

> recognize the parties' autonomy to select the law to be applied to their contract. . . . A Texas court will enforce a contractual choice of law provision unless (1) the contract bears no reasonable relation to the chosen state or (2) the law of the chosen state violates a fundamental public policy of Texas.

Id. at 1298 & n.5; Northern Ill. Gas Co. v. Airco Indus. Gases, 676 F.2d 270, 274-75 (7th Cir. 1982) ("Notwithstanding the parties' choice of law provision in their contract calling for application of Illinois law, and irrespective of the fact that this is a diversity case, federal arbitration law governs the analysis of arbitration provisions in any contract evidencing a transaction in interstate commerce."); J. Alexander Secs., Inc. v. Mendez, 21 Cal. Rptr. 2d 826, 880 (Cal. Ct. App. 1993), *cert. denied*, 114 S. Ct. 2182 (1994) (upholding an arbitrator's punitive damage award and decision to not follow the law chosen in the contract because "[t]he choice of law provision [in the contract] merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages; it does not deprive the arbitrators of their authority to award punitive damages").

[112] When parties determine the set of rules under which their differences will be arbitrated, they create a legal system for themselves. The courts, however, usually retain the final say. *See* William W. Park, *Private Adjudicators and the Public Interest: The Expanding Scope of International Arbitration*, 12 BROOK. J. INT'L LAW 629, 659-64 (1986) (illustrating national legal systems, and citing Wilko v. Swan, 346 U.S. 427, 436 (1953) (annulling an arbitration decision for "manifest disregard of the law" and noting that notwithstanding the fuzziness of this concept "few cases involve an arbitrator ignoring the correct governing law")). As to Britain, Professor Park cites a suggestion that "[n]o manner of legislation, however, will remove . . . the professional zeal of London solicitors and barristers who transplant into arbitration proceedings the habits acquired in the courts." Park, *supra*, at 662 (quoting Herman, FIN. TIMES, Oct. 20, 1983, at 38, cols. 5-8). Arguably, one reason why American courts today deem arbitration more acceptable is that arbitration has embraced—not rejected—judicial classifications, for example, the choice of forum and governing laws, such as ICC and AAA or NASD. Thus, arbitrations do not tend to undermine legal classifications.

the courts, and for good reason. Allowing the parties to determine the categories of laws that apply to their relationship would undermine the enforceability of mandatory rules. If we wish to maintain mandatory rules, then the parties should not be allowed to reclassify them as default rules. More importantly, if the parties can reclassify the laws they can eliminate the impact of other signals and consequences that accompany the classification. For example, rules within crime and tort categories that are default rules carry with them social stigma[113] and other serious consequences to violators—violations of some criminal rules can result in disqualifications from the practice of certain professions, such as law and medicine.[114] Similarly, violation of fiduciary law rules, aimed at deterring activities akin to the crime of embezzlement and the tort of conversion carry with them social stigma—few would equate breach of contract with breach of trust; most would consider breach of trust far more morally corrupt and socially harmful. If society is going to put a stigma on disloyal fiduciaries, the stigma should apply regardless of the parties' own level of morality or social judgment. Similar to some crime and tort vio-

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See Rew R. Goodenow, Comment, *Securities Arbitration—The Supreme Court Resolves the Issue of Enforceability of Mandatory Arbitration Clauses in Broker-Investor Contracts:* Shearson/American Express, Inc. v. McMahon, 73 IOWA L. REV. 449 (1988).

[113] *See* Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1227 (1985) (dealing with choice of deterrence as punishment:

> part of the "kick" of criminal punishment comes from its stigmatizing effect, an effect enhanced by such sanctions as taking away a convicted felon's right to vote, but more deeply grounded in the sense that criminal punishment is reserved for serious wrongdoing—for what in economic terms is socially more costly conduct than is characteristically dealt with by tort law. Stigma has no incapacitative effect; it is therefore wasted on the undeterrable).

Toni M. Massaro, *Shame, Culture, and American Criminal Law*, 89 MICH. L. REV. 1880 (1991) (dealing with ostracizing of sex offenders and arguing that shaming sanctions are not a solution to an effective punishment).

[114] *In re* Stephenson, 10 So. 2d 1 (Ala. 1942) (attorney's full pardon from conviction of forgery did not warrant reinstatement into the bar); *In re* Webb, 602 P.2d 408 (Alaska 1979) (attorney's conviction for the felony offense of accessory after the fact of first degree murder warranted disbarment); Alaska Bar Assoc. v. Benton, 431 P.2d 146 (Alaska 1967) (attorney's conviction on plea of guilty of grand larceny warranted disbarment); Weiss v. Board of Dentistry, 798 P.2d 175 (N.M. 1990) (dentist, convicted of four counts of making or permitting a false claim for reimbursement for public assistance services, was denied his license); Zimmerman v. Commonwealth, 423 A.2d 34 (Pa. Commw. Ct. 1980) (doctor's petition for reinstatement of his medical license, revoked by the State Board of Medical Education and Licensure because he was convicted of a felony and found guilty of immoral and unprofessional conduct, was denied).

lations, some breaches of fiduciary duties also result in disqualifications from the practice of certain professions.[115] Regardless of the weight which the courts might give to the parties' legal classification of their relationship the last word on the classification of fiduciary relationships should be with the courts.[116]

In addition, law should be structured and predictable to guide would-be actors. We are incapable of remembering all detailed items without a road map—a classification. Classifications serve to point to the group of rules that apply to particular cases. When parties can classify rules differently, it will be nearly impossible to identify the applicable categories and rules. If the same fact situations are resolved not only by different rules that the parties designed for themselves to produce different results, but also by rules that are classified differently, law would be less effective in guiding future actions.

IV

Default Rules in Public Fiduciary Law

A. *Private and Public Fiduciaries*

The principles governing fiduciary rules as default rules were discussed above in the context of private fiduciary relationships, that is, relationships with few entrustors that are likely to be cus-

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[115] *See, e.g.*, N.Y. Jud. Law DR 9-102 (McKinney 1992) (disciplinary rule imposing fiduciary duty of care on lawyers in possession of funds of another); *In re* Rubi, 652 P.2d 1014 (Ariz. 1982); Florida Bar v. Padgett, 481 So.2d 919 (Fla. 1986); Attorney Grievance Comm'n v. Boehm, 446 A.2d 52 (Md. 1982); *see generally* Stephen Gillers, Regulation of Lawyers: Problems of Law and Ethics (4th ed. 1995).

[116] Recently, a chorus of analysis critical of the contract model and its erosion of fiduciary duty has sounded. *See, e.g.*, Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 Fordham L. Rev. 375 (1988); William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 Cornell L. Rev. 407 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 Colum. L. Rev. 1403 (1985); Thomas L. Hazen, *The Corporate Persona, Contract (and Market) Failure and Moral Values*, 69 N.C. L. Rev. 273 (1991); Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 Temple L.Q. 47 (1987); *see also*, Deborah A. Demott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879; Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1486-87 (1989); Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Colum. L. Rev. 1757 (1989); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 Colum. L. Rev. 1449, 1451-57 (1989).

tom-made. How would the principles apply to public fiduciaries in commercial relationships, that is, mass-produced, non-personal relationships with numerous public entrustors?[117]

Both private and public fiduciary relationships deal with entrusted power or property, and both involve problems that fiduciary law is designed to solve. Yet, the relationships differ. For the purpose of examining whether rules governing private and public fiduciaries should be treated as default rules to the same degree, I distinguish them by two features. One relates to the power with which fiduciaries are entrusted. The other relates to the entrustors' ability to bargain with their fiduciaries around fiduciary duties.

I maintain as to the first point that the powers entrusted to public fiduciaries are greater than those entrusted to private fiduciaries: (1) by the nature of their function as providers of centralized management for numerous entrustors; (2) by the fact that public entrustors are rationally passive; (3) by the availability of markets for public fiduciary relationships. I believe that markets' discipline of public fiduciaries is less than it seems and yet markets do allow public entrustors to terminate their relationships by transferring them to others. This "exit" leaves public fiduciaries with powers over other peoples' property, and sometimes helps them acquire the properties that were entrusted to them; and (4) by the impact of public fiduciaries on the economic and financial system and on society in general.

When public and private fiduciaries are required to perform the same services, the power of public fiduciaries will be greater because public entrustors are less able to control their fiduciaries or give informed and deliberate consent to conflict of interest

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117 At the outset, it is helpful to distinguish between two similar types of public fiduciaries. The difference may be grounded in images, but they result in different laws. One type is viewed as personal fiduciary managing property pooled for efficiency (e.g. commingled funds, trust funds, pension funds). This view is grounded in private relationships that expand to mass-services. The second type is viewed as a fiduciary towards an entity owned by numerous entrustors. This view is grounded in public relationship at the outset, where small shares in managed enterprises are sold to public investors by promoters of enterprises. These types are treated differently under the law. The first type is more likely to be regulated as private fiduciaries; *see* SCOTT & FRATCHER, *supra* note 41, § 2.5 at 43 (defining relationship between trustee and beneficiary as fiduciary relationship); the second as public fiduciaries; *see* Investment Company Act of 1940, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to -64 (1994)); REVISED MODEL BUSINESS CORP. ACT (1994).

transactions.[118] Therefore, to protect public entrustors we can either find reliable consent surrogates for them, or make mandatory the rules governing public fiduciaries. Other solutions that do not relate to the issue of default rules are discussed in part V.

1. Public Fiduciaries Are Entrusted with Relatively More Power than Private Fiduciaries

a. Increased Power for Centralized Management

As compared to private fiduciaries, public fiduciaries that provide similar services have greater powers for a number of reasons. First, the function of public fiduciaries for numerous entrustors is often to provide centralized management, which requires limits on the entrustors' control over their fiduciaries in the day-to-day operations.[119]

In the private fiduciary relationship of agency, principals use agents to enter into binding legal relationships with third parties (e.g., sell or buy stocks). To perform these functions, agents need power to bind their principals legally; often they need to be vested with either title or possession of the principal's property. These services, however, can be performed under the control of the principal without affecting any other entrustors. That is why the definition of an agent includes the principal's control in the performance of his fiduciary's functions.

An agent to many principals, such as corporate management, is not, and indeed cannot be, controlled by each shareholder in the performance of management's function. That is why shareholders are precluded from interfering in the day-to-day operations of the corporation. Directors are subject to control of the shareholders only on select decisions which are very important to the shareholders and justify the cost of special procedures to ascertain the will of the shareholders who hold the majority of the shares.

Thus, at least in theory, agency is less risky to entrustor-principals than directorship is to entrustor-shareholders. Further, while principals can terminate the agency relationship, shareholders are not allowed to do so except on specific occasions when the will of the shareholders' majority can be ascertained,

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118 ROBERT C. CLARK, CORPORATE LAW 2 § 1.1 (1986); *see also* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY 102 (1970).

119 CLARK, *supra* note 118, at 2.

on election days. Even if public fiduciaries are expected to act as agents, they cannot be subject to the control or unlimited power of removal by their principals.[120]

Second, in private fiduciary relationships the personal and varied needs of entrustors guide the services and limit the powers of the fiduciaries.[121] Public fiduciaries offering mass-produced arrangements possess broader discretion to design their functions and the criteria guiding the performance of the services they offer entrustors.

There are counter arguments to the view that public fiduciaries possess more power than their private fiduciary counterparts. For one thing, when markets offer alternatives to the fiduciaries' services or opportunity to terminate the relationship through sale (e.g., of shares), public entrustors can terminate the relationship, and "discipline" public fiduciaries without the need for judicial regulation. Even if management was not regulated by fiduciary law, potentially raising the risk of corporate mismanagement, the price of the shares issued by their corporations is likely to be lower than the share price of similar enterprises whose management does not mismanage.[122] Share prices will provide market evaluation of the risk of lower management duties. Management presumably will have an interest in maintaining or raising share prices, and will propose charter amendments that would reduce their fiduciary duties only to the extent that the share prices will not fall substantially. Prices will either constrain the reduction of management's accountability, or provide investors with an additional option of acquiring shares at lower prices denoting lower quality of management's accountability. This market-contract regime provides self-executing arrangements without the need for, and the costs of, judicial enforcement.

120 In theory, directorship is less risky to entrustors than trust. While directors are subject to election by shareholders and to some control, trustees are not necessarily selected by the beneficiaries, and are not subject to their control. They can be removed only under extraordinary circumstances and usually only by court order. Public fiduciaries possess powers similar to those of trustees, who are not subject to the control of the beneficiaries in the performance of their functions.

121 Business managers need far more discretion to perform their functions than managers of passive investments. I believe that this distinction explains why a pension fund and mutual fund manager may not use pension fund money to contribute to charity while a corporate director may do so, within limits. That is so although the arguments about "social investing" are similar to those about corporate charitable contributions. *See generally* SOCIAL INVESTING (Dan M. McGill ed., 1984). This distinction also applies to relationships among fiduciaries with fewer entrustors.

122 *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 32, at 18-19.

These arguments are faulty because they are based on a number of very questionable assumptions: (1) that shareholders and sophisticated investors can price the shares correctly by determining the risk of management's reduced or non-existent fiduciary duty; (2) that the level of management's dishonesty and lack of care will remain stable once it is relieved of accountability; (3) that when investors learn about management's lack of accountability and self-dealing, investors will *not* withdraw from the markets; and (4) that a rule under which people who control other people's money can bargain for freedom from accountability helps maintain efficient markets and is socially beneficial.

I believe that it is very costly to establish shareholders' losses from mismanagement, even under the current legal regime. If management is freed from accountability, the ascertainment of shareholders' losses will be even costlier. In fact, it is doubtful that anyone, including sophisticated investors, could determine ex ante the level of risk from management's reduced duty, and price corporate shares accordingly. To predict such losses would be near impossible,[123] particularly because the level of management's dishonesty and lack of care will not remain stable once management is relieved of accountability. The old cliché about the corruptive effect of power has not yet been disproved. Besides, share prices are opaque; although prices may change, the extent to which the changes reflect the level of risk from corporate mismanagement will remain a mystery.

The force of market discipline is unclear. In an insightful article, Professor Helen Garten suggests that although markets may constrain management choices, these constraints do not necessarily produce the desired actions or forbearance that the law requires of them. "Market discipline" is not synonymous with producing lawful activities.[124] Constraints need not, by themselves, result in honest and quality performance of service. In fact, markets may increase pressure on corporate management to breach fiduciary duties. Whether the disciplining power of mar-

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123 Even if management had license to embezzle, it is not inconceivable that shares of the corporation will not be totally worthless.

124 Helen A. Garten, *Whatever Happened to Market Discipline of Banks?*, 1991 ANN. SURV. AM. L. 749; *see also* Melvin A. Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 595 (1984); Helen A. Garten, *Still Banking on the Market: A Comment on the Failure of Market Discipline*, 5 YALE J. ON REG. 241 (1988) (arguing quite persuasively that markets may restrict fiduciaries but the restrictions do not necessarily result in desirable effects).

kets is adequate and whether it leads to the right results are debatable issues.[125]

b. Public Entrustors are Rationally Passive and Have Less Power to Terminate the Relationship

Public fiduciary relationships can create practical obstacles to the removal of fiduciaries by entrustors. The election process of substitute fiduciaries is costly, especially when it is contested. Management changes can endanger the smooth operation of the enterprise. When the number of public entrustors is large, it is likely that many will possess small financial interests. Such entrustors are rationally passive rather than actively involved in monitoring and, removing their public fiduciaries (when necessary) because of the relative high costs associated with such monitoring and removal. Active entrustors cannot easily collect these costs from other public entrustors. The latter are likely to "free ride" on active entrustors' efforts.[126] Courts recognize that public shareholders are rarely active in corporate governance affairs, even if they may suffer losses from management's misappropriation. Therefore, regardless of whether such shareholders abstain or ratify management's conflict of interest transactions, the courts do not, and indeed should not, give such shareholders' behavior full credence. Instead, courts should and do examine more closely the ratified transactions on their merits.[127] In sum,

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[125] *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). The efficient market hypothesis does not strongly support price as an alternative to self-help by security holders. First, some people doubt the validity of this hypothesis. *See* JAMES D. COX ET AL., SECURITIES REGULATION 32 (1991) (citing a number of sources). Among the faithful followers, very few economists subscribe to a strong hypothesis. *Id.* Second, studies that show a five percent difference in the stock prices of companies that waived the fiduciary duty of care are not convincing. A five percent difference is not small. It is also uncertain how nonprofessionals would react to clearly advertised and disclosed breaches of fiduciary duty. The courts, as Professor Carney has complained bitterly, simply are not convinced. *See* Carney, *supra* note 2, at 904, 910, 916, 950.

[126] *See* Mark J. Roe, *German "Populism" and the Large Public Corporation*, 14 INT'L REV. L. & ECON. 187 (1994); *see also* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

[127] *See, e.g.*, Beard v. Elster, 160 A.2d 731 (Del. 1960) (finding that shareholder ratification of a limited stock option plan, even when passed by a disinterested board, was not sufficient to prove that benefits accrued to the corporation and that the burden of proof became the defendants'); Gottlieb v. Heyden Chem. Corp., 83 A.2d 595 (Del. Ch. 1951), *rev'd*, 90 A.2d 660 (Del. 1952) (finding stockholder ratification did not operate to invoke the sound business judgment rule because of the indifference to, or sympathy with, the directors, of a majority of stockholders such

as their numbers grow, the entrustors' ability and incentives to terminate the relationship with their fiduciaries weakens. The larger the group of entrustors becomes, the greater the freedom from accountability their fiduciaries have, and the less weight should be given to the entrustors' bargain around fiduciary law rules. A fiduciary managing $500 million for one entrustor has far less power than a fiduciary managing the same amount for 50,000 entrustors.[128]

c. *The Availability of Market Alternative To Terminate Public Fiduciaries May Discipline Them But Also Augments Their Power*

It is true that, to the extent entrustors hold liquid interests, they can terminate their relationship with their fiduciaries by selling the interests ("exit") rather than by removing the fiduciaries ("voice.")[129] Recent corporate takeovers, institutional investors' activism, and activism of the independent directors of large corporations seem to suggest that other alternative mechanisms are at work to render corporate management more flexible and creative, less complacent, and more responsive to the changing environment. Arguably, that may be the reason why waivers of fiduciary duty of care have become more acceptable.[130] Yet, in

that did not trigger the necessary good faith exercise of business judgment by directors in dealing with corporate assets).

The explanation for shareholder apathy relates to shareholders' cost/benefit analysis *ex ante*. That is, shareholders are rationally apathetic before they know that management has misappropriated corporate funds. *Ex post*, shareholder losses may be sufficiently high for aggrieved shareholders to get involved in corporate governance issues or organize other shareholders to do so. Even though there are advocates for such statutes, no corporate statute to date has allowed corporate charters to relieve management from liability for breach of the duty of loyalty. That is, no statute has yet viewed such a relief from liability as notice to shareholders amounting to consent.

128 Private fiduciaries' lesser powers are manifested by their job security, fees, freedom to engage in conflict of interest transactions, and other legal rules governing their behavior. Generally, commercial fiduciaries are more entrenched and less accountable than politically elected representatives. Both types of fiduciaries have discretion during their tenure. Political fiduciaries, however, face far more competition for re-election, are exposed to far more public scrutiny, and must raise campaign funds under severe limitations. Unlike corporate directors, who engage in corporate-funded proxy fights, political fiduciaries are not allowed to fund their campaigns with public money. *See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, *reh'g denied*, 130 N.E.2d 610 (N.Y. 1955).

129 *See* HIRSCHMAN, *supra* note 118.

130 *See* GA. CODE ANN. § 14-2-830(b) (1995); CAL. CORP. CODE § 204(10) (West 1994); REVISED MODEL BUSINESS CORP. ACT § 2.02(b)(4) (1994). The American

light of past experience, I venture to both predict that the courts will not, and suggest that they should not, relinquish their jurisdiction over fiduciaries in egregious cases, regardless of the parties' bargains or waivers of fiduciary duties in corporate statutes and charters, by shareholders or otherwise. Courts will react because the risks that such cases pose to our economic system are too great.

Most importantly, the ability of shareholders to terminate the relationship with their managements by selling their shares *augments* the public fiduciaries' power, as compared to that of fiduciaries in personal trust situations. When these shareholders terminate the relationship they do not recoup the entrusted property.[131] That property remains in the hands of the fiduciaries, who then simply serve others who purchase the shares. If we compare corporate fiduciaries to other fiduciaries under the control of entrustors or courts, we will not see markets as disciplining corporate fiduciaries, but as ensuring their tenure. Shareholders' option to "exit" reduces judicial supervision and the incentives of entrustors to remove the fiduciaries, as they would in the case of private fiduciaries. Therefore, it is a mistake to view markets as justifying more lax fiduciary rules.[132]

Third, the necessity to avoid deadlock and hold-outs through unanimous consent requirement produces a majority rule for entrustors. That rule can dilute the individual power of small entrustors (and increase the powers of larger ones) and in some

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Law Institute's Principles of Corporate Governance allows for limits on managements' duty of care. *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19 (Proposed Final Draft Mar. 31, 1992) (permitting the certificate of incorporation to limit damages to not less than one year's compensation for breach of duty of care under limited circumstances). Arguably, allowing fiduciaries to contract to limit damages is perhaps better than allowing them to contract out of fiduciary duties altogether; that is, this permission strikes the balance between unlimited damages while enforcing important fiduciary duties; *see also* Coffee, *Judicial Role*, *supra* note 8; Frankel, *Fiduciary Relationship*, *supra* note 27, at 191-93.

131 This assumes that a share represents a claim on corporate assets upon dissolution and liquidation, and a claim to a future stream of income subject to the discretion of the directors.

132 The ability to sell the securities in the markets is an especially weak alternative for strict fiduciary rules when the selling shareholders are not rendered whole; often they sell at a loss. Entrustors' ability to reduce losses is not even a close equivalent to their ability to remove incompetent or disloyal fiduciaries.

I presume that the objectors to mandatory fiduciary rules believe that private power (markets, or public fiduciaries) rather than public power could limit fiduciaries' potential abuse.

cases augment the fiduciaries' powers by coalitions with concentrated majority or minority entrustors.

d. Public Fiduciaries' Actions Have More Impact on the Economy, Financial System and Society

As compared to private fiduciaries, public fiduciaries have greater impact on the economy and financial system by affecting more people, and the flow of capital from borrowers to savers. For example, it seems that the policies underlying the Securities Acts are based on a number of assumptions: First, the viability of the securities markets depends on the participation of small investors. Second, small investors will withdraw from the markets not only, or necessarily, when they sustain serious losses, but also, or even mainly, if they perceive these losses to be the result of an unfair market system. Even people who are willing to gamble will not play with the other players' loaded dice and when the rules of the game are rigged in favor of others. Thus, among other things, investor protection is designed to assure the existence of a fair securities market—a system that would give small investors a fair chance against large investors, corporate insiders, and market intermediaries.[133] Third, the integrity and fairness of the securities markets as institutions cannot be left to individual investors. It is too precious, and too vulnerable. Therefore, the

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133 Whether the assumptions about small investors' reactions are correct requires additional research; as to future behavior, perhaps it cannot ever be proven. We can draw tentative conclusions from other cultures that have not developed financial intermediation either through markets or through institutions such as banks, insurance companies, or mutual funds. Lack of trust is one of the main reasons for emaciated financial systems in some countries. The price of mistrust is high, especially for countries that desire to develop commerce. Without trust in the system and in financial intermediaries, savings remain unproductive, or remain invested only in the savers' own enterprises (or the enterprises of relatives and friends) and are limited to the savers' productivity. In many countries, people do not deposit their money in the banks, let alone buy securities. Instead, they buy and hoard unproductive gold or invest in other countries, and thereby perpetuate their impoverished economy. In American culture, such a system is hard to imagine, and is hardly probable. Yet, we should fear the possibility that our financial intermediaries will lose the peoples' trust and, if distrust settles, the consequences for our economic system could be disastrous. *See* RUTH BENEDICT, PATTERNS OF CULTURE 130-167 (1934) (describing a culture based on mistrust in a destitute society); FRANCIS FUQUYAMA, TRUST, THE SOCIAL VIRTUES & THE CREATION OF PROSPERITY (1995) (arguing that trust of persons outside the family contributes to economic prosperity); Edward H. Lorenz, *Trust and the Flexible Firm: International Comparisons*, 31 INDUS. REL. L.J. 455, 455-63 (1992) (noting that the practices of labor-management consultations in Germany and Japan during the post World War II decades contributed to high levels of trust among firms in these countries). *Id.* at 457.

protection of the Securities Acts must be made mandatory, and their waiver should be prohibited.[134] These three assumptions may explain why, notwithstanding all the innovative scholarship in favor of allowing insider trading,[135] Congress not only continued to prohibit the practice, but recently imposed heavier penalties on violators.[136]

Thus, the confidence of small entrustor-investors in their public fiduciaries is more important to the financial system than the confidence of entrustors in their private fiduciaries. If people cease to entrust their money to private fiduciaries, the financial system would suffer far less than if runs occurred on institutions, such as banks and mutual funds or in the securities markets.

2. *Feasibility and Credibility of Entrustors with Public Fiduciary to Bargain Around the Rules*

a. *Entrustors' Consent Is Weak and Indirect*

In private fiduciary relationships, each entrustor must consent to the bargain around the rules.[137] Could the numerous entrustors in a public trust or corporation, who are not allowed to interfere in the operation of the enterprise, give effective consent to particular conflict of interest actions? For numerous reasons, it is

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134 *See, e.g.*, Securities Act of 1933, § 14, 15 U.S.C. § 77n ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."); Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a); Investment Company Act of 1940, § 47(a), 15 U.S.C. § 80a-46(a); *see also* Investment Company Act of 1940 §§ 17(a), (b), 15 U.S.C. §§ 80a-17(a), (b); Landrum-Griffin Act § 501(a), 29 U.S.C. § 501(a) (1994) (general exculpatory clauses relieving union officials from liability are void as against public policy); RESTATEMENT (SECOND) OF AGENCY §§ 82-104 (1958) (ratification); 2 TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS 233-35 (1978).

135 *See generally* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). Arguably, without trust, investors will demand higher returns, and competition for funds will bring about disclosure that would in turn provide the same protection voluntarily. In fact, there are issuers of highly risky stocks who would prefer not to disclose, and investors might invest in such stocks and lose their savings. The arguments for both sides have been fully documented with no clear victor emerging.

136 *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (amending §§ 21A-C of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78u-1 to u-3); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (amending § 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78t-1).

137 SCOTT & FRATCHER, *supra* note 41, § 216.2, at 333-34 (stating that when several beneficiaries exist, each must consent). The identity of the entrustor may be problematic, for example, when the trust is revocable by the settlor. *Id.* at 340-41.

more problematic to assure the quality of the consent of small investors to waive their rights.

Under some laws, entrustors are presumed to have actually consented to the bargain if they received prior information about the fiduciaries' conflicts of interest.[138] For example, if a publisher of an investment advisory letter provides advice regarding certain securities, and discloses publicly his conflicts of interest about these securities, those subscribers who follow his advice are deemed to have consented to the conflicts—the parties are deemed to have bargained around the rule that prohibits the adviser from acting in conflict of interest.

In this case, allowing disclosure as an alternative to active consent may be justified because, after disclosure, subscribers have a clear choice to refrain from or follow the advice. Following the advice is an act which could be presumed to manifest their consent. Perhaps the advisers' cost of obtaining active consent from thousands of clients is far higher than the subscribers' costs of protecting themselves from their fiduciaries' appropriation.[139] Thus, in some circumstances, entrustors will be deemed to have consented by silence or inaction after the fiduciaries' disclosure.[140]

In the corporate setting, however, if the information about

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138 For an analysis of the common law rule regarding silence as consent, see Avery Katz, *Transaction Costs and the Legal Mechanics of Exchange: When Should Silence in the Face of an Offer Be Construed as Acceptance?*, 9 J.L. ECON. & ORG. 77 (1993).

139 Similarly, if the beneficiaries of a trust receive notice that the trustee proposes a conflict of interest transaction, and do not react within a reasonable time, their inaction may be deemed to be a binding consent, especially if the cost to the trustee of obtaining their active consent is lower than the cost to the beneficiaries of informing the trustee. This assumes, of course, that the beneficiaries are fully advised of all material facts. SCOTT & FRATCHER, *supra* note 41, § 170.2, at 323-24.

140 A comparison of the subscribers to the advisory letter with corporate shareholders who receive prior disclosure of managements' conflict of interest shows some difference and some similarities. On the side of differences, while shareholders bear the costs of reading the proxy materials and of voting, subscribers do not view as waste the time and effort spent in reading the materials and determining how to invest. In fact, they pay to receive the materials, and desire to make the investment decision. Subscribers cannot terminate the relationship by exercising "voice." They can only terminate the relationship by terminating the subscription. The adviser will continue to publish. Shareholders who do not consent can terminate the relationship by exercising "voice." In the case of small shareholders their "voice" will be heard only if they organize, which may involve substantial costs. Sale is far less expensive than exercising "voice," but can also involve losses, especially after disclosure of managements' wrongs. Shareholders who keep their shares may also suffer losses through lower dividends, and eventually in lower market prices (or bankruptcy plans).

conflict of interest is incorporated into corporate charters that are not brought specifically to the attention of the shareholders, the shareholders do not make any decision based on this so-called disclosure, except if we believe that the share prices would represent the degree of public entrustors' decision. The apparent consent that numerous entrustors give to their public fiduciaries' conflict of interests is similar to the "social contract."[141] It represents a theoretical model, not reality. That is why implicit in traditional corporate law is the recognition that shareholders cannot and do not give fully informed independent consent.

b. Surrogate Consenters Are Also Fiduciaries Requiring Supervision; Therefore, They Do Not Solve the Problem of Consent

Much of corporate law involves a search for surrogates to provide consent for the many entrustors. The surrogates include (1) the courts; (2) intracorporate groups such as disinterested shareholders, disinterested directors, and committees; (3) the markets—the "black box" of market prices (for corporate shares, products, corporate managements), professional money managers and advisers who evaluate corporate fiduciaries or whose opinions are reflected in the market prices; and (4) the effect of the aggregate action of shareholders in denying consent by the sale of the shares. The search for surrogates has led to a relaxation of the rules regulating public fiduciaries.

At the outset, courts treated directors as almost-trustees, or at least as hybrids between trustees and agents. One hundred and twenty years ago a court expressed its deep commitment to the trust model in corporate law:[142]

Shareholders are similar to subscribers, however, in that subscribers can terminate the subscriptions with relatively little cost to themselves, as can the shareholders, especially if they sell their shares at the right time. Also, when the subscribers terminate the subscriptions, they terminate the advisers' power over them, as do shareholders who sell their shares. Further, neither subscriber nor shareholder apathy means that they *consent* by their inaction to managements' appropriation. At most, their apathy, driven by cost, tends to reflect either indifference or lack of consent.

141 For a broad theory of consent, see Randy Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986). Moreover, when subscribers terminate their subscriptions, the publishers' gains are reduced. When shareholders sell their shares, however, they do not at the same time terminate managements' control over the corporate properties, although share prices may fall, which may affect managements.

142 *See, e.g.*, Stewart v. Lehigh Valley R.R. Co., 38 Court of Errors & App. 505 (N.J. 1875), *reprinted in* DETLEV F. VOGTS, BASIC CORPORATION LAW 240, 241

> [W]here [a director has a] right . . . which must stand, if at all, upon an express contract, and which does not arise by operation . . . of law, then he shall not hold it against the will of his *cestui que trust*; for in the very bargain which gave rise to it, in which he should have kept in view the interest of that *cestui que trust*, there intervenes before his eyes the opposing interest of himself. . . . Nor is it proper for one of a board of directors to support his contract with his company, upon the ground that he abstained from participating as director in the negotiations . . . [in which] he ought to have participated . . . .[143]

Transactions in conflict of interest were voidable at the behest of the entrustor-shareholders. The shareholders could either consent to conflict of interest transactions or seek to avoid such transactions.[144] Under agency and trust law, only entrustors (and their agents) such as trust beneficiaries or principals in agency, could give consent. The courts did not volunteer to provide consent, even if the beneficiaries could not give consent, for example, because they were minors. The courts limited their function to ensuring that the entrustors' consent was independent and informed.

Corporations, however, raised serious problems. A requirement for shareholders' unanimous consent would create a "holding out" problem. While the majority voting rule somewhat reduces the ability of minorities to hold out and extract more than their due, a single individual shareholder still could avoid transactions that the other shareholders supported, and which would benefit the corporation.

In a revolutionary step, the courts began to act as surrogates for the shareholders, which changed the substance of the default rules. Leaving the power to consent solely in the hands of the entrustors makes it harder for the fiduciaries to engage in conflict of interest transactions: entrustors can refuse to consent arbitrarily. If the courts (or other surrogates) exercise this function, they must adhere to standards; otherwise they are not accountable for their decisions. Therefore, courts established the standard of fairness, under which they approved conflict of interest transac-

(1979) ("[T]he true legal rule is, that such a contract [entered in conflict of interest] is not void, but voidable, to be avoided at the option of the *cestui que trust*, exercised within a reasonable time. I can see no further safe modification or relaxation of the principle than this."); *see also* Marsh, *supra* note 78.

143 VOGTS, *supra* note 142, at 241-42.

144 *Id.*

tions. The standard narrows the sphere of refusal to consent, and entitles corporate directors and officers to engage in conflict of interest transactions that are fair.[145]

With time, courts also recognized as surrogates for consent on behalf of the corporation and its shareholders, intracorporate groups, such as disinterested directors, directors' committees, and disinterested shareholders. However, because these surrogates are fiduciaries as well,[146] the courts began to supervise them as to their conflicts of interest, independence, information and deliberations—to determine the legal effect of their consent.

Thus, today's surrogates do not satisfactorily solve the problem of controlling public fiduciaries' conflicts. They are costly and sometimes unreliable.

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145 *See* Marsh, *supra* note 78.

146 That is why I do not subscribe to commentators' suggestions for relaxing the limitations on the intervention of controlling persons and institutions in corporate governance; such persons and institutions are no more (and may be less) qualified than directors and officers to consent to conflicts of interest for small shareholders. In fact, these are the persons and institutions that can take advantage of the shareholders and should themselves be accountable for exercising power over the corporate enterprise and indirectly over the shareholders' property. I note that the reasons for these restrictions were problems of conflicts of interest transactions and relationships in which institutional investors engaged.

There is extensive scholarship advocating the encouragement of institutional investors as watchdogs of the managements of portfolio companies. In order to perform this function, however, restrictions on institutional investors have to relax. *See* Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75 (1993); *see also* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992). For an argument promoting a private-ordering approach to security regulation, see Larry E. Ribstein, *Private Ordering and the Securities Law: The Case of General Partnerships*, 42 CASE WES. RES. L. REV. 1 (1992) (arguing that the courts permit parties to opt out of the disclosure and anti-fraud provisions of the federal securities laws by the choice of business form); *see also* Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not be Treated as Securities and Possible Steps to Encourage This Result*, 45 HASTINGS L. J. 1223 (1994). The SEC and the courts would likely view limited liability company membership interests as securities. While general partnership interests are usually not viewed as securities, the Ninth Circuit has not ruled out the possibility that the securities laws would apply to limited liability company interests. *See* Koch v. Hankins, 928 F.2d 1471 (9th Cir. 1991) (applying Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981), investments structured as general partnerships was not determinative of their status as securities. Rather, the economic realities of the transactions determined their status); *see also* Securities Act of 1933, § 14, 15 U.S.C. § 77n ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.").

c. *An Exception: An Independent Government Agency as Surrogate for Consent*

Another type of consenter is an independent administrative agency under a scheme that applies to fiduciaries of investment companies (mutual funds). This scheme has been in effect for more than fifty years and imposes on these fiduciaries strict prohibitory rules.

Advisers to mutual funds often are entrepreneurial fiduciaries as well as public fiduciaries, and have long been recognized as such. They, rather than the public, bear the initial costs of organizing the investment companies, distributing their securities, registering the companies and the securities with the Securities and Exchange Commission (SEC), and managing the portfolios before they reach a minimal size to cover the expenses. These advisers take the risks that the companies will not succeed and will have to be liquidated. The advisers' role as promoters is socially valuable. Yet, these advisers are subject to the most restrictive (to the best of my knowledge) conflict of interest regulation of public fiduciaries, very similar to that of trustee. They are simply prohibited from engaging in conflict of interest transactions. For those transactions that have built-in protection for investors there are exemptive rules. If these advisers wish to engage in other transactions of this sort they may apply to the SEC for an exemption.[147] This regime did not prevent investment advisers from establishing new investment companies and flourishing to manage one third of the whole financial system. In fact, this regime, with all its costs, may have helped them grow without any government guarantee, which all other institutional intermediaries have.[148]

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147 Investment Company Act § 17(a), (b), 15 U.S.C. § 80a-17(a), (b). The SEC will grant the exemption if it is convinced that the transactions are fair and reasonable. Third parties may seek a judicial hearing.

148 *See* Tamar Frankel, *The Pros and Cons of a Self-Regulatory Organization for Advisers and Mutual Funds*, 1 INVESTMENT LAWYER 3 (1994) (citing *Oversight Hearings on the Mutual Fund Industry, On the Importance of Mutual Funds to the Economy and to Investors and to Look at the Adequacy of Current Federal Oversight Over the Industry and the Possible Need for Legislative or Regulatory Changes, Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess., S. Hrg. 1, 2 (Nov. 10, 1993)); *see also id*. at 5 n.32 (opening statement by Senator Christopher J. Dodd: "this [mutual fund] industry has been an extraordinary success story"); *id.* at 5 n.32 (statement of James S. Riepe, Managing Director, T. Rowe Price Associates, Inc.) (asserting mutual fund regulation is stringent but does not prevent innovation; the funds "are the success story of the financial services industry because . . . [they] have garnered investors

Whether this model of surrogate consenter is appropriate for all public fiduciaries is unclear. Arguably, different businesses require different expertise to determine the fairness of conflict of interest transactions relating to them. Yet, such transactions prohibited under the Investment Company Act also involve different businesses that require such expertise, and the SEC has managed to render judgment in all of them, with the help of expert witnesses and the parties.[149]

Whether the cost of such government agency may exceed the benefits to the corporations and their shareholders is currently unknown. Maybe arbitrators, like the arbitrator in conflicts between broker dealers and their customers now in place, can serve as substitutes for judges. In any event, these routes should be explored to discover institutional arrangements in which consent to conflict of interest transactions can be more reliable.

V

Implications of the Contractarian View in the Absence of Meaningful Entrustors' Consents

If we adopt the contractarian view, we will continue to recognize all fiduciary rules as default rules and give effect to broad consents of public entrustors regardless of how indirect or empty they are. I submit that as we continue to do so, we will produce two results. One is to eliminate fiduciary law altogether. The other is to create property rights in fiduciary positions, such as office.

A. *Eliminating the Fiduciary Law*

1. *In Reality: Empty Consents Eliminate Fiduciary Law Altogether*

We can recognize that by accepting empty consents of entrustors to fiduciaries' breach of duties of care or loyalty, we eliminate fiduciary law and reverse its default rules. Existing rules prohibit negligence and conflicts of interest actions unless permitted by entrustors or their surrogates; however, the contract

confidence"); *id.* at 3 n.14 (statement of Mathew P. Fink, President, Investment Company Institute) (attributing the change and growth of the mutual fund industry in part to the innovative products and services that met investor needs as well as the stringent regulation imposed on mutual funds).

[149] *See* Frankel, *Fiduciary Relationship*, *supra* note 27.

regime would permit all negligence and conflict of interest actions unless explicitly prohibited by entrustors or their surrogates. While now, permission by entrustors must be limited to particular transactions, and should be independent and informed, under the contract regime permission can be open-ended and indirect, through surrogates and market mechanisms. Entrustors must expressly protect themselves by contracts—a bonanza to the legal profession—or else their fiduciaries can use the entrusted property for their own benefit. Presumably, unless the corporate charters so provide, shareholders will have no right to bring derivative suits (however limited they may become under increasing strictures).

There are already a number of examples of the contractarian trend.[150] One new example concerns limited liability corporation statutes. Even though the driving force behind these corporate statutes is the avoidance of double taxation, the statutes allow incorporators to write their constitutive documents as contracts and to design the duties of their managers without regard to fiduciary law. If the documents contain waivers of fiduciary duties, the courts will be asked to determine whether the waivers will be disregarded and the duties will be superimposed on existing documents.[151] Current developments in the law suggest that, while chanting the ancient rhetoric, we are beginning to grant public fiduciaries rights similar to those of squatters' adverse possession, without formally abrogating or creating property rights.[152]

2. *We Need a Legal Model of Trust Relationship*

We should reject the view that all rules applicable to public fiduciaries are default rules, no matter how tenuous the "contract" bargain around these rules. If, as I suggest, the model of fiduciary law will be erased in the public fiduciary context, the cost to society will be quite high.

I believe that law should provide society with two models for

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[150] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1994); N.Y. BUS. CORP. § 721 (McKinney Supp. 1995).

[151] See the proliferation of limited liability company statutes, described in Goforth, *supra* note 146.

[152] For example, in the corporate context, definition of a transaction in conflict of interest in § 8.60 of the RMBCA is limited to an action by the corporation itself, not to economic actions by a director not involving the corporation. The directors' use of "poison pill" rights to obviate takeover is not a transaction under § 8.60. Neither is the directors' purchase of the corporation's shares on the open market from a third party. *See* REVISED MODEL BUSINESS CORP. ACT § 8.60 (1994).

financial and economic interactions: the model of fiduciary relationship representing trust and dependency; and the model of contract relationship representing mutual suspicion, "realistic" mistrust, and independence. These are, of course, theorical models. Trust plays a role in contracts; self interest plays a role in fiduciary relationships. Yet, the contract model alone will not do. The trust model is important for a number of reasons.

First, pervasive mistrust impoverishes society;[153] trust can bring rich rewards to society.[154] Second, the very existence of a trust model constitutes a self-enforcing mechanism. It helps internalize the trustees' self-image as honest and respected persons. It calls for the trustees to live up to the public's expectations. Society's expectations of a public fiduciary offer a way to compel, even "discipline," public fiduciaries' behavior.[155]

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153 *See, e.g.*, EDWARD C. BANFIELD, THE MORAL BASIS OF A BACKWARD SOCIETY (1958); BENEDICT, *supra* note 133. One example of the destructive force of "reality v. trust" is the "negative campaign" waged in the political arena today. As candidates smear each other, the public tends to distrust both candidates, the political process, and political institutions. Negative campaigns may help tear down the existing political structure. This may not be bad in itself, but other candidates or institutions will likewise be unable to sustain trust, and will fall victims to the campaign tactics that helped bring them to power.

154 Trust is in part a cultural trait. Americans are trusting and, some would say, gullible people. State securities laws are called "Blue Sky laws" for a reason: the legal system presumes that Americans would buy anything, including the Blue Sky. In some countries those who save their money do not trust the securities markets or even the banks. They invest their savings in non-productive assets, like gold, to the detriment of the countries' economies.

However, even Americans' naivete is wearing thin. They have become more sophisticated and more disillusioned. Once they withdraw from the markets, and they have in the past, it takes years for them to forget their experiences and return. Admittedly, the probability of full investor withdrawal from the securities markets may be small, but the magnitude of the harm to the economy from such withdrawal is staggering. Therefore, the legal system should be concerned with maintaining investor trust both in corporate management and other financial intermediaries who are the investors' fiduciaries. Allowing the tinkering with the model of fiduciaries may erode trust. Therefore, waivers of fiduciaries' duties should not be allowed where our financial system can be at risk. *See* Allan W. Vestal, *Choice of Law and the Fiduciary Duties of Partners Under the Revised Uniform Partnership Act*, 79 IOWA L. REV. 219, 225 (1994) (arguing that the default choice of law rule under RUPA contradicts general choice of law policy by adopting contractarian, rather than a "more flexible, evaluative and content-considering choice of law analysis."). The market-in-partnership law model is normatively erroneous because the private interests of partners should not supersede or displace the social interest in direct regulation. *Id.*

155 It is indeed rational that emotions motivate human behavior generally, and organizational behavior specifically. *See* Don L. Coursey et al., *Fear and Loathing in the Coase Theorem: Experimental Tests Involving Physical Discomfort*, 16 J. OF LEGAL STUD. 217 (1987) (reaffirming the Coase Theorem, i.e., parties choose an efficient outcome, in a bargain situation with asymmetric payoffs; however, the

Third, this internalization is much like the moral interdependence theory of lawyer-client relationships. Recognizing that lawyers frequently collaborate with clients, not merely advise them at arms length, lawyers must accept some responsibility for the outcomes they achieve and thus internalize, at least in part, the moral dilemmas of their clients.[156]

Fourth, the public trustee model influences other peoples' behavior. If society demands high standards of public fiduciaries, others will likely conform to similar standards. As a result, public fiduciaries, when choosing between honesty and self-gain, will strive to meet the articulated social standards, or at least, to avoid admitting failure and experiencing the associated shame. Thus, arguably, the very existence of a model of a fiduciary induces corporate managements to adhere to the duty of care and loyalty. In contrast, if entrustors and others habitually view fiduciaries as contract parties, they will also live down to the contract standard.

Fifth, the legal fiduciary model serves an important role, notwithstanding the possible internalization of other social norms by public fiduciaries. As one scholar suggested, a trust-based model of the firm must contain the traditional fiduciary duties because business relationships that require a balance of self-interest and trustworthiness are potentially unstable over time.[157] Contract alone cannot fill this stabilizing role because the parties are unable ex ante to identify ex post problems that arise from absence of reciprocal treatment. Societal and corporate normative standards bolster a commitment to honor other persons' interests. Furthermore, by adopting norms as law, these norms are communicated to the large number of persons within society's sub-units, and the legal enforcement of these norms complements informal sanctions, such as social disapproval and refusal to deal with violators. The discipline of management arises not only from public fiduciaries' fear of external punish-

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Coase Theorem may not apply when a choice involves degrading conduct, physical discomfort, or other affront). Similarly, in strategic decision-making, the desire to avoid the discomfort of shame or guilt from engaging in behavior deemed socially unacceptable will motivate an actor to avoid such behavior and thus influence decision-making.

[156] *See* Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507 (1994).

[157] *See* Marsh, *supra* note 78.

ment, but perhaps more so from the fiduciaries' internalization of the expectations of society (or the corporation).

Sixth, the trust model can serve as a "decentralized" lawmaking, absorbing and enacting social custom. Such lawmaking develops by applying community norms to determine fault and liability, for example, by having established the community's consensus about what its members ought to do. When actors internalize these norms, a completely decentralized legal system is in place, which in theory dispenses with the need for state law and enforcement. Ample evidence supports the notion that informal sanctions to enforce accepted norms are often more important than state enforcement of these norms.[158]

Seventh, informal sanctions to enforce accepted norms are usually effective when the same parties engage in continuing relationships. The promise of gains from future transactions,[159] reciprocal treatment ("tit-for-tat"), the threat of termination of the relationship ("exit") and internalization of the norms of behavior, all strengthen informal enforcement of trustworthiness today. In the corporate context, however, management deal mostly with numerous and changing shareholders. In such a context, self-imposed efficient or mutually advantageous norms will be practiced less frequently. Shareholders cannot effectively reciprocate by terminating the relationship without incurring high costs and facing free-rider problems. Therefore, managements internalize the norms of behavior only partially, and informal enforcement as to management falls short of the optimal level. In the corporate context, optimal deterrence demands supplementing informal sanctions with legal sanctions. The appropriate role of the state, then, would be to draw on efficient social norms and elevate them to the level of law.[160] Stricter mandatory rules on public

158 *See* Robert C. Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623 (1986) (describing evidence that rural landowners in the face of high transaction costs, i.e. legal rules, ignore or do not know the legal trespass laws, and instead enforce informal norms, or perpetuate the prior (efficient) allocation of resources); *see generally* ELLICKSON, *supra* note 107.

159 *See* Wendy J. Gordon & Tamar Frankel, *Enforcing Coasian Bribes For Non-Price Benefits: A New Role for Restitution*, 67 S. CAL. L. REV. 1519 (1994).

160 *See* Robert D. Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT'L REV. L. & ECON. 215 (1994) (positing the usefulness of decentralized lawmaking particularly in a specialized business network and setting forth a method for adjudicating business norms: first, lawmakers should identify business community norms; second, lawmakers should identify the incentive structure giving rise to the norm; and third, the efficiency of the incentive structure

fiduciaries would foster such internalization and protect against the instability of trust relationship over time.[161]

Eighth, if the trust model did not exist, and if entrustors viewed their fiduciaries "realistically" and needed to verify the fiduciaries' trustworthiness, entrustors would (1) expand the monitoring of their fiduciaries at higher costs and reduced benefits from the relationship; (2) withdraw into the "do it themselves" mode, reducing specialization in services that require a high level of investment and bring benefits to society; and (3) abandon the activity altogether—for example, cease to invest in mutual funds. If the activity is beneficial, the losses to society as well as to individuals could be substantial.[162]

2. *Creating Property Rights in Office*

Another result of recognizing empty entrustors' consents is to create property rights in directorships and offices for management. The contractarian regime is bound to produce this new

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should be analyzed using economic tools, and only efficient incentive structures should be enforced by law).

161 In describing the market mechanism's effect on creating properly responsive management, Edward S. Herman stresses the importance of culture and environment, not just on creating law out of ad hoc or informal business practices, but on crafting real reform and improvement of corporate governance standards. He asserts that it was the political and moral climate of the 1920s and 1930s that institutionalized the best business practices such as requiring disclosure, forbidding insider trading, permitting shareholder derivative suits and creating the SEC. Given "the whole climate of opinion" and its outgrowth in government regulation as sensitizing boards of directors to reform, Herman aptly quotes, "If the medieval moralist was often too naive in expecting sound practice as a result of lofty principals alone, he was at least free from that not unfashionable form of credulity which expects it from their absence or from their opposite." Edward S. Herman, *The Limits of the Market as a Discipline in Corporate Governance*, 9 DEL. J. CORP. L. 530, 539 (1984) (quoting R.H. TAWNEY in RELIGION AND THE RISE OF CAPITALISM).

162 Arguably, if corporate charters reduce or remove management's accountability and investors discover management's misappropriation, there is a serious danger that investors will withdraw from the markets. Empirical studies suggested that the price of the stock of such corporations have fallen by about five percent (and some think this is a large discount and some discount the discount). For a discussion of these studies see 1 TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES § 3.3.3, at 86 (1991). Yet another current trend of small investors points to a far larger impact. Small investors are investing through intermediaries, as is demonstrated by the recent enormous growth of mutual funds. If investors lose their trust in corporate managements or in their money managers, I do not believe that they will refrain from selling because of lower prices. They will try to cut their losses. As the studies of "runs" have shown time and again, investors are likely to withdraw from the institutional investors through which they have invested in corporate securities.

type of property in a public office. In fact, such property rights existed in the past, and were slowly terminated with the emergence of democracy.[163] Unlike private fiduciary relationships, corporations mirror political institutions that started with the rulers as the owners of the realm. Office constituted a species of property that could be bequeathed, sold, delegated and given as a gift. With the development of democracy the status of the rulers changed to that of trustees, holding the power of government in trust for the people. The power to rule was shorn of all its ownership features: the power could not be bequeathed, delegated, sold and given as a gift. Rulers were not allowed to benefit from the power except by specified and authorized compensation.[164] These principles apply to corporate management.[165] Thus, if the rules governing public fiduciaries are default rules that can be changed by imaginary and unreal consents, we will return to the ancient property rights of office.

By itself, this conclusion does not mean that the trend is bad. After all, if obtaining consent from public entrustors is costly and they themselves are not willing to bear the costs of having their voices heard, management should be allowed to acquire limited property rights in their office, similar to squatters' rights based on adverse possession. Yet, I suggest that awarding management such property rights, whether formally or in fact, is generally not a good idea.

First, this kind of a property right does not produce the desirable incentives that we expect property rights to produce. Rather, such a right in office produces the kind of incentives that bureaucracies possess, and that centralized management economies have demonstrated to be less productive and less competitive. Our concept of ownership vests control in those who take the residual risks (and residual gains) because we believe that those who take the residual risk from economic resources are the most suitable to set the optimal level of risk for the use of these resources: not so low as to produce gains to pay only the creditors and not so high so as to leave assets to pay only the creditors. Thus, if control without residual risk passes to corporate manage-

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163 *See* 2 SIR WILLIAM BLACKSTONE, COMMENTARIES 36.

164 *See* SCOTT & FRATCHER, *supra* note 41, § 170.22 at 415 (stating general rule that trustee is not entitled to receive a benefit other than compensation).

165 Corporate management may be the "humble servants" of the shareholders the way the British High Commissioner of Palestine signed off on every letter that carried his facsimile signature.

ment (though with some residual gains), management's decisions will not be optimally efficient.

Arguably, as compared to small shareholders, management should be entitled to some propriety rights. Even though small shareholders contribute risk capital to the enterprise, they (1) lose less than each member of management when the corporation experiences losses, and (2) contribute less than management members to the success of the company. Even though members of management have not contributed substantial amounts of risk capital to the enterprise, they have in many cases contributed their talents and lives to the enterprise and made it a success. Thus, it is a misnomer to call small shareholders owners of the enterprise. They should be cast as "lenders of risk capital," and management as holding substantial powers and rights of the owners.[166]

For political and doctrinal reasons, neither the legislatures nor courts will explicitly rearrange the ownership package.[167] The arguments for such division of risks, benefits and control undermines our concept of ownership, and also opens the door to claims by other contributors of labor to ownership rights in the enterprise. In our system, labor is not entitled to control the means of production by virtue of its contribution, and the power of management to control the enterprise is legitimized on the basis of representing the corporation and its shareholders, not on the basis of its contribution to the growth and success of the corporation. Those who provide service (as fiduciaries or employees or independent contractors, or any other type of relationship) no matter how extensively their fortunes are linked to the enterprise, and how deep their commitment to the enterprise is, cannot become owners by virtue of these factors.[168] Commitment to the enterprise demonstrates loyalty that would suggest lax rather

166 Treating small shareholders as lenders is problematic because management of a solvent corporation owes little, if any, fiduciary duty to lenders, who must protect themselves contractually. *See* Painter, *supra* note 156, at 532-35 (noting that creditors exert control over corporations either by detailed contract or by the recall or repayment of loans, both of which are costly and ill-suited device for the small investor).

167 *See* Frankel, *Fiduciary Relationship*, *supra* note 27, at 191-93.

168 *See e.g.*, Joseph William Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 614 (1988) (arguing that employees had a reliance interest which entitled them to enforce the sale of the plant to them, and criticizing the decision in Local 1330, United Steel Workers v. United States Steel Corp., 631 F.2d 1264 (6th Cir. 1980), refusing to recognize such employees' claims).

than strict rules, but does not "buy" additional entitlements at the expense of the owners of the enterprise.

Second, a realistic view of public fiduciaries may justify the laxity of corporate law as compared with private fiduciary law by the simple fact that those who own more property (private entrustors) command greater protection of their property, in terms of rules and judicial enforcement, than those who own little property (shareholders in publicly held corporations).[169] This explanation might seem cynical, but is grounded in history when political and governmental powers were tied to property ownership. It was property owners who used and employed fiduciaries and who needed protection from fiduciaries' abuse of power.[170] It was rich property owners who used fiduciaries to evade inheritance and tax laws; those who owned little property were not occupied with such problems.[171] Thus, in the past and today the private entrustors are those large property owners who can employ and use particular fiduciaries. The small property owners are the public entrustors who seek the services of public fiduciaries. They have less clout under the legal system.

I do not find this realistic view a justification and reject it. The law ought to protect small owners as it does large owners, not only because the law should offer equal protection, but also because our economy is not built on the savings contributions of the very rich but on the savings contributions of the middle class.[172] Even if protection of the small entrustor is more costly overall, such protection provides incentives that make society better off long-term.

169 We have seen that private fiduciaries are regulated more strictly than public fiduciaries. For example, in the corporate context, definition of a transaction in conflict of interest in §8.60 of the RMBCA is limited to an action by the corporation itself, not to economic actions by the director not involving the corporation. The directors' use of "poison pill" rights to obviate takeover is not a transaction under § 8.60. Neither is the directors' purchase of the corporation's shares on the open market from a third party. *See supra* note 152. Just as importantly, per capita, private entrustors command more of the courts' time, as compared to public entrustors.

170 *See* George T. Bogert, Trusts § 2, at 6 (6th ed. 1987) (in the early stages of the development of trusts in England, their principal objectives included avoiding the burdens of holding legal title to land and facilitating transfers of land inter vivos or by will).

171 *See* Scott & Fratcher, *supra* note 41, § 1 at 7 (trusts have been used to evade tax and inheritance laws). These laws affected real property owners. The poor were concerned with other problems.

172 *See supra* part IV regarding the possible withdrawal of savings of public entrustors.

Finally, at this point it seems clear that the main problem with public fiduciary law is the absence of a reliable entity to consent to conflict of interest transactions. The problem does not arise when fiduciaries "own" their office, so to speak. They may own a fiduciary business as independent contractors.[173] The problem arises when fiduciaries acquire "squatters' rights" to entrusted powers or property through misappropriation because the owners find it too costly to protect their property from the fiduciaries' conversion, and there is no surrogate for the owners to consent or prevent the misappropriation. Regardless of whether public fiduciaries act as independent contractors, or employees or elected officials, the duties of loyalty and care apply to them and should be effectively enforced against them.

3. *Make All Public Fiduciary Rules Mandatory*

So long as public entrustors cannot give effective consent and we believe that legal fiduciary relationships are important, we should render all fiduciary rules mandatory, and simply ignore so-called consents of public entrustors.[174] In any event, the courts should continue to superimpose fiduciary principles on whatever statutory or contractual arrangements are in place, and I hope will continue to view with great skepticism the intracorporate and external surrogate consenters now in place, until the culture that contractarian policies have nurtured will be overcome by a culture of trustworthiness and self limitation.

CONCLUSION

Fiduciary law and contract law are designed to address somewhat different problems. Fiduciary law is designed mainly to deter fiduciaries from misappropriating entrusted power and acting with lack of care. Similar to the crime of embezzlement and the torts of conversion and negligence, fiduciary law regulates the holders of power that belongs to entrustors. Contract law is

[173] This is the situation of investment advisers to investment companies, described part IV *supra*.

[174] This conclusion does not necessarily mean that Congress should pass a federal corporate law for all corporations. The conclusion might support a federal law applicable to the largest corporations in this country. Examples of such partial federal laws are the Securities Exchange Act of 1934 and the Investment Company Act of 1940, which are superimposed on whatever legal structure investment companies adopt under state law. To the extent that they do not conflict, state laws govern. Similar fiduciary principles can be applied to the largest public fiduciaries in this country.

designed to formalize and enforce mutual promises between parties. It regulates both parties equally. The main difference between the two systems revolves around the right of one party to rely on the other. Entrustors are entitled to rely on their fiduciaries to a greater extent than contracting parties are entitled to rely on each other.

There are good reasons for allowing the entrustors and their fiduciaries to bargain around fiduciary rules and for enforcing the entrustors' consent to waive the fiduciaries' duties. There are also good reasons for providing a special process for these bargains and waivers, different from the contract process. This process is necessary in order to transform the relationship from the fiduciary mode to a contract mode.

In addition, there are reasons to limit entrustors' ability to waive some of their rights. Although the limitations seem paternalistic, they can be justified by concerns that, "once badly burned," entrustors will refrain from entering fiduciary relationships, to the great detriment to society as a whole. Even though some fiduciaries will be scrupulously honest and careful, a sufficient number of bad experiences might convince entrustors to limit their fiduciary relationships rather than bear the costs of protecting themselves.

Our present economic and business system requires that entrustors enter into numerous fiduciary relationships. If they withdraw, the system on which our national financial and economic well-being is based is likely to disintegrate. The probability of such an occurrence may be low, but the harm from such disintegration may be devastating. To prevent such a disastrous result, fiduciary duties should be imposed and entrustors' waivers of such duties should be allowed only under well-defined circumstances, or prohibited altogether. In sum, fiduciary law is not, and should not be, contract.

Public fiduciaries are different from private fiduciaries because they usually are vested with more power and are subject to less constraint. Therefore, the requirements of the process of the entrustors' consent to conflicts of interest by such fiduciaries should be stricter. However, we have not found an efficient mechanism to effectuate this process. Neither have we found reliable surrogates to consent for the numerous entrustors.

We thus have two possible solutions. One is to impose all fiduciary rules as mandatory. This solution will preserve the legal trust model, without which an economy such as ours cannot exist long. Further, we should not abandon the search for effective surrogates, and reexamine possible models such as a government agency or private compulsory arbitrators, who are independent and knowledgeable business persons to act as surrogate consenters for public entrustors. The second solution is the contractarian solution. In essence, it eliminates fiduciary law altogether and vests some kind of property rights in office, property rights that we have abolished generations ago with the evolution of democracy. I reject this solution as extremely harmful to our society. In sum, the anti-contractarians have it.