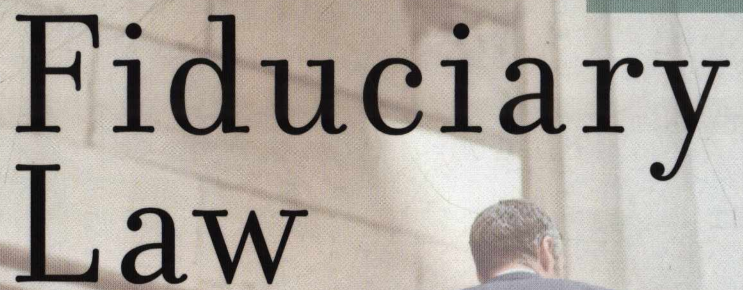

Tamar Frankel

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FIDUCIARY LAW

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Published by Oxford University Press, Inc.
198 Madison Avenue, New York, New York 10016

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Library of Congress Cataloging-in-Publication Data

Frankel, Tamar.
Fiduciary law / Tamar Frankel.
p. cm.
Includes bibliographical references and index.
ISBN 978–0–19–539156–5 (hardback : alk. paper)
1. Trusts and trustees—United States. I. Title.
KF730.F728 2010
346.7305'9—dc22

2010020814

1 2 3 4 5 6 7 8 9

Printed in the United States of America on acid-free paper

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To my husband Ray Atkins and my children Anat and Michael

CONTENTS

Acknowledgments xi
Introduction xiii

CHAPTER 1 THE NATURE OF FIDUCIARY RELATIONSHIPS 1

A. Introduction 1
B. The Recurrent Elements of Fiduciary Relationships 4
C. A Proposed Definition of Fiduciary Relationships 6
D. Examples of Fiduciary Relationships and Their Boundaries 42
E. How Do the Courts Recognize Fiduciary Relationships? 62
F. The Dark Side of Fiduciary Relationships 73
G. The Debate 77

CHAPTER 2 WHERE DOES FIDUCIARY LAW COME FROM? 79

A. Introduction 79
B. The Laws of Hammurabi and Eshnunna 80
C. The New Testament 83
D. The Sharia Islamic Law 84
E. Jewish Law 86
F. Influence of Moral Themes and Religion 88
G. Roman Law 90
H. High Middle Ages 92
I. Recent U.S. History 96
J. The Debate 97

CHAPTER 3 THE DUTIES OF FIDUCIARIES 101

A. Introduction 101
B. Fundamentals 103

C. The Main Duties of Fiduciaries 106

D. The Duty of Loyalty 107

E. Duties Implementing the Duty of Loyalty 121

F. The Fiduciaries' Service-Contracts and Compensation 131

G. The Debates 146

H. When Should Fiduciaries Consider Public Interest? 156

I. The Duty of Care 169

J. Serving Entrustors Whose Interests Conflict 177

K. Fiduciaries' Rights and Protections from the Entrustors' Claims 182

L. Fiduciary Duties in Legislation 183

CHAPTER 4 DEFAULT RULES IN FIDUCIARY LAW 195

A. Introduction 195

B. The Process of Releasing Fiduciaries from Their Duties under Fiduciary Rules 200

C. The Nature of Consent and Surrogate Consenters 207

D. Default Rules and Contracts 212

E. The Debate 215

CHAPTER 5 WHY VIEW FIDUCIARY LAW AS A SEPARATE CATEGORY? 217

A. Introduction 217

B. Categories Matter 217

C. Should Fiduciary Law be Viewed as a Category? 223

D. The Debate 229

CHAPTER 6 THE COURTS' REGULATION OF FIDUCIARIES, REMEDIES, AND PROCEDURES 243

A. Introduction 243

B. Courts' Use of Judicial Discretion 243

C. Remedies Providing Relief on Violations of Fiduciary Duties 248

D. Equitable Remedies 256

E. Punitive Damages 258

F. Dissolution of a Corporation 260

G. Criminal Sanctions 260

H. Standing to Sue and Procedural Issues; Common Law and Equity 262

I. Liability of the Transferee of Entrusted Property Who Knew of the Entrustment 267

J. Resulting Trusts 267

K. Conclusion 269

CHAPTER 7 THE ROLE OF FIDUCIARY LAW IN FACILITATING ENTRUSTMENT AND TRUST 271

A. The Nature and Role of Trust 271

B. The Barriers to Abuse of Trust and Dishonesty 272

C. The Debate 276

Epilogue 279
Bibliography 289
Table of Cases 293
Index 305

ACKNOWLEDGMENTS

No book is written by one person alone. Ideas are drawn from many sources, written, and verbal. The end-notes and bibliography acknowledges only a few. Throughout the years I have received assistance from researchers and commentators. Singling out some may be unjust. Yet I want to specifically thank those who have helped shape this book during the past two years. Jake Brooks has read the versions and gave great, perceptive comments. William Hecker, Esq. and Claudia Calberston enriched the authority base of the manuscript by meticulous and responsible research. My husband, Ray Atkins has patiently read the manuscript and offered invaluable straightforward comments. My son Michael Frankel had marvelous ideas and my daughter, Anat Bird's experiences helped shape my thoughts. The workshop at Boston University Law School has been a source of insights and Mr. George Michaels-an invaluable financial support. I owe all a debt of gratitude.

Tamar Frankel
Massachusetts, 2010

INTRODUCTION

Most of us maintain fiduciary relationships throughout our lives. We relate to others both as fiduciaries (agents, corporate officers and directors, trustees, lawyers and physicians), and as the parties to fiduciaries (principals, investors, beneficiaries, clients and patients). These relationships can be embedded in contracts, in property transfers, in shareholding, and in other types of everyday transactions. And yet, little has been written about all these relationships as a group. Where did they come from, and where are they going in the future?

This Book offers a theory of fiduciary law, uncovering its underlying structure, principles, themes and objectives, and laying out a map of fiduciary law's reach and its limits. Because we review various fiduciary relationships together, we need a name for all parties to whom the various fiduciaries relate. In this Book, we call these parties Entrustors. The name is derived from the word entrustment, which all parties to relationships with fiduciaries make—they entrust to fiduciaries property and power. The word Entrustors is also a derivative of the word trust, on which all fiduciary relationships must be based.[1]

Like all laws, fiduciary law is shaped by the society which it governs–by the pressures society exerts on its members outside the law, and the values society's members feel constrained to follow. The greater the pressures, and the higher the values self-limiting antisocial activities are, the lower is the need for law. The reverse is also true. If social pressures and values denouncing antisocial behavior are weak, there comes a point when law must be used to prevent the reign of antisocial activities, even though there may be a time lag before law is activated.

In America, among social pressures is public opinion, expressed in newspapers, television and mass interaction by electronic devices. Among the values are the balances between reliance on others and self-reliance; costs and benefits, risk-avoidance and risk-taking, commitment to self and to society.

Pressures society exerts on its members. In the United States, unless public opinion is strong, loud, and persistent, it does not seem to deeply affect powerful fiduciaries' misbehavior. Neither does public opinion seem to play a decisive role in imposing strict fiduciary law rules. In fact, the powerful fiduciaries' success leads. The lore of equality in the United States promotes admiration for fiduciaries that earn millions every year. "If they can do it, so can I" is especially influential when securities market prices rise and quick money is to be had.

1. The word "entrustor" was used in Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (1983). In 2008, the word was not found in the Webster Dictionary, although "entrust" and "entrustment" were. Nonetheless, in a 2008 Google search the word "entrust" in connection with fiduciary duties was found in over 2,400 sources.

American fiduciaries seem to be less affected by shame and empathy as fiduciaries in other cultures are.[2] And even when public outrage at exorbitant compensation spills over, it meets with a strong resistance by these fiduciaries and their supporters. The process of tightening fiduciary rules is slow. Similarly, although one court has taken a stronger view of fiduciaries' compensation[3] and the Supreme Court has shown interest in the fees of investment companies' advisers,[4] and even though there are suggestions that brokers should be imposed with fiduciary duties, it is unclear whether the trend towards imposing tighter fiduciary duties will continue. In general, only very strong public pressures tilt the scales towards stronger legal restraints of fiduciaries.

The lore of self-reliance is strong in the United States. Self-reliance applies to the dependents as well as the strong. The belief in self-reliance weakens legal restraints to protect the weak against the strong. The idea is that at most, entrustors should be entitled to disclosure in order to equalize "asymmetric information" held by the strong. Once disclosure is made, entrustors should fend for themselves. This attitude does not necessarily support fraud and asymmetric expertise. Yet, because the vision of the American person as a self-reliant person is paramount, the need for law or for government to protect entrustors is weakened—Americans can take care of themselves as against their fiduciaries.

Americans tend to evaluate legal constraints in terms of cost. This tendency leads to restricting fiduciary law. After all, the cost and benefits of antisocial behavior are hard to quantify as compared to the costs and benefits of legal constraints. It is difficult, if not impossible, to quantify the losses to society from violations of fiduciary duties and the harm to the economy and financial system from such violations. Besides, the costs of violations change. After all, even if investment banks breached their fiduciary duties and failed, they might revive, or others will rise.

In contrast, the cost of government regulation can be quantified in dollars and cents. Government officials stay on the job and their numbers may sometimes grow, even if their services are no longer needed. Further, regulation is likely to reduce innovations and the fiduciaries' profits. These present losses to society. The lore of "small government" is accompanied by the lore that markets will take care of problems and competition will control excesses. Even after the crash of 2008 there were voices that objected to government interference and

2. Tamar Frankel, Trust and Honesty (2006).

3. Complaint, SEC v. Bank of Am., No. 09CV6829, (S.D.N.Y Aug. 3, 2009); Joshua Gallu & Lorraine Woellert, *Bank of America May Face More Claims, SEC Aide Says (Update 3)*, Bloomberg, http:/acprof:oso/www.bloomberg.com/apps/news?pid=20601087&sid=ak53n.FrzbYg&pos=4.

4. Jones v. Harris Assocs., L.P., 527 F.3d 627 (7th Cir.), *reh'g denied, reh'g en banc denied*, 537 F.3d 728 (7th Cir. 2008), *vacated, remanded*, No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).

argued that the markets would have solved the problems better. These are arguments against imposing constraints on fiduciaries.

On the entrustors' side, many Americans are risk-takers. They borrow on the assumption that things will turn out better, and problems will somehow work themselves out. Many tend to seek short-term satisfactions. Many can be swayed by sales talk. Not surprisingly, advertising and sales play a crucial role in America. The promise of money benefits for entrustors reduces the view of the risks that they might take. Therefore, law seems to be an impediment to risk-taking until Americans discover the cost of risk-taking and the consequences of illusions. Risk-taking contradicts the imposition of constraints, including legal constraints.

In the balance between the individual's interests and commitment to the collective, Americans choose the individual. It matters not that a large percentage of Americans are not independent earners but employees.[5] It matters not that market bubbles and crashes are the result of mass following and absence of individual decision-making. Americans insist on their right as individuals to follow the crowd. Americans are a generous people and open-handed contributors. But as a matter of principle a commitment to the public good has not been the American vision. The "tragedy of the commons" theory is based on the assumption that people will try to maximize their benefits at the expense of others and that private ownership results in more productivity than public ownership. This conclusion has proven accurate in the United States. Public ownership may have been successful when people needed the joint communal effort to advance or even survive. With prosperity, private ownership induced far more drive and creativity.[6] Individualism resists constraints, including law and the government. The considerations described above may pressure to reduce the need for fiduciary law, even when law is needed.

Fiduciary law rules should be examined, explained, and evaluated in light of America's social pressures and values. The sections entitled Debates in this Book reflect the conflicts about social pressures and values mentioned here. Changes in fiduciary law reflect changes in society. When the balance tilts to extremes, both by fiduciaries and entrustors, and when both fail to withstand temptation, fiduciary law should play the role of correcting the imbalance.[7]

5. In the recent census about 120 million people in the United States are employees. U.S. Census Bureau, *Statistics of U. S. Businesses*, http:/acprof:oso/www.census.gov/econ/susb/ (last visited Mar. 30, 2010).

6. In Israel, the Kibutzim, the joint agricultural settlements, were very successful until they became more prosperous. The division of benefits and burdens shifted from equality, and they became similar to business enterprises rather than to joint efforts.

7. Government officials are fiduciaries too (being entrusted with public assets and power). They might slide in the same slippery slope and succumb to temptation to amass more power than their tasks need, use their power for their own benefit and fail to

Like other rules governing social and human relationships, fiduciary law reflects the inherent contradictions in society. To survive, humans must depend on others. In fact, society is built on its members' specialization and reliance on each other's expertise. However, the greater the need for specialized and dependent persons, the higher is the dependents'—entrustors'—risks that their reliance would be abused and harmful. That is because not all trusted fiduciaries can withstand the temptations to benefit from entrustment while not all entrustors can protect themselves against harm from fiduciary relationships. Therefore, society recognizes and creates different mechanisms to strengthen the fiduciaries' reliability. Among these mechanisms is fiduciary law.

A similar contradiction appears in society's approach to reliance. While people must rely on others, people are expected to protect themselves against their fiduciaries' abuse of trust. The line between reliance and self-protection depends on the particular actors (*e.g.*, adults or children), on the nature of the interaction among them (*e.g.*, equal or unequal bargaining power), and on the culture and needs of the society in which they live (*e.g.*, cultural strength of shame and empathy). In addition, in situations in which entrustors and fiduciaries have similar interests in a transaction, the entrustors themselves may consent to relieve the fiduciaries of legal constraints. The line is not carved in granite and is seldom specified for each and every situation. The principles and examples in this Book offer guidance towards this line.

Reliance and trust are closely related. Both trust and reliance are self-contradictory. I define trust as a reasonable belief that the other party will tell the truth and perform its promises. Volitional reliance may be viewed as active trust. Both reliance and trust are socially valuable, especially in situations involving high cost of verifying the truth of other people's statements and the reliability of their promises. The Russian proverb "Trust but verify" is self-contradictory but true. People compare the cost of trusting and relying on others with the cost of verification (or avoiding interaction).

Law poses conflicts of its own. The benefits of constraining abuse of entrustments, increasing trust and reliance must be weighed against the costs of these constraints both for the government and to the fiduciaries. The costs of legal constraints to the fiduciaries must be weighed against the benefits of gaining entrustors' trust and reliance. And, as in evaluations of human relationships, there is a distinction between the short-term certain benefits and risks and future probable losses.

In some respects all fiduciaries expose their entrustors to the same kind of risk (abuse of entrustment and poor performance of service promises). Therefore, the focus of the law is not as complicated as the variety of fiduciaries and the

perform their tasks well. This Book, however, deals with fiduciaries—the holders of entrusted private power. The analogy to government power is discussed in the Epilogue.

rules that govern them seems to indicate. The theory of fiduciary law seeks to mark the area of balance between the risks of entrustment and the cost of verification, self-protection, and government interference. The lower the costs of verification, the greater the entrustors' ability to self-protect, the lower the legal intervention would be. It may be more difficult to isolate the particular point in which a slippery slope towards abuse of entrustment begins. It is easier to mark the range of danger zone when a slippery slope has begun or likely to begin. In this area certainty of a particular rule (if it can ever be achieved) may be watered down to reach the goal of maintaining trust in, and reliance on, fiduciary services. Therefore, fiduciary law focuses on the range of the slippery slope towards fiduciaries' abuse of entrustment and lack of reliance performance.

A view of fiduciary law as a category that embraces different fiduciaries has critics. Some critics advocate the traditional focus on each type of fiduciary (*e.g.*, agents, directors, professionals). They argue that combining all fiduciaries under one roof creates an indeterminate law.[8] To be sure, the category of fiduciaries is open to new members, both similar and different from the other. Indeed, to this extent fiduciary law may be viewed as indeterminate. However, I argue that there is no rule of law that is clear and determinate. The issue is always one of degree.

Others deny the existence of fiduciary law, and view fiduciary relationships as species of contract, consisting of default rules and the fiduciaries' duties of disclosure. However, fiduciary law contains features similar to tort law, equitable remedies and other areas of law. It has its own characteristics. Different views of fiduciary law have far reaching consequences. These views affect social mores. For example, the contract mode shifts the burden of self-protection to individual actors in the markets. The tort mode views every fiduciary's transgressions as a civil wrong. Fiduciary law has a flavor of its own, as this Book will demonstrate.

THIS BOOK IS ORGANIZED AS FOLLOWS:

Chapter 1 defines fiduciary relationships. It outlines the elements that compose the relationships and exposes gray areas in which fiduciary relationships might arise or fade and disappear. Chapter 1 highlights the disagreements and margins of uncertainty involved in defining fiduciary relationships and the debates about the role of the law in recognizing fiduciary relationships.

Chapter 2 offers an overview of roots and history of fiduciary law. The materials point to the problems that the ancient laws addressed, and the

8. *See* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L. J. 879, 879 (1988) (narrating the indeterminacy of fiduciary law).

impact of culture, religion, and commerce on the solutions those laws offered. Against this short background of over 3000 years, some of the colors of the present law emerge sharper and more vividly.

Chapter 3 deals with fiduciary duties. It outlines the rationales for imposing different degrees of such duties in different situations. The material in Chapter 3 demonstrates the connection between the potential severity of fiduciaries' abuse of power, the inability of the entrustors to protect their entrustment against fiduciaries' abuse, and the strictness of the rules that the law imposes.

Chapter 4 discusses the way in which fiduciary duties can be relaxed and changed by an agreement among entrustors and their fiduciaries. Many fiduciary duties are default rules allowing entrustors to waive their rights under the law, provided the entrustors are independent of their fiduciaries, and received all the information they needed to determine whether to waive the law's protective rules. In this Chapter we view situations in which fiduciaries are obligated to many entrustors, whose interests are conflicting, and the principles and guides that the fiduciaries should follow in such situations.

Chapter 5 focuses on the arguments concerning the status of fiduciary law as a category. What is so important about categories? The previous Chapters demonstrate the unique nature of fiduciary law. This area of law is part property and part contract; it rubs shoulders with tort law and criminal law. Should it remain unique and be viewed separately? This Chapter raises the issue, the arguments, and the implications of categorizing fiduciary law as contract, and argues for a view of fiduciary law as a separate category.

Chapter 6 proceeds to analyze the courts' discretion in fashioning fiduciary rules, the courts' self-imposed limitation in exercising their discretion, the remedies that can be meted out on breach of fiduciary duties, and the equity and common law court procedures that draw on the historical judicial sources of the duties: the British common law and equity courts.

Chapter 7 examines the idea and practice of trust. Even though most human relationships are based on some degree of trust, fiduciary law aims at situations that require a high level of trust. The Chapter explores the nature and reasons for the law's interference in support of trusting relationships.

No area of the law is static. But fiduciary law seems more dynamic than others. It touches many disciplines such as economics, philosophy and ethics. It raises the fundamental issue of private entrusted property and power, similar to entrusted government political power. In both cases the people voluntarily give their property and empower a trusted few to act for particular purposes. In both cases there are structures aimed at preventing abuse of such entrusted property and power. Not surprisingly, fiduciary law raises strong and passionate

disagreements about its reach and even about its existence as a category. The Book closes with a short Epilogue that notes the similarities between fiduciary law and the laws and theories concerning governing political power. As private power deepens and affects larger parts of the population the comparison should not escape us.

I have taken positions on these and other issues, but have included the ideas contradicting my positions. The ultimate judge in these debates is you, the reader.

1. THE NATURE OF FIDUCIARY RELATIONSHIPS

A. INTRODUCTION

This chapter offers a general definition of fiduciary relationships. The definition draws on the problems fiduciary relationships raise, and highlights the elements of the situations in which court decisions and legislation recognize these relationships. The chapter also discusses the courts' rationales in determining that a relationship is fiduciary.

Rarely do court decisions and legislation provide a general definition of fiduciary relationships. Legislation,[1] the Restatements of the Law (ALI),[2] and Uniform Codes and Statutes, such as the Uniform Trust Code,[3] define species of fiduciary relationships for the rules the legislation contains. Courts are less focused. While dealing with the facts of a particular case, the courts often base their classification on a more detailed list of elements to define fiduciary relationships.[4]

---

1. *See, e.g.,* Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(3) (2000) (definition of "affiliated person"); *id.* 15 U.S.C. § 80a-2(a)(9) (definition of "control"); *id.* 15 U.S.C. § 80a-35(b) (investment adviser of registered investment company has fiduciary duty with respect to compensation or payments by investment company to adviser or affiliate); Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1002(21) (2000) (definition of "fiduciary" with respect to pension plan); DEL. CODE ANN. tit. 12, § 3301(b) (2001) (definition of "fiduciary" for fiduciary relations law); MD. CODE ANN., EST. & TRUSTS § 15-114(a)(2) (West 2001) (definition of "fiduciary" for guidelines and standards for investment of assets).

2. RESTATEMENT (SECOND) OF AGENCY (1958); RESTATEMENT (THIRD) OF TRUSTS (2003); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994); *see,* e.g., WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP (3d ed. 2001); AUSTIN WAKEMAN SCOTT, WILLIAM FRANKLIN FRATCHER, & MARK L. ASCHER, SCOTT AND ASCHER ON TRUSTS (5th ed. 2007); FRANKLIN A. GEVURTZ, CORPORATION LAW (2000).

3. Uniform Trust Code § 103(20) defines a "trustee" to include "an original, additional, and successor trustee, and a cotrustee." Note: The duties/powers of a trustee are outlined in sections 801–817. Specifically the duties are at sections 801–814 and the powers at 815–817. UNIF. TRUST CODE (2005), http://www.law.upenn.edu/bll/archives/ulc/uta/2005final.txt (last visited Aug. 13, 2007). States that have enacted the Prudent Investor Act are encouraged to reenact that Act as Section 9 of the Code, less certain duplicative provisions. The Uniform Trusts Act (1937) is incorporated into/superseded by the Uniform Trust Code.

4. *See* Linden Place v. Stanley Bank, 167 P.3d 374, 375 (Kan. Ct. App. 2007) (defining a fiduciary relationship as one where "special confidence is placed in one who, in equity and good conscience, is bound to act in good faith and with due regard to the interest of the one placing the confidence").

For example, in one case concerning the Employee Retirement Income Security Act, the court noted that generally, "under ERISA, a person or entity may be deemed a fiduciary either by assumption of the fiduciary obligations (the functional or de facto method) or by express designation by the ERISA plan documents . . . Someone is a functional fiduciary under ERISA: to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan or has any discretionary authority or discretionary responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan."[5]

Similarly, a Kansas court wrote: "A fiduciary relationship implies a condition of superiority of one of the parties over the other. Generally, in a fiduciary relationship, the property, interest or authority of the other is placed in the charge of the fiduciary." In addition, "A fiduciary is in a position to have and exercise, and does *have and exercise influence over another.*" The court also said, "A fiduciary relationship imparts a position of *peculiar confidence placed by one individual in another.* A fiduciary is a person with a duty to act *primarily for the benefit of another.*"[6]

One reason for the paucity of a general definition of fiduciary relationships may be the many situations and contexts in which these relationships appear. That could make the courts' generalization difficult or even impossible.[7] After all, courts focus on a set of facts, and set forth the rules with respect to the particular situations before them. As Justice Brennan of the United States Supreme Court observed, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"[8] Justice Brennan has outlined the courts' functions: defining the boundaries of various fiduciary relationships and the law that governs them, as they develop. This is a very broad mandate that narrowed over time.

5. *In re* Elec. Data Sys. Corp. "ERISA" Litig., 305 F. Supp. 2d 658 (E.D. Tex.), *class certification granted by, in part, class certification denied by, in part,* 224 F.R.D. 613 (E.D. Tex. 2004).

6. Denison State Bank v. Madera, 640 P.2d 1235, 1241 (Kan. 1982). *See also* Arst v. Stifel, Nicolaus & Co., Inc., 86 F.3d 973 (10th Cir. 1996); Manassas Travel, Inc. v. Worldspan, L.P., No. 2:07-CV-701-TC, 2008 U.S. Dist. LEXIS 35217 (D. Utah Apr. 30, 2008); First Sec. Bank of Utah v. Banberry Dev. Corp, 786 P.2d 1326, 1333 (Utah 1989).

7. Manassas Travel, Inc. v. Worldspan, L.P., No. 2:07-CV-701-TC, 2008 U.S. Dist. LEXIS 35217 (D. Utah Apr. 30, 2008) (stating that "[s]ince the existence of a fiduciary relationship depends on the facts and circumstances of each individual case, there is no exact definition of a fiduciary relationship which may be applied universally.").

8. SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1942).

While Justice Brennan outlined the courts' functions in establishing fiduciary law conflicts of interest rules, the Federal Court of Appeals in Australia declined to set forth fiduciary law rules on the basis of a similar remark: "'Australian courts have consciously refrained from attempting to provide a general test for determining when persons [. . .] stand in a fiduciary relationship.' It may be, as their Honours said, that the term 'fiduciary relationship' defies definition. This is because of the difficulty of stating a comprehensive principle suitable for application to different types of relationships that carry different obligations. . . ."[9]

The desire to leave fiduciary law's door open for similar relationships in new contexts may induce some American courts to generally define fiduciary relationships.[10] Other courts that tend to view fiduciary relationships as a species of contract might decline to offer a general definition and seek their definition within the confines of the specific terms of the parties' agreements.[11] A court may search for an explicit statutory creation of fiduciary relationships, denying its authority to recognize fiduciary relationships between individuals and the public.[12] Other courts consider social interests, e.g., in examining a private hospital's power to deny access and use to a physician (that was qualified generally).[13]

There have been many attempts to define fiduciary relationships. Some definitions start with a fiduciary's obligations. One academic resorted to the historical jurisdiction of England's trust and agency laws. These two types of fiduciary relationships were litigated in different courts. This distinction may explain why

9. Australian Sec. & Inv. Comm'n v Citigroup Global Mkts. Australia Pty. Ltd., [2007] FCA 963 (June 28, 2007).

10. *See, e.g.,* Martinelli v. Bridgeport Roman Catholic Diocesan Corp., 10 F. Supp. 2d 138, 156 (1998) (citing Tamar Frankel, *Fiduciary Law,* 71 Cal. L. Rev. 795, 836 (1983)).

11. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty,* 36 J.L. & Econ. 425, 427 (1993) ("a fiduciary relation is a contractual one characterized by unusually high costs of specification and monitoring"); *see* Maksym v. Loesch, 937 F.2d 1237, 1243 (7th Cir. 1991) (stating that where a contract creates a fiduciary duty, "the failure of one party to explain the terms of a written contract to the other before the other signs is not fraud, or undue influence"). *See generally* 3 E. Allan Farnsworth, Farnsworth on Contracts § 12:20, 12:20(a) (2d ed. 2001) (discussing distinctions between fiduciary and contractual relationships).

12. United States v. Murphy, 323 F.3d 102, 104–05 (3d Cir. 2002) (chairman's conduct concerned a contracts-for-payments scheme he organized by using his considerable influence over county officials to procure contracts for a medical-services corporation. The court held that the Bribery Act does not create a fiduciary relationship between a corporate chairman and the public, noting that no other criminal statute creates such a relationship between a defendant and the public. Without the anchor of a fiduciary relationship established by State or federal law, it was improper for the District Court to allow the jury to create one).

13. Baptist Health v. Murphy, 365 Ark. 115, 125 (2006).

trust is separate from contract law but agency is not.[14] Therefore, agency, it seems, does not involve equitable principles even though the roots of the problems posed for the principal in agency law are the same as the roots of the problems posed for the trust beneficiaries.

Yet, it is doubtful that the choice of British courts hundreds of years ago should justify a distinction in our law today. Besides, the history of trust and agency started much earlier. Trust in Roman law arose before the special English courts system existed. Looking further back, agency and trust complemented each other, based on the same fundamental principles and approach. An explanation that links the law to the jurisdiction of the British courts opens the door to changing the law with the change of the jurisdiction, an approach that can mislead and do harm. After all, the purpose of law is to address problems. Similar problems should be subject to similar laws, regardless of which courts deal with them.

Viewing English law, Joshua Getzler summarized in a few sentences fiduciary law:

> A fiduciary obligation is a legal requirement that a person in a fiduciary position should promote exclusively the beneficiary's interests, and refrain from allowing any self-interest or rival interests to touch or affect his or her conduct . . . [T]he obligation will take on variable intensities in different contexts; and self-interest or rival interests may be permitted if clearly disclosed and allowed by the beneficiary, or perhaps allowed by accepted general practice or by approval of a court or legislature. Typically the fiduciary will have a continuing relationship with the beneficiary that resists complete specification by agreement or contract and instead bestows discretions; and the fiduciary will generally have strong powers to change the beneficiary's legal position and affect his or her interests unilaterally [which make it] difficult for the beneficiary to monitor the fiduciary's conduct of his or her business, hence strong remedies are accorded to the beneficiary to restore balance to the relationship.[15]

B. THE RECURRENT ELEMENTS OF FIDUCIARY RELATIONSHIPS

While the definitions of fiduciaries are not identical, all definitions share three main elements: (1) entrustment of property or power, (2) entrustors' trust of fiduciaries, and (3) risk to the entrustors emanating from the entrustment. In addition to these features, the definitions contain more detailed elements that

14. John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 647–49 (1995) (trust was litigated in the courts of equity; agency—in the common law courts).

15. Joshua Getzler, *Duty of Care*, *in* BREACH OF TRUST 41 (Peter B.H. Birks & Arianna Pretto eds., 2002) (footnotes omitted).

distinguish one species of fiduciaries from another. Yet, these differences derive from the three elements mentioned above. For example, agency is defined as a "fiduciary relation, which results from the joint manifestation of consent by one person that another shall act on his behalf and subject to his control, and of consent by that other so to act.[16] The agent acts for or on behalf of the principal . . ."[17] This definition highlights (1) the entrustment of power by the principal to the agent, (2) the degree of trust among the parties, and (3) the level of risk that the principal-entrustor takes in entering the relationship. In the case of agency the principal is able to control the agent's actions and that signals a lower level of risk.

Trust is created when a property owner (settler) (1) entrusts property to another (trustee); (2) with an intent of imposing a fiduciary duty on the trustee; (3) requiring the trustee to manage the entrusted property; (4) for the benefit of specified beneficiaries.[18] In this definition of trust the entrustment of property is highlighted, as well as the fiduciary's duty to using the entrusted property for the benefit of others. There is no mention of control over the trustee and no mention of the beneficiaries' consent to the arrangement. Indeed, trust beneficiaries do not choose nor control the trustee.

Agency is created when a property owner or any person (principal) (1) entrusts property or power; (2) to another (agent); (3) with directions on how to use the property or power; (4) under the control of the principal. Agency involves a consensual element—both principal and agent must agree to the arrangement. Agency involves the principal's control over the agent's activities with respect to the entrusted property or power.

The differences between trust and agency relate to the nature of the entrustment or property or power, the level of risk to the entrustors from the fiduciaries' abuse of entrustment and the ability of the entrustor to control such abuse. In a legal trust, entrustment of property is a required element. In contrast, agency may involve entrustment of property and/or power. The agent's powers may be broader than those of the trustee. But while the trustee is bound by the trust document, the agent is bound by the principal's control. These differences are

16. Nelson v. Serwold, 687 F.2d 278, 282 (9th Cir. 1982) (citing Grace Line, Inc. v. Todd Shipyards Corp., 500 F.2d 361 (9th Cir. 1974); RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958); *see also* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). "The agent acts for or on behalf of the principal. . . ." 687 F.2d at 282 (citing NLRB v. United Brotherhood of Carpenters, 531 F.2d 424 (9th Cir.1976)); *see also* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

17. 687 F.2d at 282 (citing NLRB v. United Bhd. of Carpenters, 531 F.2d 424 (9th Cir. 1976)); *see also* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

18. Branson Sch. Dist. RE-82 v. Romer, 161 F.3d 619, 633 (10th Cir. 1998) (citing RESTATEMENT (SECOND) OF TRUSTS §§ 2, 17, 23, 23 cmt. (a) (1959)), *cert. denied*, 526 U.S. 1068 (1999); *see also* RESTATEMENT (THIRD) OF TRUSTS § 2 (2003).

reflected in the law. In general, trust law imposes on the trustee more limits than agency law does on the agent.

C. A PROPOSED DEFINITION OF FIDUCIARY RELATIONSHIPS

The following definition lists the factors that give rise to fiduciary relationships and their attendant fiduciary duties. Not everyone agrees with this list of factors or even with the existence of fiduciary law as a separate category. The disagreements and their reasons are discussed in a later chapter.

The suggested features that all fiduciaries share are the following:

First, fiduciaries offer mainly services (in contrast to products). The services that fiduciaries offer are usually socially desirable, and often require expertise, such as healing, legal services, teaching, asset management, corporate management, and religious services.

Second, in order to perform these services effectively, fiduciaries must be entrusted with property or power.[19]

Third, entrustment poses to entrustors the risks that the fiduciaries will not be trustworthy. They may misappropriate the entrusted property or misuse the entrusted power or they will not perform the promised services adequately.

Fourth, there is likelihood that (1) the entrustor will fail to protect itself from the risks involved in fiduciary relationships; (2) the markets may fail to protect entrustors from these risks; and that (3) the costs for the fiduciaries of establishing their trustworthiness may be higher than their benefits from the relationships.

In such situations, it is likely that the parties will not interact, unless the law intervenes to protect the interests of society in the provision of these services by meeting the needs of both parties or—as economists might express the idea—by reducing the costs of the relationship to both parties. Each of these features is discussed below in detail.

1. Fiduciary Services: the Importance of Specialization and Mutual Reliance in Society

Our economy and standard of living depend on specialization. Some people specialize in an activity and offer their expertise to others. In turn, these specialists rely on others for services outside their own area of expertise. Fiduciary services do not cover all specializations that members of society need. Fiduciary relationships usually involve expertise, such as medicine, law, investment management, and teaching, or significant power over those who rely on the services.

19. *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty* (Draft) (noting that "property" is a difficult concept to define and suggesting the term "critical resource") (on file with author).

Expert services are useful to society. Duplication of such expertise by many people is wasteful and costly to society. It takes years to study medicine and law. It requires long-term experience to become an effective manager of a large enterprise. In contrast, other specialized services do not require as great an investment of effort and time. The electrician, plumber, and hairdresser offer specialized social services that are important to others. But their expertise can be acquired in a relatively short time, and more people can specialize in them. Barring special circumstances, the providers of these services are not fiduciaries. As discussed below, if the magnitude of entrustment is large, for example, the concentration of control over pools of investors' money to be managed by others, the nature of the services may be not as socially crucial, yet be classified as fiduciary.

Expert organizations serve as fiduciaries as well. Bank trust departments, advisory organizations that manage mutual funds, other intermediaries in the financial system offer useful services that take years to develop. In addition, some actors are crucial to a social system such as the financial system. These actors form the channels for our everyday interaction and exchange among strangers. If the channels are not trusted, the entire system is endangered, affecting the national economy, our way of life, and our standard of living.

Some intermediaries, such as bank trust department advisers and pension fund fiduciaries, are regulated under fiduciary law principles. Other intermediaries, such as commercial banks, are regulated under contract law to ensure safe and sound operations. Then they are enabled and required to abide by their promises. Thus, bank and insurance custodians are regulated differently from pawnshops, even though their services are similar in many respects. The main difference between their services is that bank and insurance regulation aims at assuring the financial system, while pawnshops' regulation aims at clarifying the private parties' mutual rights and ensuring the performance of obligations with respect to the valuables that are used as collateral.[20] Both, however, offer services to enhance the effectiveness of the financial system.

2. Entrustment

a. The Importance of Entrustment Entrustment is the most important aspect of fiduciary relationships. It greatly affects the existence, nature, and rules of fiduciary relationships. The word "confidence" that courts occasionally use may mean more than mere confiding in the other party. It can mean confiding secrets as well. This type of confidence is especially reasonable if entrustment enables

20. Mark E. Van Der Weide & Satish M. Kini, *Subordinated Debt: A Capital Markets Approach to Bank Regulation*, 41 B.C. L. Rev. 195, 215 (2000) (discussing the different goals of regulators and a company's shareholders. Shareholders are riskier in order to gain profits, while regulators are more conservative in order to ensure the financial system's stability).

the other party to serve the entrustor.[21] As one court stated, "[g]enerally, in a fiduciary relationship, the property, interest or authority of the other is placed in the charge of the fiduciary."[22]

Entrustors entrust property or power to fiduciaries not for the purpose of benefiting the fiduciaries but for the purpose of benefiting the entrustors (or their designates). Entrustment is designed to facilitate the fiduciaries' services to the entrustors. In addition, or perhaps because of this purpose of entrustment, entrustment must be accompanied by conditions. Entrustment is not a gift. Thus, money handed over to a priest in the form of a trust, which allowed the trustee-priest to do with the money whatever he saw fit, was held not to be a legal trust.[23] It could be classified as a gift that remains with the priest, or it could be ignored, and remain vested in the entrustor or his estate.

b. Entrustment Varies Entrustments, however, vary depending on the nature and terms of the entrusted property and power. These terms are not required by law; they are chosen by the parties. But once the terms are established, the law determines the classification and the legal consequences of the relationships. For example, the legal definition of "trust" includes entrustment of property—the transfer of full ownership of property, subject to fiduciary duties.[24] If the trustor reserves to himself a limited decision power, the arrangement may still be classified as a trust. But if the trustor reserves to himself so much power over the property and its use, amounting to full control over the trustee's decisions and performance of his service, the relationship will remain fiduciary, but might be characterized not as a "trust" but as an "agency,"[25] and different rules would apply to the fiduciary.

21. Lash v. Cheshire County Sav. Bank, Inc., 474 A.2d 980 (N.H. 1984) (citing Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 275 (1983)) (other citations omitted).

22. Arst v. Stifel, Nicolaus & Co., Inc., 86 F.3d 973 (10th Cir. 1996).

23. Finegan v. Theisen, 52 N.W. 619 (Mich. 1892); Ross v. Conway, 28 P. 785 (Cal. 1892). *But cf.* 2 William Franklin Fratcher, Scott on Trusts § 5:124.4 (4th ed. 2001) (discussing the bequeathence of trusts to priests for saying of the masses); 4A William Franklin Fratcher, Scott on Trusts § 11:371.5 (4th ed. 2001).

24. *See* Hamilton v. Mercantile Bank, 621 N.W.2d 401 (Iowa 2001) (citing Restatement (Second) of Trusts § 16c, at 54 (1959)) ("No trust is created when property is transferred to an individual for life with remainder to another because the life tenant takes title outright, the only restriction being the duration of the estate. In a trust, by comparison, legal and equitable ownership of the land are severed. The trustee's action is restricted by an overarching fiduciary duty.").

25. Denver Nat'l Bank v. Von Brecht, 322 P.2d 667 (Colo. 1958) (this difference is important when the trustor has died. Agency expires with the death of the principal. A trust does not. A trust to take effect after the trustor's death, however, is deemed a will and requires certain formalities. If those are not followed, the trust has no effect. In this case the plaintiffs sought to set aside a trust agreement, arguing that the "trust agreement" was not a trust, because the settlor retained too much power over the entrusted property. In that case the agreement would constitute a trust in a will, which would not be valid because it did not comply with the necessary form of a will (e.g., witnesses)). *But see* Brooks v. Valley Nat'l Bank, 539 P.2d 958 (Ct. App. Ariz. 1975), *aff'd*, 548 P.2d 1166 (Ariz. 1976) (a mortgagor's payments covering future insurance and taxes are not entrusted to the bank. Therefore, the income from the bank's investments of these payments does not belong to the mortgagor but to the bank).

Similarly, an adviser that controls and manages clients' assets is entrusted with more power over the clients' decisions concerning their property than an adviser who advises clients on how to manage their investments, which they control. While both advisers are fiduciaries, the different degrees of entrusted power result in different rules applicable to the two types of advisers. A software engineer who designs the software for an investment adviser, that follows market stock price trends, might have less discretion than either adviser. Consequently, such an engineer might be a very slight fiduciary or perhaps not at all. Down the line, a reporter of financial news and a newspaper containing evaluations of investments have less discretion in determining the readers' investments, and in addition to constitutional protection of free speech may not be the readers' fiduciaries.[26]

The different degrees of entrusted power determine whether the service providers are fiduciaries, and if they are—how strict their fiduciary duties should be. For example, in *Brophy v. Cities Service Co.*[27] an executive secretary of a corporate director and officer acquired confidential information that the corporation was planning to purchase its shares on the open market, in quantities sufficient to cause a rise in the shares' market price. Before the corporation executed its purchases this secretary acquired the corporate shares for his personal account, or for the account of his nominees, and sold the shares at a profit after the price of the shares rose as a result of the corporate acquisition.

Usually, secretaries, like servants, are not considered fiduciaries. The employers' control over their activities leaves them little discretion and negligible entrusted power. But in this case the secretary was held to occupy "a position of trust and confidence toward the corporation, with respect to the information so acquired, and the purchase of its stock for his own account was a breach of the duty he owed to" the corporation.[28] That is, the confidential information was entrusted to him, as part of his services to the corporation, and as to that information he was a fiduciary, notwithstanding his status as a servant. In his position it was not efficient or even possible to prevent him from acquiring the information. He may have acquired the information as he typed or filed it.

In another case the Fourth Circuit held that even though limited partners are not usually fiduciaries of the partnership, when these limited parties were acting

26. Imposing fiduciary duties on such newspapers and reporters might conflict with the First Amendment protection of free speech. *See* Lowe v. SEC, 472 U.S. 181 (1985) (concurring opinions of Justice White, the Chief Justice, and Justice Rehnquist).

27. Brophy v. Cities Serv. Co., 70 A.2d 5, 7 (Del. Ch. 1949).

28. *Id.*

as contractors for the partnership, and controlled its accounting for a project development, they were fiduciaries when they used these accounts for the purpose of receiving a bank loan.[29]

c. **Entrustment Does Not Depend on the Expertise of the Entrustor** Entrustment to an expert remains an entrustment even if the entrustor possesses the same expertise. To be sure, the expert entrustor can reduce the entrusted power or his risks from the entrustment. However the relationship remains fiduciary. That is because the entrusting expert is presumed to reduce his control over the expert he chose. He may have chosen to go on vacation or is too emotionally involved to perform the services himself (e.g., operating on a family member or representing oneself in court). Thus, a lawyer that is entrusted with the case of another lawyer is a fiduciary of his lawyer client.

d. **Entrustment Can Result from Different Legal Relationships** Entrustment can result without any other legal relationship, such as entrustment of money to a friend to buy jewelry for the entrustor. Entrustment can result in the context of a contract. For example, a U.S. bank is not a fiduciary of its depositors and borrowers. The bank is a contract-debtor to depositors and contract-creditor to borrowers. However, if a bank continues to hold money that a person has borrowed from the bank, the bank is entrusted with this money and must hold it for the benefit of the new owner—the borrower. In such a case the bank has become a fiduciary of the borrower.[30] The line is not always clearly drawn. For example, in one case a borrower (mortgagor) was required to deposit in the bank the amounts of future taxes and insurance related to the mortgaged property. The bank invested and profited from the deposited money. The court held that these profits on the deposited money belonged to the bank, and not to the borrower. That court emphasized the contractual obligation of the borrower to deposit these payments under the terms of the mortgage loan. Once possession of the deposit passed to the bank, the bank had the right to benefit from the investment of the deposited money. Presumably, however, the bank had a duty to pay the taxes and the insurance, even if its investments of the deposited amount experienced a loss.[31]

Similarly, "[d]ebtors in possession [of their own assets] and those who control them owe fiduciary duties to the bankruptcy estate."[32] In this case, the debtors

29. S. Atl. Ltd. P'ship of Tenn. v. Riese, 284 F.3d 518 (4th Cir. 2002) ("The district court did not err in denying the expelled partners judgment as a matter of law on the breach of fiduciary duty claims because regardless of their status as limited partners, the partnership had reposed a special confidence in them by authorizing them to act as a contractor for the partnership, take control of the accounting for a development project, and in preparing draw requests for a bank loan.") (LEXIS Case Summary).

30. Lash v. Cheshire County Sav. Bank, Inc., 474 A.2d 980 (N.H. 1984) (citing Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 275 (1983)) (other citations omitted).

31. Denver Nat'l Bank v. Von Brecht, 322 P.2d 667 (Colo. 1958).

32. Lange v. Schropp (*In re* Brook Valley VII), 496 F.3d 892 (8th Cir. 2007).

were the owners of the assets, but in bankruptcy, the assets are entrusted to the debtor for the benefit of the creditors. Whatever assets the debtors controlled are deemed an entrusted property in the bankruptcy regime.

e. **Entrusted Power Rises with the Number of the Entrustors and Amount of Entrusted Assets** For two reasons, fiduciaries that serve numerous entrustors in a standardized manner acquire power that is greater than the power of fiduciaries that serve individuals, even if the individual entrustors are very wealthy. First, fiduciaries for numerous entrustors are likely to control a larger amount of resources than private fiduciaries would receive. After all, the aggregate amount of a large number of small entrusted assets can be larger than the amount of a few large individual entrustments. With control of a large amount of assets comes power. Fiduciaries that control billions of dollars control the choice of the services that are necessary to manage these assets. This choice, including, for example, the choice of the bank in which the deposit accounts and investment accounts will be deposited, induces competition by banks to please the decision makers—the fiduciaries-power-holders, rather than the small investors whose assets are to be deposited. This competition for the good graces of the fiduciary money manager can be ongoing. A bank seeking to attract large cash accounts is likely to offer personal benefits to fiduciaries empowered to choose banks for their entrustors. Legal ownership becomes somewhat confused with beneficial ownership, and the fiduciaries' contribution becomes the basis for entitlement. When treated like the owners, fiduciaries can begin to feel like the owners.

Second, the entrustors' ability to control their fiduciaries is weakened with the rise in the entrustors' number. The entrustors may not be well organized, may have different interests and different ideas about the benefits that their fiduciaries must pursue. While individual entrustors may call their fiduciaries for information, as the number of entrustors grows, such a practice is less feasible for reasons of cost and administrative difficulties. What is possible in a fiduciary relationship with few entrustors is far more difficult in a fiduciary relationship with thousands of entrustors.[33] In addition, the right and ability of each of numerous entrustors to give directive can result in a deadlock and holdouts. Such control "can dilute the individual power of small entrustors (and increase the powers of larger ones) and in some cases augment the fiduciaries' powers by coalitions with concentrated majority or minority entrustors."[34] To be sure, entrustors could be organized and have their own representatives to negotiate with the fiduciaries, like unions in their relationships to corporate management, or corporate directors. Nonetheless, "at least in theory, agency is less risky to entrustor-principals than directorship is to entrustor-shareholders."[35] The larger the number of

33. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1253, 1258–59 (1995).

34. *Id.* at 1258–59.

35. *Id.* at 1253.

entrustors, the weaker the entrustors' ability is to exercise constraints and enforce accountability on the fiduciary.[36]

f. Trusting Alone Does Not Necessarily Mean Entrustment Entrustment generally involves the entrustors' trust. However, as a Texas court held, the necessary degree of trust in fiduciary relationship must be quite high.[37] "'[M]ere subjective trust does not . . . transform arm's-length dealing into a fiduciary relationship.'"[38] "In order to give full force to contracts, we do not create such a relationship lightly."[39] "To impose an informal fiduciary duty in a business transaction, the special relationship of trust and confidence must exist prior to, and apart from, the agreement made the basis of the suit."[40] "[E]arlier projects were arms-length transactions entered into for the parties' mutual benefit, and thus do not establish a basis for a fiduciary relationship."[41] In fact, the agreements governing the earlier projects expressly disavowed the creation of any fiduciary duties or other special relationships.

However, in one case a number of insurance companies combined to create a sales force targeting seniors and carefully planned to gain the seniors' trust for the purpose of ultimately selling to these senior citizens unsuitable annuities. The careful plans to gain the seniors' trust, for the purpose of selling to elderly persons who cannot understand the annuities, may trigger fiduciary duties. The court held that these facts were sufficient to allege the imposition of fiduciary duties on the companies and their salespersons.[42] Similarly, a large employer's relationships with an employee may trigger the employer's fiduciary duties to the employee when it used the employee's invention and bought it for a pittance.[43] Thus, a court may take into account the personal trust in the relationship that may trigger fiduciary duties. In this respect the notions of fiduciary relationship and undue influence[44] come very close.

36. *See* George M. Frankfurter et al., Divided Policy 31 (2003).

37. Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171, 176–77 (Tex. 1997) (citing Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 594 (Tex. 1992), *superseded by statute on other grounds as noted in* Subaru of Am., Inc. v. David McDavid Nissan, Inc., 84 S.W.3d 212, 225–26 (Tex. 2002)).

38. *Id.* at 177.

39. *Id.*

40. Associated Indem. Corp. v. CAT Contracting, 964 S.W.2d 276, 288 (Tex. 1988).

41. *Id.* (holding that preexisting indemnity agreement between surety and contractor "was an arms-length transaction entered into for the parties' mutual benefit" and thus did not "justify[] a special relationship of trust and confidence.").

42. *In re* Am. Investors Life Ins. Co. Annuity Marketing & Sales Practices Litig, Nos. 04-2535, 05-3588, 2007 U.S. Dist. LEXIS 64967 (E.D. Pa. Aug. 29, 2007).

43. Roberts v. Sears, Roebuck & Co., 573 F.2d 976 (7th Cir. 1978).

44. Undue influence is "[t]he improper use of power or trust in a way that deprives a person of free will and substitutes another's objective." Black's Law Dictionary (9th ed. 2009).

3. The Concepts of Property Rights, Power, and Their Entrustment

The identity and classification of entrusted property is an important ingredient of fiduciary relationships.[45] Like all legal categories, property is not well-defined and its boundaries are frayed. Therefore, entrustment of property leaves gray areas as well.

a. Legal Concepts of Property Rights and Power Throughout the ages jurists have argued about the meaning and impact of property rights and power. Aristotle viewed property as "our power to dispose of it or keep it."[46] In the seventeenth century, scholars focused on the owner's right to exclude others from his property. Thus, Hugo Grotius, regarded as the first modern rights theorist,[47] contributed to the "traditional" triad of political rights: the rights to life, liberty, and property.[48] He suggested a "two-step process"[49] to define the source and nature of property. The first is an individual's use of the property, placing her in the proper relationship with an asset, and second, some social recognition of this relationship.[50] Occupancy or use of assets necessarily can be viewed as an exclusive possession including the right to exclude others from the assets. Whatever "each had occupied he should have as his own."[51] "For the essential characteristic of private

45. State *ex rel.* Bonner v. Dist. Court, 206 P.2d 166, 169 (Mont. 1949).

46. Aristotle, Rhetoric 1361a21–22 (W. Rhys Roberts trans., 1954); *see also* Aristotelis, Politics 1262b37–1264b26 (W.D. Ross trans., 1952) (384 BC–322 BC). Ancient Roman scholars separated legal concepts from real-world application and argued that Roman law did not define ownership. Alan Rodger, Owners and Neighbors in Roman Law 1 (1972); Alan Watson, The Law of the Ancient Romans 49–70 (1970) (scholarship tries to explain the lack of a definition for ownership as a result of the practical-oriented approach to theory and the reluctance to use definitions because "every definition in civil law is dangerous; for it is rare for the possibility not to exist of its being overthrown."); *see* Adam Mossoff, *What is Property? Putting the Pieces Back Together*, 45 Ariz. L. Rev. 371, 391 (2003) (citing G. Inst. II.1-289 (W.M. Gordon & O.F. Robinson trans., 1988)); Dig. 7.1.1 (Paul. Vitellius 3); Dig. 50.17.202 (Javolenus, *Letters* 11). The scholars assumed that Roman lawyers were more interested in the meaningful, real-world application of legal concepts and that they were generally reluctant to use definitions in civil law.

47. Knud Haakonssen, Hugo Grotius and the History of Political Thought, *reprinted in* Grotius, Pufendorf and Modern Natural Law 35, 36 (Knud Haakonssen ed., 1999); Richard Tuck, Natural Rights Theories: Their Origin and Development 71 (1979).

48. Adam Mossoff, *What Is Property? Putting the Pieces Back Together*, 45 Ariz. L. Rev. 371, 379 (2003).

49. *Id.* (Adam Mossoff is a defender of the integrated theory of property and describes Grotius' work as "paradigmatic of the integrated theory.").

50. The individual possesses *only use-rights* in the original state of nature. Hugo Grotius, De Jure Belli ac Pacis Libri Tres 186 (Francis W. Kelsey trans., 1925) (1625) (the title translates to *The Law of War and Peace*) (referring to a famous Cicero analogy by quoting Marcus Tully Cicero, De Finibus, III.xx.67: "Although the theater is a public place, it is correct to say that the seat which a man has taken belongs to him.").

51. Hugo Grotius, De jure Belli ac Pacis Libri Tres 70–71 (Francis W. Kelsey trans., 1925) (1625).

property is the fact that it belongs to a given individual in such a way as to be incapable of belonging to another individual."[52] The second step is a social consent to the individual ownership, that is, when "all agreed" to an exclusive ownership under the circumstances:[53] Property right derives from the right to live and the presumption that one's life, limbs and liberty is an exclusive right follows the recognition that a property right is inherently an exclusive right.[54]

John Locke in 1690 reformulates the first step of Grotius's theory and relied upon acts of acquisition and labor to define property rights, removing the condition of consent. He assumed that "[n]o body has originally a private Dominion, exclusive of the rest of Mankind."[55] The right to use assets in the state of nature is not an exclusive right but rather a moral claim that others should allow one to be included in the general use of the commons.[56] Property rights derive from

52. HUGO GROTIUS, DE JURE PREAEDAE COMMENTARIUS 228 (G.L. Williams & W.H. Zeydel trans., 1964) (the title translates to *Commentaries on the Law of Prize and Booty*). *De Jure Praedae* was originally a brief written by Grotius in 1604, and was included (in a substantially revised version) in Grotius' second famous published work, *Mare Liberum* (1609). The brief was rediscovered and first published as a separate manuscript in 1868. George Finch, *Preface to* GROTIUS, PRAEDAE. Conclusion: People have first use-rights in the original state of nature; exclusion moves people from use-rights in the state of nature to property in civil society. *See* Adam Mossoff, *What Is Property? Putting the Pieces Back Together*, 45 ARIZ. L. REV. 371, 383 (2003).

53. Adam Mossoff, *What Is Property? Putting the Pieces Back Together*, 45 ARIZ. L. REV. 371, 382 (2003) (quoting HUGO GROTIUS, DE JURE BELLI AC PACIS LIBRI TRES 189–90 (Francis W. Kelsey trans., 1925) (1625)).

54. Adam Mossoff, *What Is Property? Putting the Pieces Back Together*, 45 ARIZ. L. REV. 371, 383, 384 (2003). For the support of his own theory *see generally* HUGO GROTIUS, MARE LIBERIUM (James B. Scott, ed., Ralph Van Deman Magoffin, trans., 1916) (1608) (the title translates to *Freedom of the Seas*) (Grotius wrote on pressing political and legal issues of his day: one of these issues was the claim of the Portuguese in the late sixteenth and early seventeenth centuries that they owned the oceans traversed by their trade ships. Grotius wrote on behalf of the Dutch East India Company and sought to repudiate these property claims by the Portuguese. In this treatise, *Mare Liberium*, Grotius denies the property claim by arguing that the oceans cannot be possessed. He concludes "that which cannot be occupied, or which never has been occupied, cannot be the property of any one, because all property has arisen from occupation." HUGO GROTIUS, MARE LIBERIUM 27 (James B. Scott, ed., Ralph Van Deman Magoffin, trans., 1916) (1608); And further: "[S]ince the sea is just as insusceptible of physical appropriation as the air, it cannot be attached to the possessions of any nation." *Id.* at 39.))

55. JOHN LOCKE, TWO TREATISES OF GOVERNMENT § 26, at 286 (Peter Laslett ed., 1988) (1690); And further: "[God's original grant] was not to Adam in particular, exclusive of all other Men: whatever Dominion he had thereby, it was not a Private Dominion, but a Dominion in common with the rest of Mankind." *Id.* § 29, at 161.

56. *See* JAMES TULLY, A DISCLOSURE ON PROPERTY: JOHN LOCKE AND HIS ADVERSARIES 61 (1980). JOHN LOCKE, TWO TREATISES OF GOVERNMENT § 27, at 287–88 (Peter Laslett ed., 1988) (1690) ("every Man has a Property in his own Person. This no Body has any Right to

labor when a person mixed an object with his labor he joined to it with something that is his own and thereby makes it his property. Individuals exclusively own their life and labor (suum), and labor extends this moral ownership over things appropriated from the commons.[57] Grotius, Pufendorf, and Locke assume that property rights derive from prior rights to life and liberty.[58] They agree that the right to exclude is a necessary characteristic of the concept of property.

In the eighteenth century William Blackstone's *Commentaries* defined property as "originally acquired by the first taker, which taking amounts to a declaration that he intends to appropriate the thing to his own use and it remains in him . . . till such time has as he does some other act which shows an intention to abandon it."[59] Blackstone concluded that possession is the primary element of the concept of property and exclusion derived from it. In sum, possession or labor is the primary element of property. Exclusion derives from this preexisting possession/labor—after individuals begin the process of creating civil society.[60] Therefore, property rights are both a concept and a moral right that is integrated with an individual's other moral rights. Property is integrated conceptually and normatively.[61] The socially-oriented legal-relationship view of property rights began to take root in the contemporary American legal mind with Oliver Holmes and Wesley N. Hohfeld. The essence of property right is the power of excluding others because the right to exclude is the only purely formal, social element of property rights. Property right, like all rights, is shorthand for identifying a

but himself. The Labour of his Body, and the Work of his Hands . . . are properly his. Whatsoever then he removes out of the State that Nature hath provided, and left it in, he hath mixed his Labour with, and joined to it something that is his own, and thereby makes it his Property.").

57. Adam Mossoff, *What Is Property? Putting the Pieces Back Together*, 45 ARIZ. L. REV. 371, 388 (2003).

58. *Id.* at 389.

59. 2 BLACKSTONE, COMMENTARIES *9.

60. Adam Mossoff, *What Is Property? Putting the Pieces Back Together*, 45 ARIZ. L. REV. 371, 393–94 (2003) (confronting the argument of Merrill, a representative of the exclusion theory, who argues that the right to exclude cannot be derived from the right to use, in Thomas W. Merrill, *Property and the Right to Exclude*, 77 NEB. L. REV. 730, 730 (1998), and clarifying that Merrill's "reason backward" refers to his perspective that presupposes a pre-existing legal system with a full array of property entitlements and justifying his own integrated theory from a perspective of "reason forward" from a non-property to a property context); James Madison, *Property*, NAT'L GAZETTE, Mar. 5, 1792, *reprinted in* JAMES MADISON, THE MIND OF THE FOUNDER 186 (Marvin Meyer ed., 1981) (and further: "a man has a property in his opinions," he has property "in the safety and liberty of his person," and "he may be equally said to have a property in his rights"). James Madison (1792) assumed that property has a "larger and juster meaning, [in which] it embraces everything to which a man may attach a value and have a right."")

61. *See* Adam Mossoff, *What Is Property? Putting the Pieces Back Together*, 45 ARIZ. L. REV. 371, 402 (2003).

particular set of "social relations" between people in society.[62] From this socially-oriented view of Holmes there emerged the "bundle theory" at the turn of the century.

Wesley N. Hohfeld analyzed the concept of a "right" by its correlation of claims and duties among individuals, regarding property assets.[63] He viewed a property right as a "complex aggregate of rights (or claims), privileges, powers, and immunities."[64] Property rights function as a set of social relations. Possessory rights—to acquire, to use, and to dissolve—are inadequate in defining the core of property rights because they fail to capture the social-oriented function of property.[65] Therefore, the right to exclude is the essential element or "stick" of property because it is the only formal element of the concept of property that reflects its social function.[66]

In his dissent in *Moore v. Regents of University of California,*[67] Judge Mosk noted that "the concept of property is often said to refer to a 'bundle of rights'"[68] and "'[s]ince property or title is a complex bundle of rights, duties, powers and immunities, the pruning away of some or a great many of these elements does not entirely destroy the title.'"[69] Therefore, public policy may limit the entitlement to property. For example, the majority of the California Supreme Court held that, in light of the danger to the development of medical research, a human cell is not property capable of entrustment.[70] A person's body cells are

62. OLIVER W. HOLMES, JR., THE COMMON LAW 246 (1991) (1881) ("But what are the rights of ownership? . . . The owner is allowed to exclude all, and is accountable to no one.").

63. Wesley N. Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning,* 26 YALE L.J. 710, 743 (1917).

64. *Id.* at 746.

65. *Id.* at 747 (It "is a very inadequate view" of property that its "sole purpose" is for "guarding or protecting A's own physical use[] or enjoyment of . . . land.").

66. *See* Felix S. Cohen, *Dialogue on Private Property,* 9 RUTGERS L. REV. 357, 370–71 (1954).

67. Moore v. Regents of Univ. of Cal., 793 P.2d 479 (Cal. 1990), *cert. denied,* 499 U.S. 936 (1991).

68. *Id.* at 509 (Mosk, J., dissenting).

69. *Id.* at 510 (Mosk, J., dissenting) (quoting People v. Walker, 90 P.2d 854, 855 (Cal. Ct. App. 1939)). As more people participate in such games, the value of virtual property is increasing, along with the potential for abuse due to the lack of recognition of virtual property rights. Arguably, with no recognition of such rights, users have little or no remedy for abuse and service providers have no incentive to prevent it. *See also* Viktor Mayer-Schonberger & John Crowley, *Napster's Second Life?: The Regulatory Changes of Virtual Worlds,* 100 NW. U.L. REV. 1775, 1779–80, 1826 (2006).

70. 793 P.2d 479. The majority of the judges was concerned that classifying the remains of human body as property would put serious obstacles on medical research. Yet, it is not clear that the obstacle was fully removed because the court imposed fiduciary duties on the researchers-physicians to disclose their interest in using the patient's cells for profit-oriented research. This disclosure enables the patient to demand part of the fruits of the research based on his body's cells, and otherwise obstruct the research. Yet, the court balanced entrustment of property against entrustment of power, discussed below, and voted for the latter.

not property for the purpose of determining fiduciary relationship between a patient and his physician.[71] But as we shall see later, the patient's entrustment of power over his body to the physician creates a fiduciary relationship between the two.[72] Similarly, intellectual property can be entrusted to create a fiduciary relationship,[73] but not always.[74]

In sum, property rights may be explained best as an integrated unity of exclusive rights to acquire, use and dispose of assets. The right to exclude is essential but not the only characteristic, nor most fundamental to the concept of property. The right to exclude is the formal requirement of how the acquisition, use and disposition of property occur as against other members of society.[75]

b. Power and Property In this Book "power" means legally protected freedom to do or not to do what one wishes without the interference of other persons, including the ability to limit one's freedom by one's free will and actions (e.g., entering into binding obligations with respect to assets and property rights). Power and property rights are closely related. As noted, property rights include the power to use assets and to exclude third parties from its use, with government's help. Control is power that can be entrusted, thereby creating fiduciary relationships. Therefore, controlling shareholders may not treat themselves to corporate assets more generously than they treat the minority shareholders.[76]

71. *Id.* at 489.

72. Prosise v. Foster, 544 S.E.2d 331 (Va. 2001) (the physician-patient relationship exists if a patient entrusts his or her treatment to the physician).

73. Stevens v. Marco, 305 P.2d 669 (Cal. Ct. App. 1957) ("Where an inventor entrusts his secret idea or device to another under an arrangement whereby the other party agrees to develop, patent and commercially exploit the idea in return for royalties to be paid the inventor, there arises a confidential or fiduciary relationship.").

74. Wolf v. Superior Court, 130 Cal. Rptr. 2d 860 (Ct. App. 2003) ("no fiduciary relationship between author of a novel and a film studio to which author had assigned his rights for possible commercial development in return for percentage of future revenues").

75. Adam Mossoff, *What Is Property? Putting the Pieces Back Together,* 45 ARIZ. L. REV. 371, 394, 396 (the opposite view is that the right to exclude is the formal means by which Anglo-American legal rules identify and protect the substantive core of rights that constitute property).

76. Lynch v. Patterson, 701 P.2d 1126 (Wyo. 1985); Locati v. Johnson, 980 P.2d 173 (Or. Ct. App. 1999) (a small group of minority shareholders acting in concert can be considered majority shareholders, and therefore owe fiduciary duty to non-members of the group), *appeal after remand,* 131 P.3d 779 (Or. Ct. App. 2006); *see* Pepper v. Litton, 308 U.S. 295, 311 (1939) (stating that "[h]e who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. . . . He

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Although many power-based fiduciary relationships directly or indirectly involve property rights, there are fiduciary-entrusted powers based on the disparity of knowledge and experience among parties to a relationship. Physicians, lawyers, teachers, and priests fall into this category. Law may interfere to "even up" the disparity by fiduciary law.

The concept of power is broad, and may relate both to property rights and to non-property rights. Services—whether professional or others—are not easily commodified. However, they represent power, such as the ability to induce others to act in a certain manner, as investment advisers do, or operating on, and otherwise affecting, a patient's body, as physicians do. Services can relate to assets, such as the agent's power to bind the principal to a legal obligation of sale, but not necessarily so. A surgeon exercises power over a human body even though the body is not usually considered property subject to property rights.[77]

As noted, property rights include the right to change legal relationships with respect to an asset subject to property rights, such as selling, gifting, and bequeathing the asset, and to subdivide the rights to the asset, such as mortgaging and leasing it.[78] In this context some property rights are transferred from the owner to the recipient of all or part of the rights. A sale transfers all the rights. A lease transfers some of the rights under certain limitations. In some cases the law excludes property rights from certain assets. Thus, copyright laws exclude ideas from the realm of legal property rights.[79]

c. **Entrustment of Property Rights** Generally, property rules aim at facilitating markets in assets.[80] The purpose of facilitating market transactions leads to rules designed at reducing the transaction costs of trading. Therefore, the

cannot use his power for his personal advantage and to the detriment of the stockholders and creditors. . . . [F]or the aggrandisement, preference, or advantage of the fiduciary [is] to the exclusion or detriment of the cestuis.").

77. *See* Moore v. Regents of Univ. of Cal., 793 P.2d 479 (Cal. 1990), *cert. denied,* 499 U.S. 936 (1991) (although a patient does not have property rights over his body, and cannot entrust his body cells, the patient can entrust the power over his body to a surgeon, under certain conditions, that rendering the surgeon a fiduciary of the patient).

78. These rights may be subject to legal restrictions, many of which are designed to prevent those vested with property rights from using these rights to harm others. For example, while information can carry property rights, there is a legal prohibition on using information to blackmail others.

79. Anti-Monopoly, Inc. v. General Mills Fun Group, 611 F.2d 296 (9th Cir. 1979) (business ideas, such as a game concept, cannot be copyrighted).

80. The concept of property rights relates to something capable of being traded. That something must be an asset that can be commodified (e.g., land, information, even sex, but not love). *See* Jonathan Remy Nash, *Framing Effects and Regulatory Choice,* 82 NOTRE DAME L. REV. 313, 329 (2006) (stating "commodification goes beyond commensurability: Property-like features and market-like transactions are not required for commensurability, but are critical to commodification.").

number of legal forms of property rights is limited.[81] Among the permissible forms of property rights is the legal trust form. This form differs from the other permissible forms.

Entrusted property rights are different from other forms of property rights. The recipient of the rights–the trustee—may be vested with very broad property rights vis-à-vis the world at large, but is limited in the use of these property rights by the purpose for which these rights were granted, under the directives of entrustment. These directives, however, need not conform to legal permissible property rights. Thus, a condition in the sale of an asset, that the buyer will not resell the asset to a particular individual, is not enforced by the seller. But the same condition in a trust instrument may be enforced by the beneficiaries under trust law.

Entrustment of property splits property relationship. Toward the entrustors, fiduciaries maintain personal relationships (*in personam*) with respect to the entrusted property, and do not have rights in the entrusted property or powers. Toward third parties and the world at large (*in rem*), the fiduciaries are the owners. This bifurcated status offers advantages.[82] As owners, fiduciaries are able to deal with third parties and perform their services to entrustors effectively. At the same time, the fiduciaries' personal duties toward the entrustors strengthen the entrustors' protection from the fiduciaries' abuse of the trust. Had the ownership rights passed fully to fiduciaries, the entrustors would have weaker contract protections from abuse of their fiduciaries' duties.

A two-sided ownership relationship, however, presents ongoing problems. One problem relates to the entrustors' ability to follow entrusted property if their fiduciaries misappropriated the property and sold it in violation of their trust. The answer may depend on whether the buyers of the property knew that the property was entrusted.[83] If the sale by the fiduciaries took place in usual circumstances, and the buyers were not aware that the sale constituted a breach of fiduciary relationships, and paid fair value for the assets, the buyers' rights should be protected. Otherwise, the trustee's ability to trade in the market will be limited, and the suspicion of breach of trust may affect market efficiencies.

This consideration, however, poses conflicting public policies and legal principles. On the one hand, having no property rights, a seller of stolen property cannot bestow such rights on others. On the other hand, markets could not exist if the buyers had to prove or verify the sellers' rights to the sold property.

81. Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law,* 73 B.U. L REV. 389 (1993) (citing 5 HERBERT T. TIFFANY & BASIL JONES, THE LAW OF REAL PROPERTY § 1343, at 161–62 (3d ed. 1939 & Supp. 1992)).

82. Joshua Getzler, *Rumford Market and the Genesis of Fiduciary Obligations, in* MAPPING THE LAW: ESSAYS IN HONOUR OF PETER BIRKS 577–98 (A. Burrows & A. Roger eds., 2006) (footnotes omitted).

83. Diduck v. Kaszycki & Sons Contractors, Inc., 974 F.2d 270 (2d Cir. 1992).

The compromise is a rule that so long as the buyers paid market price for the property and had no knowledge or signals that the seller did not own the property, the buyers should be entitled to it. In the case of entrustment the problem is more severe, because a property that belongs legally to a fiduciary might be sold in violation of fiduciaries' duties. Therefore, while common law countries have accepted the property rights split, civil law countries have not. They have followed a clearer market orientation.[84] However, they found a solution to violation of fiduciary duties by incorporating in their contract laws some of the remedies that appear in the common law remedies for breach of fiduciary duties. "In Europe, contract does the work of trust."[85]

4. Kinds of Entrusted Property and Power

a. Information One tempting situation which corporate fiduciaries face is entrustment of valuable information that management acquires by virtue of its position before the information can be used by anyone else. In the 1920s Judge Cardozo prohibited a managing partner from using information he received as seemingly the only lessor of property. In fact, this person had a "silent partner" and the property belonged to the partnership.[86] Similarly, in 1939 the Delaware Court prohibited a corporate management member from using a tempting "corporate opportunity."[87] It is the "insider information" that has been prohibited and is still too tempting for too many people to avoid using,[88] and it is timely information regarding the composition of mutual fund portfolios that enables one shareholder to benefit at the expense of other shareholders by "market timing."[89] All these situations involve fiduciaries who are entrusted with valuable information, and use it for their own benefit.

The case of Frank Snepp[90] is unique but instructive. Snepp was a CIA agent who published a book after he left the agency without submitting it for CIA

84. *Id.* at 283 (exceptions when the buyers know that defendant trustee could be held liable for breach of fiduciary duty and that defendant owners could be held liable for knowingly participating in such breach).

85. John Langbein, *The Contractarian Basis of the Law of Trusts,* 105 YALE L.J. 625, 671 (1995).

86. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J.).

87. Guth v. Grace Co., 5 A.2d 503 (Del. 1939).

88. Rule 10b-5, Securities Exchange Act of 1934, 17 C.F.R. § 240.10-5 (2009).

89. Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing,* 25 ANN. REV. BANKING & FIN. L. 235 (2006).

90. Snepp v. United States, 444 U.S. 507 (1980) (some footnotes omitted) (citations omitted); Raycon Corp. v. Ceramtech, Inc., No. 20-9332, 2000 Mich. App. LEXIS 2511, at *2 (Ct. App. Mar. 28, 2000) (defendants found liable for using confidential information to start new company and directly compete with former employer); Synergetics, Inc. v. Hurst, 477 F.3d 949, 961 (8th Cir. 2007) (judgment against two former employees for trade secret misappropriation, breach of fiduciary duty, and other counts when they started a new, competing company despite the signing of confidentiality agreement).

review, as was required under his contract with the agency.[91] The Government sought a court declaration that Snepp had breached his contract obligations, an injunction, and the imposition of a constructive trust for the Government's benefit on all profits that Snepp might earn from publishing the book.[92] The Supreme Court held that "Snepp breached a fiduciary obligation and that the proceeds of his breach are impressed with a constructive trust."[93] The contract obligation in this case involved an entrustment of property which was misappropriated, in violation of Snepp's fiduciary duty.

A fiduciary relationship regarding information may apply when there are few shareholders in a corporation. Each of the shareholders may be deemed a fiduciary of the other shareholders with respect to information that each received in his position as a shareholder. If shareholder A receives a third party's offer to buy his shares, and then turns to the other shareholder B and offers to buy B's shares for a lower amount than the price that A was offered for his shares, without disclosing the offer to B, A is deemed B's fiduciary with respect to this information. A may be liable to B for misappropriating this information.[94] Controlling shareholders of

91. 444 U.S. at 507–08. "Upon the eve of his departure from the Agency in 1976, Snepp also executed a 'termination secrecy agreement.' That document reaffirmed his obligation 'never' to reveal 'any classified information, or any information concerning intelligence or CIA that has not been made public by CIA . . . without the express written consent of the Director of Central Intelligence or his representative.'" *Id.* at 508 n.1. The District Court granted an injunction and imposed a constructive trust on Snepp's earnings from the book.

92. *Id.* at 508. "The District Court found that Snepp had "willfully, deliberately and surreptitiously breached his position of trust with the CIA and the [1968] secrecy agreement" by publishing his book without submitting it for prepublication review. Snepp deliberately misled CIA officials into believing that he would submit the book for prepublication clearance. The publication of the book had "caused the United States irreparable harm and loss." The District Court therefore enjoined future breaches of Snepp's agreement and imposed a constructive trust on Snepp's profits." [Thus, Snepp's profits from the book had to be paid over to the government.] *Id.* at 508–09 (citation omitted). "At the time of suit, Snepp already had received about $60,000 in advance payments. His contract with his publisher provides for royalties and other potential profits." *Id.* at 508 n.2. The Court of Appeals upheld the injunction against future violations of Snepp's prepublication obligation, but denied the constructive trust, based on Snepp's First Amendment right to publish unclassified information. *Id.* at 509–10.

93. *Id.* at 510.

94. Adams v. Catrambone, 359 F.3d 858 (7th Cir. 2004) (stating that fiduciary duty may exist between the only two shareholders in a close corporation); Barth v. Barth, 659 N.E.2d 559 (Ind. 1995), *appeal after remand,* 693 N.E.2d 954 (Ind. Ct. App. 1998); Melvin A. Eisenberg, *Principles of Corporate Governance,* 1 A.L.I. § 5 (2005) ("Directors, officers, and other persons who control corporations have fiduciary duties that are not necessarily the same as those owed by trustees. In closely held corporations, however, such persons may

large corporations have a similar fiduciary duty. Control of the corporations creates an entrustment of power over the minority's interests.

Information may be ambiguous. Whether entrusted information creates fiduciary relationships may depend on the understanding of the parties. The Supreme Court of California noted that the mere disclosure of confidential information, such as a valuable invention, does not establish a fiduciary relationship. This is especially if the parties' contract demonstrated that the relationship constituted an exchange of this confidential information for 2% of certain profits from the information. However, the decision did not mean that confidential information cannot be entrusted.[95]

Whether information is entrusted may depend on who created it. Clients' information that was aggregated by an investment bank into proprietary confidential information was not deemed entrusted by the client, but rather constituted the investment bank's property. In this case as well, the court did not imply that information cannot be owned, but focused on who created it, and thereby owned it.[96]

b. Public Office Is a public office property? This question arose in the 1800s. Two cases reached conflicting answers related to somewhat different legal issues. One case held that "office" was property, focusing on the fees and benefits that an officeholder is entitled to receive. This case viewed the limitations on the use of public service as mere descriptions of the office-related functions.[97] The other case held that an office is not property, noting that the power of the office is entrusted to the officeholder for the benefit of the citizens and not for the officeholder's own benefit. Therefore, the entitlement to compensation for performing public services did not change the nature of the office and did not constitute property.

be deemed to have a relationship similar to that of partners, with duties analogous to those stemming from that relationship."); *see* Neubauer v. Goldfarb, 133 Cal. Rptr. 2d 218 (Ct. App. 2003) (finding a breach of a fiduciary duty in omitting to disclose to a shareholder information affecting the value of their shares before that shareholder sells the shares).

95. City of Hope Nat'l Med. Ctr., 181 P.3d 142, 154 (Cal. 2008) (citing RAFAEL CHODOS, THE LAW OF FIDUCIARY DUTIES § 1.21, at 55 (2000)).

96. Washington Steel Corp. v. TW Corp., 602 F.2d 594, 601 (3d Cir. 1979); *see* Carpenter v. United States, 484 U.S. 19, 26 (1987) ("'Confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit, and which a court of equity will protect. . . .'") (quoting 3 W. FLETCHER, CYCLOPEDIA OF LAW OF PRIVATE CORPORATIONS § 857.1, at 260 (rev. ed. 1986) (footnote omitted)); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961) ("Even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. . . . [C]lients may not expect of a broker the benefits of his inside information at the expense of the public generally.").

97. Hoke v. Henderson, 15 N.C. (4 Dev.) 1 (1833).

The two conflicting views of the same relationship persist today. As in the past, the disagreements relate to a distinction between an entrustment of the power of office that must be used for the benefit of the population[98] and an exchange of fees for services, to which the officeholder is entitled.[99] Today, corporate officers and directors are entrusted with the control of corporate assets to be exercised for the benefit of the corporation and its shareholders. The same officers are entitled to compensation in exchange for their services. Exchange and entrustment can, and often do, reside in the same relationship. Yet they should be distinguished, and be subject to different rules.

c. Signals of Authority There are situations that are not viewed as public office yet signal public authority. *Reading v. Attorney-General* is an old English case that demonstrates entrustment of an authority signal.[100] An army sergeant stationed in Egypt in the 1900s received about £20,000 for helping transport whiskey and brandy through custom checkpoints in Cairo. The truck carrying the cases of liquor was not stopped nor did the driver pay customs because the sergeant sat in the truck, clothed in his uniform. The court held that the Crown was entitled to the money that the sergeant received.

"[I]f a servant takes advantage of his service and violates his duty of honesty and good faith to make a profit for himself, in the sense that the assets of which he has control, the facilities which he enjoys, or the position which he occupies, are the real cause of his obtaining the money as distinct from merely affording the opportunity for getting it, that is to say, if they play the predominant part in his obtaining the money, then he is accountable for it to the master . . . The uniform of the Crown and the position of the suppliant as a servant of the Crown were the only reason why he was able to get this money, and that is sufficient to make him liable to hand it over to the Crown."

The court did not hold the sergeant to be a fiduciary because the sergeant was not acting in the course of his duty. Nonetheless, he "was using his position as a sergeant in His Majesty's army, and the uniform to which his rank entitled him, to obtain the money which he received . . . [A]ny official position, . . ., which enables the holder to earn money by its use gives his master a right to receive the money

98. State *ex rel.* Bonner v. District Court, 206 P.2d 166, 169 (Mont. 1949).

99. One of the difficult issues in the regulation of investment companies stems from section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (2006). The section imposes fiduciary measures on fees and expense charged to mutual funds. Imposing fiduciary duties on the exchange of services for pay mixes the two types of legal relationships and has resulted in a split in the courts. *See* Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.), *reh'g denied, reh'g en banc denied,* 537 F.3d 728 (7th Cir. 2008), *vacated, remanded,* No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010) (resolving split by recognizing factors to determine fiduciary standard); Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 822–23 (8th Cir. 2009).

100. Reading v. Attorney-General, 1 All E.R. 617 (House of Lords Mar. 1, 1951) (citations omitted).

so earned even though it was earned by a criminal act. 'You have earned,' the master can say, 'money by the use of your position as my servant. It is not for you, who have gained this advantage, to set up your own wrong as a defence [sic] to my claim.'"[101] Thus, the underlying reasons for entitling the Crown to the money that the sergeant earned were based on entrustment. An agent who exceeds his authority entrusted to him by a principal is similar to the sergeant in the *Reading* case. Any benefits that such an agent received would be subject to accounting for the benefit of the principal as well.

d. Property in the Virtual World Perhaps a new property will appear in a virtual world.[102] A virtual world can be created by game developers. In such a world numerous participants from the real world interact inside it. The game creates a parallel, second life. The participants in the game play their roles by their "avatar," their online identity. These players interact, "fight" together to win their "rewards," in the form of "virtual property" using game "currencies" and "items." The games seem like a child's fantasyland. Yet this fantasy had real impact in the real world not merely by providing revenues to the companies that offer these game services.[103]

MMORPG is a game played through the Internet. It involves a rare virtual weapon. In March 2005, one player acquired the weapon. Another player borrowed the weapon and promised to return it. Instead he sold it for the equivalent of more than $1000 in real cash. The weapon "owner" reported the theft to the authorities, but the authorities did not take the complaint seriously and did nothing. They doubted whether the incident was theft. After all, the stolen item was a virtual weapon! The owner then took the law into his own hands, met with the "thief," stabbed him "repeatedly in the left chest and killed him."[104] While this might have been a uniquely bizarre incident, one could imagine similar disputes and lawsuits in the future.[105]

e. Examples of Entrustment of Power Agency, an ancient and recognized fiduciary relationship, constitutes an entrustment to the agent of the power to bind his principal to legal obligations. Similarly, entrustment of power appears in the relationship between physician and patient. For example, in *Moore v. Regents of University of California*[106] a physician, who performed an operation on a patient and used the patient's unique cells for scientific and lucrative purposes without disclosing the fact to the patient, was held to have violated his fiduciary duties to the patient. That is because the physician was the patient's fiduciary and failed to disclose his strong conflicting interest in determining whether the operation and tests were for the benefit of the patient or for his own benefit and profit (and perhaps for the benefit of the public as well). The decision of whether to operate was entrusted power over the patient. This decision power triggered a fiduciary relationship, which gave rise to a duty to seek the patient's consent to this treatment by this physician.[107]

5. Entrustment Poses Risks to Entrustors

Fiduciary relationships pose risks for entrustors. To be sure, any relationship with others poses risks (while it offers benefits). However, fiduciary relationships are risky in a special way, and the level of these risks varies, depending on the type of services that the fiduciaries offer, the nature and magnitude of the entrusted property and power, and the efficient control over the fiduciaries' ability to abuse the entrustment in them and the quality of their services' performance.

To perform their services, fiduciaries must be entrusted with various amounts of valuable assets and various degrees of discretion (power). To be effective, they must have a degree of freedom to act without resorting to prior approvals; they cannot be fully directed in the use of entrusted property or power or in the

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101. *Id.*

102. This material is drawn, with consent, from a paper by Adrian Wong Chun Kit, in satisfaction of a seminar requirement on fiduciary law at Boston University Law School, Spring 2007 entitled *Fiduciary Duty in the Virtual Property?: Looking into the New Challenges the Virtual Internet World Poses into the Relationship Between Internet Service Providers and Users.* The paper is edited and abridged.

103. The players themselves are selling and trading virtual items in the real world, for real world U.S. currency. The average participants are adults, and have attached real world money value to their items. The players take their "virtual property" seriously. Theodore J. Westbrook, Comment, *Owned: Finding a Place for Virtual World Property Rights*, 2006 Mich. St. L. Rev. 779, 785 ("The average age of users and the amount of time spent by these users in virtual worlds are also indicative of the social and economic impact of MMGs. It may be surprising to some that most users of popular MMGs are adults. For example, the average age of an Everquest user is 25.7 years. While women make up a small percentage of Everquest users, their average age is 29, somewhat higher than the overall average.") (footnotes omitted).

104. For a more detailed report of the incident, *see* Amalie Finlayson & Reuters, *Online Gamer Killed for Selling Virtual Weapon*, Sydney Morning Herald, Mar. 30, 2005, http://www.smh.com.au/news/World/Online-gamer-killed-for-selling-virtual-weapon/2005/03/30/1111862440188.html.

105. Questions arise (1) whether it would be easier for the developers to solve the disputes; for example, in the above situation, by restoring the item; (2) whether the developers have a duty to protect the virtual property; and particularly (3) whether virtual property should be considered property under the law.

106. Moore v. Regents of Univ. of Cal., 793 P.2d 479 (Cal. 1990).

107. The issue is interesting because by disclosing to the patient his interest in developing the patent, the physician would enable the patient to extract some benefits from the patent. This may have been one reason for the physician's silence on this matter. Nonetheless, the patient would have a conflict of his own, if he believed that the physician could cure him but only on condition that the patent developed from the patient's cells will belong entirely to the patient. The result in this case is to relegate the parties to "market negotiations" rather than predetermined rules.

performance of their services. Depending on the nature of the services, greater specifications, constraints, or control over the fiduciaries' performance would undermine the very utility of the relationship. Consequently, fiduciary relationships are risky to entrustors because their fiduciaries might misappropriate in many ways the entrusted property or power or fail to perform their services with care or fail to follow the directives attached to the entrustment. The less specific the directives must be, and the more discretion the fiduciaries must have to perform their services, the higher the entrustors' risks become.

This section 5 starts by listing the source and nature of the risks that entrustors bear from fiduciary relationships. The section proceeds to discuss the barriers that reduce these risks, and concludes with the limits on the ability of entrustors and third parties to control and reduce the risks.

a. Entrustment is a Prior Condition to Fiduciaries' Services In fiduciary relationships, entrustors are always the vulnerable party. Before the relationship is established, and during negotiations with fiduciaries, entrustors might have the upper hand or at least have an equal bargaining power with the fiduciaries. Wealthy entrustors are able to choose the fiduciaries of their liking, while many fiduciaries may be desperately seeking entrustors as they compete with other fiduciaries.

However, once the relationship is established, the fiduciaries must be entrusted with property or power. Otherwise, the fiduciaries cannot perform the bargained for services. Therefore, entrustment must occur before the fiduciaries perform their part of the agreement. From that point on, the entrustors are the weaker party in the relationship.

A classic example of prior entrustment is a situation in which an inventor provides information about his invention to a commercial developer. The developer cannot develop the invention without full information about the invention. Yet, once the inventor discloses the information, the inventor has given in advance all he had, while the developer has given nothing, until he received all that the inventor can give.[108]

Thus, an important element of fiduciary relationships is prior entrustment as contrasted with a simultaneous exchange. However, in *City of Hope v. Genentech*,[109] which will be discussed in more detail later, the court held that a prior disclosure of an invention was an exchange, based on the contract language, among other elements. Thus, an agreement of the parties may negate the weight to be given to the prior entrustment of entrustors to their fiduciaries.[110]

b. Inability to Specify the Fiduciary's Activities in Advance Many fiduciary services cannot be specifically prescribed. The inevitable discretion that fiduciaries must have raises the entrustors' risks. To be sure, there are long-term contractual relationships that require entrustment of one party to another. However, in these relationships entrusted power is usually specific. Most importantly, the product of the services involved can be tested before the entrusting party receives its part of the bargain. But in the case of fiduciary relationships, the specifications must be vague, and the risks of misappropriation are greater because the test of whether particular specifications were accomplished cannot be severed from the services as a whole. It is hard to determine whether a lawyer's answer to a particular question in the courtroom was the right one without reviewing the entire proceedings and what has happened after the answer was made. Similarly, it is difficult to assess the decision of a money manager without evaluating the investment strategy, the portfolio as a whole, and the circumstances of the investor or investors. Even then, the validity of such an evaluation can be uncertain. A comparison with other similar performances may also be inaccurate.[111]

In this respect a comparison between a fiduciary relationship and a construction contract relationship is illuminating. Construction contracts usually contain copious specifications.[112] The performance of most specifications can be tested upon completion. Therefore, before a part of the building under construction is covered, which would prevent examination of compliance with the specifications, a qualified architect or engineer inspects to make sure that the specifications were met. Thus, for example, the expert architect verifies that the amount of cement poured into the foundation of the building was as required before the foundation is covered. Similar specifications cannot be imposed on a money manager who chooses investments or on a surgeon in the operating room.

Some limits can indeed be imposed. For example, usually, lawyers are not entrusted with the power to settle claims. A settlement does not require a split

108. *See* City of Hope v. Genentech, Inc., 181 P.3d 142 (Cal. 2008).

109. *Id.*

110. As to the weight that the courts give to the language of the parties' contract and the consequences of the courts' approach, see Chapter 6.

111. C. Boone Schwartzel, *Is The Prudent Investor Rule Good for Texas?*, 54 BAYLOR L. REV. 701, 840 (2002) (proposing that the *Restatement (Third) of Trusts* could have required fiduciary investment decisions to be evaluated in the context of the portfolio as a whole increasing flexibility and risk taking); Brooks J. Holcomb, *Total Return Trusts: New Power to Adjust Between Income and Principal*, 38 ARIZ. ATT'Y 24, 25 (2002) (challenged the prudent person rule that evaluated performance asset by asset, stating that it is unfair to impose liability for an underperforming single asset when the portfolio performed well).

112. *See, e.g.*, Zannoth v. Booth Radio Stations, Inc., 52 N.W.2d 678, 684 (Mich. 1952) (architect has primary duty of good faith and loyalty to employer and must make full disclosure of all known matters that employer should learn); Palmer v. Brown, 273 P.2d 306, 315–16 (Cal. App. 1954) (architect owes client fiduciary duty of loyalty and good faith); Holy Cross Parish v. Huether, 308 N.W.2d 575, 577 (S.D. 1981); Vikell Investors Pacific, Inc. v. Kip Hampden, Ltd., 946 P.2d 589, 597 (Colo. App. 1997) (undisputed facts did not support fiduciary or confidential relationship); Winsted Land Dev. v. Design Collaborative Architects, P.C., No. CV 960071571, 1999 Conn. Super. LEXIS 2180 (Super. Ct. Aug. 12, 1999); Strauss Veal Feeds, Inc. v. Mead & Hunt, Inc., 538 N.E.2d 299, 303 (Ind. App. 1989).

second decision. Hence the clients can retain the decision power with respect to settlement. But in other situations the decision must be left to the professionals, and sometimes can only be determined on the spot, while performing the service. These fiduciaries must possess the power to exercise the decision power whenever necessary.

Because fiduciaries' services cannot be performed without first entrusting property or power to the fiduciaries, the services of the fiduciaries cannot be evaluated except after entrustment. In addition, many types of fiduciary services are hard to evaluate at the time of the bargain, or over a short period. For example, a corporate manager may be gifted and devoted, but the corporation may fail for unexpected economic and political reasons. Only over time can the manager's performance be measured. A lawyer may draft a faulty will. Yet the fault may be discovered only years later, after the death of the person who made the will. In contrast, some exchanges of items or services can be evaluated and tested at the time of the bargain, such as the purchase of shoes and the service of car repairs. These are not usually deemed fiduciary.

c. Risk from Entrustment Cannot Be Easily Limited Without Reducing the Value of the Fiduciaries' Services It is not possible to prescribe for fiduciaries the precise way in which they are to perform their services. The directives to fiduciaries must be general, and the precise ways in which they are to perform their services must be left to them, both if they are the experts, and if their performance is subject to a changing or unknown environment, such as investment management or the development of a potentially path-breaking patent. Any itemized controlling directives to fiduciaries are likely to undermine the utility of their services.

This does not mean that some fiduciaries cannot be subject to more specific directives than others. The degree of restrictions depends on their services. In fact, the definition of various fiduciaries relates in part to the specificity of the directives that can be given to them without eliminating the usefulness of their services. The more specific the directives are, the less discretion they will have, and the lower their legal duties become. Limited discretion presumes less entrustment and lower supervision costs for the entrustors.

There comes a point where the persons who provide services are not fiduciaries. For example, as a general rule, a "servant" is not a fiduciary. When principals, such as employers, can protect themselves against their servants' abuse of trust without undermining the benefits from the servants' services, they should do so. And yet, when a servant is entrusted with particular information, and the costs of enforcing the servant's trustworthiness with respect to the use of that information are high (and contract is ineffective), the courts may view that part of the relationship as fiduciary and impose on the servant fiduciary duties.[113]

113. Jostens, Inc. v. Kauffman, 842 F. Supp. 352, 354 (C.D. Ill. 1994) (the cost of enforcing an employee's trustworthiness may come as a restrictive covenant, which imposes a

d. Monitoring Fiduciaries' Performance Involves High Costs for Entrustors The risks to entrustors from fiduciary relationships is high because monitoring the fiduciaries in the performance of their services is costly to the entrustors, sometimes more costly than their benefits from the relationships. "The policy [underlying fiduciary law] can also be put in evidential terms . . . fiduciary law erects its prophylactic rules and prohibits profit-taking precisely because the stronger party to a fiduciary relationship controls all evidence of the relationship and can easily conceal wrongdoing from the vulnerable party or the court."[114]

The cost of monitoring the fiduciary to prevent abuse of entrusted property or power may be one of the elements of fiduciary relationships. Monitoring costs influence the design of fiduciary duties. The rules are fashioned by taking into account the costs of the restrictions on the fiduciaries, as well as the benefits to fiduciaries of reducing their costs of convincing entrustors of the fiduciaries' trustworthiness. This section focuses on the risk to entrustors from entrustment and the non-legal protections available to entrustors. At the low end these costs will affect the decision on whether the relationships are fiduciary.

The fact that the entrustor is an expert who chooses another expert in the same area does not reduce the entire risk of the relationship. Such an expert can choose a better fiduciary, but like all others he must entrust property or power to the fiduciary, or else lose the entire benefit from the relationship. Such an expert entrustor, however, could monitor his fiduciary better. And to the extent that the entrustment by an expert reduces entrusted power, the rules applicable to the fiduciary may be less stringent. But the relationship remains a fiduciary one. For example, "sophisticated investors" may be able to choose better money managers and monitor them more effectively, but their risk of abuse of trust remains nonetheless. The 2008 discovery of a Ponzi scheme of billions of dollars that was practiced on sophisticated investors demonstrates the point. To meticulously supervise and monitor the activities of the person who perpetrated the fraud over so many years was too costly for many such sophisticated investors. Some suspected fraud and avoided investing. But too many did not.[115] They went about their own business rather than attempt to monitor and control their fiduciaries.

In general, the ability of the entrustors to protect themselves is doubtful. The Court of Appeals of the Seventh Circuit, for example, interpreted a statute

fiduciary duty on the employee to his employer. Restrictive covenants may be used to protect sensitive, competitive information; an example would be a non-compete contract); *In re* Toy King Distribs., Inc., 256 B.R. 1, 166 (Bankr. M.D. Fla. 2000) (stating "absence or resignation does not necessarily sever a fiduciary's duty to the corporation").

114. Joshua Getzler, *Rumford Market and the Genesis of Fiduciary Obligations*, *in* Mapping the Law: Essays in Honour of Peter Birks 577–98 (A. Burrows and A. Roger eds., 2006) (footnote omitted).

115. Robert Frank et al., *Madoff Jailed After Admitting Epic Scam*, Wall St. J., Mar. 12, 2009, at A1, LEXIS. News Library, Wsj File.

explicitly imposing on investment managers fiduciary duties concerning excessive fees, against the backdrop of the market. That court expressed its strong belief that fiduciary duty is limited to public disclosure. With appropriate information, investors and the financial markets are effective in setting the fees and expenses of financial managers' services.[116] Other courts disagreed. They have introduced explicit and detailed guidelines for the directors to determine excessive fees and expenses.[117] The Supreme Court resolved the disagreement, following the view of the Second Circuit, recognizing specific factors.[118] These specific factors are not rigid, however., The board must use its discretion as a negotiator at arm's length. Further, the fee will be deemed excessive if it "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."

e. The Markets Do Not Necessarily Reduce the Entrustors' Risks Professor Roberta Romano distinguished among types of fiduciary relations. Relations that are less affected by market forces (e.g., guardian-ward, union leader-union member, "and, to a lesser extent," attorney-client (as "lawsuit claims cannot be sold")) involve more stringent obligations than relations that are more affected by market forces (e.g., manager-shareholder, broker-investor, manager-debt holder, majority-minority shareholder). That is because markets provide incentives that might protect entrustors, and high transaction costs may require stricter legal obligations.[119]

Yet, markets do not always reduce entrustors' risk from fiduciaries' services. For entrustors, reducing the risk from the fiduciaries' misappropriation by controls and monitoring can be too costly, or alternatively, may reduce and perhaps eliminate the value of the fiduciaries' services altogether. For fiduciaries, establishing trustworthiness, for example, by providing guarantees, can be more costly than the rewards from the relationship. Temptations may be too great. Public information may be scant, personal, or biased. Experts' performance may be confidential. Rating may be faulty. In such situations, the markets do not reduce the entrustors' risks.

116. Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.), *reh'g denied, reh'g en banc denied,* 537 F.3d 728 (7th Cir. 2008), *vacated, remanded,* No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).

117. Gartenberg v. Merrill Lynch Asset Mgmt, Inc., 740 F.2d 190 (2d Cir. 1984).

118. Jones v. Harris Assocs. L.P., No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).

119. Roberta Romano, *Comment on Easterbrook and Fischel: Contract and Fiduciary Duty,* 36 J.L. & Econ. 447, 449–50 (1993) (it is not clear whether, in the multiple principal context, the duty of loyalty should be more strict, or more difficult to enforce, In addition, fiduciaries who receive incentive or contingent compensation (e.g., managers, some attorneys) should be subject to weaker duties than others (e.g., trustees, guardians, union leaders)).

Fiduciaries may limit the entrustors' risks by self-limitation or self-risk-taking.[120] Like contract parties, such as sellers that have no relationship with buyers, fiduciaries may seek to show their trustworthiness by demonstrating that entrustors' risks are low. For example, market sellers promise buyers to accept returns of sold products, under certain conditions. The offer serves to signal the sellers' trust in the high quality of their merchandise. Stores may offer to match their price with any lower price for similar items. This offer serves to signal the sellers' assurance that their store prices are indeed the lowest.

However, these ways of establishing trustworthiness are less available to fiduciaries. That is especially so when price is not the main incentive that drives buyers. For example, it is doubtful whether patients who must undergo heart surgery would choose the least expensive surgeon. Performance may not be evidence of good surgeons either. After all, success depends not only on the surgeons' skills but also on the patients' physical condition and other circumstances. Other assurances, such as third-party warranties, can be costly.

Some fiduciaries organize associations in which members undertake to limit their behavior and monitor their practices. In exchange the associations vouch for the members' trustworthiness. Professional organizations, such as the American Bar Association and the American Medical Association, serve such a purpose. The existence of these mechanisms reduces the entrustors' risks.[121]

Can entrustors "discipline" fiduciaries by terminating the relationship with the fiduciaries? If they could, there would be no need for fiduciary law.[122] After all, the share price of mismanaged corporations is likely to be lower than the share price of similar enterprises operated by accountable and honest management. Share prices provide the market's evaluation of the risk of lesser management duties. Management presumably is interested in maintaining or raising share prices. Management may propose charter amendments to reduce their fiduciary duties only to the extent that the share prices will not fall substantially. Prices will either maintain management's accountability, or provide investors with an added option of acquiring shares at lower prices denoting the lower quality of management's accountability. This market-contract regime offers self-executing arrangements without the need for, and the costs of, judicial enforcement.[123]

120. Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agent: Cooperation and Conflict Between Lawyers in Litigation,* 94 Colum. L. Rev. 509, 551 (1994) (attorneys self-limit themselves with the code of professional responsibility, like other forms of fiduciary obligations that put their clients' interests ahead of their own); *see* Leo Katz, *Preempting Oneself: The Right and the Duty to Forestall One's Own Wrongdoing,* 5 Legal Theory 339 (1999).

121. *See* Tamar Frankel, *Trusting and Non-Trusting on the Internet,* 81 B.U.L. Rev. 457 (2001).

122. Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 18–19 (1991).

123. *Id.* at 18–19.

And yet, it is doubtful whether shareholders and sophisticated investors can price correctly the risk of management's violations of fiduciary duties.[124] Besides, it is questionable whether the level of management's dishonesty and lack of care remains stable once it is relieved of accountability. If it is not nipped in the bud, small misdeeds can become habits and lead to greater misdeeds.[125] And when it is discovered, it might be too late to salvage much of the lost property.

In addition, when shareholders sell their shares they do not withdraw their entrusted assets from dishonest fiduciaries (except in the case of investment companies that offer redeemable securities). Those assets remain in the hands of the fiduciaries, who continue to control entrusted assets. To be sure, corporations led by dishonest management may lose their financing and fail. In that case the shareholders will lose. Markets seem to ensure the tenure of management at least until shareholders' outrage becomes too "hot" for Congress to ignore.[126] A comparison of corporate fiduciaries to other fiduciaries under the control of entrustors or under the control of the courts is not likely to show "market discipline" of corporate fiduciaries. In fact, it might show that markets have retained management tenure and high compensation.[127] The belief in the effect and possibility of 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 reduction or elimination of fiduciary rules.

Further, management's wrongdoing may not be limited to the particular corporation which it serves. When investors learn about management's lack of, or lower, accountability and rising self-dealing, investors might withdraw not only from the corporation but from the markets. In fact, the events in years 2008 and 2009 suggest that at some point shareholders withdrew from the financial system. They sold their shares not only of corporations led by risk taking and dishonest managements but also of corporations that had honest and hard working managements; and not only of corporations in a particular services or industries but of shares and financial assets, no matter who issued them.[128]

124. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1255 (1995).

125. *See* TAMAR FRANKEL, TRUST AND HONESTY 80–83 (2006).

126. Sudeep Reddy, *Tapping AIG Furor, Regulators Seek Power to Seize Nonbanks*, WALL ST. J., Mar. 25, 2009, at A2, LEXIS, News Library, Wsj File (noting that AIG paid "bonuses to employees in the same unit that triggered many of its problems" and regulators' authority to stop the payments was limited; Congress may grant government authority to seize nonbanks and freeze their contracts).

127. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 53–58 (2004) (arguing that market forces "are unlikely to impose tight constraints on executive pay").

128. E.S. Browning, *Stock Investors Lose Faith, Pull Out Record Amounts*, WALL ST. J., Dec. 22, 2008, at A1, LEXIS, News Library, Curnws File.

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. Perhaps that may be the reason why waivers of fiduciary duty of care have become more acceptable. Nonetheless, market monitoring and evaluation of fiduciaries' performance are often ineffective in controlling abuse of trust. If the performance of corporate executives is poor, investors exercise the "Wall Street rule," by selling their stock, rather than exercising "voice"—fighting to replace the executives or limit executive compensation.[129]

Since the year 2000, shareholder activism has been rising,[130] and in 2006 the Securities and Exchange Commission responded to shareholders' pressure demanding to reduce executive compensation, with a rule that requires corporate management to offer a more itemized disclosure of their benefits and compensations.[131] But, true to American philosophy, legislators, regulators and the courts have been reluctant to influence, let alone set, fees and compensation.[132] The decision was left to the market and the entrustors. And when large corporations have been seeking government handouts in the 2008–2009 economic crisis, Congress has linked its largess to limits on the corporations' executives' compensations.[133] As society became the investor in these corporations, society, like investors, can impose its conditions on corporate executive compensation.

Perhaps government pressures and angry investors' voices have begun to reach managements ears. Goldman Sachs "blinked" at the public's reaction to the enormous bonuses bestowed on top management in 2009.[134] The shakeup of executive compensation reached executives of hedge funds as well. On December 28, 2009 the *Wall Street Journal* noted that a hedge fund promoter "is considering offering lower fees to investors depending on how long they lock up their money. . . . These fees also may be based on performance over the duration of the

129. *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006).

130. *Id.*

131. Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A (Aug. 29, 2006), 71 Fed. Reg. 53,158 (Sept. 8, 2006) (codified as amended in scattered sections of 17 C.F.R.).

132. *E.g.*, Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.), *reh'g denied, reh'g en banc denied*, 537 F.3d 728 (7th Cir. 2008), *vacated, remanded*, No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010) (rejecting Seventh Circuit view that market forces are sufficient to protect investors from excessive fees).

133. Dick K. Nanto, *The Global Financial Crisis: Analysis and Policy Implications*. Apr. 2009 ("The United States will provide US$13.4 billion in emergency loans to General Motors and Chrysler. Limits on executive compensation are a requirement for funds.").

134. Cassell Bryan-Low, *Easier Terms Aid Hedge-Fund Rally*, WALL ST. J., Dec. 28, 2009, at C1, LEXIS, News Library, Wsj File.

investment rather than annually as is typical."[135] The measures link the managers' fees to those of the investors. A day later[136] the same paper noted proposed changes at Morgan Stanley. More compensation would be deferred over time and performance would be benchmarked against rival firms. Executives will receive for 2009 only stock bonuses, and only a quarter of pay in cash—and the rest in deferred stock. Wall Street is attempting to minimize outside criticism and "keep staff happy." "Most of the thirty top employees would submit to 65 percent or more of their pay to deferrals or 'clawbacks' or the possibility of returning the money in the event of future losses. In addition, about 20 percent of total compensation would come in shares awarded based on Morgan's share price compared with peers' share prices." Executive pay will be affected by "Morgan's return on equity versus present benchmarks over a three-year period." Significantly, there will be changes in "the pay practice of traders, adjusting compensation for how much risk they take for the firm." For the year 2009 Morgan will pay to management $14 billion compared to Goldman Sachs. But Morgan is expected to sustain losses for 2009 while Goldman is expected to reap gains. Morgan's CEO has forgone his bonuses for three years.

Goldman Sachs and Morgan Stanley reacted to investor clients' pressures by giving shareholders a "say on pay" vote. TIAA-CREFF suggested that Morgan Stanley would consider a shareholder advisory vote on pay. AFL-CIO has proposed a study of the widening gap of management and employees. One large client inquired about executives' bonus-repayment for the year in which the investment bank lost so much money for its clients.[137]

To be sure, there are market actors who help monitor fiduciaries, such as secured and unsecured creditors, corporate outside directors, and the courts entertaining shareholder suits. However, the incentives and purposes of these monitors do not always identify with the interests of the entrustors. Such monitors might focus on certain aspects of the fiduciaries' activities but have a blind eye on others. In fact, law and market monitors interact. If the monitors are effective, law recedes. If the monitors are ineffective, then law might intervene. If the law does not intervene, then sometimes (not always) a danger to the economy and financial system may arise.[138]

The entrustors' risk is linked to the type of fiduciary relationship. The use of the fiduciaries' service involves different risks for entrustors, from embezzlement

135. *Id.*

136. Aaron Lucchetti, *Morgan Stanley to Overhaul Pay Plan*, WALL ST. J., Dec. 29, 2009, at C1, LEXIS, News Library, Wsj File.

137. Susanne Craig et al., *Banks Brace for Bonus Fury*, WALL ST. J., Jan. 11, 2010, at A1, LEXIS, News Library, Wsj File (Chief Executive Officer of Goldman Sachs admitted that no one is likely to be happy with the new pay).

138. *See, e.g.*, EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST (2007).

and dishonest behavior to poor performance.[139] The risks to the entrustors and the protections from these risks are crucial to identifying fiduciary relationships and their classification. Thus, there are differences between control by the principal in the agency relationship; shared control by partners; low or no control by a trust beneficiary; little control and inability to escape the relationship in a closed corporation; and indirect "controlling influence" by publicly-held corporate shareholders that are able to escape the relationship by selling their shares. The relationships that the parties choose may fall into any one of several legal categories that reflect entrustment and the existing controls to prevent abuse of entrustment. The rules that apply to these categories are distinguished by the strictness they impose on the fiduciaries. The lower the controls are, the greater the strictness of the rules.

6. The Boundaries of Entrustment

a. No Need for Entrustment The law limits the fiduciary relationship to the needed entrustment. Thus, physicians are not fiduciaries of their patients in all health respects, but only to the extent and nature of the entrustment. A physician who treats a patient for a broken bone is unlikely to be held a fiduciary for the patient's asthma or tendency to hysteria. Nonetheless, there is a gray area in which a physician, who is not an expert in a particular area of medicine, is assumed to have more expertise than the patient, and is required as a fiduciary to make suggestions, for example, that the patient see an expert.[140]

Similarly, teachers are fiduciaries with respect to their power to award grades. The power to grade is entrusted to the teachers for sole benefit of the school or university, future employers, and the students. Therefore, teachers may not misappropriate the power for their own benefit (e.g., accept or demand valuable "gifts"). But teachers may accept gifts after they have graded the particular students' performance.

There are, however, fiduciaries named "agents" that are subject to a far broader duty than usual agents. For example, section 17(e) of the Investment

139. *See* Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209 (1995).

140. Jerald J. Director, Annotation, *Malpractice: Physician's Failure to Advise Patient to Consult Specialist or One Qualified in a Method of Treatment Which Physician Is Not Qualified to Give*, 35 A.L.R.3d 349, at § 2[a] (1971) (stating that "[a]lthough most of the cases involving treatment by a general practitioner or surgeon recognized that under certain circumstances the physician has a duty to advise his patient to consult a specialist or one qualified in a method of treatment which the physician is not qualified to give, a physician who failed to so advise his patient was not held liable for malpractice in every instance. Thus, under the circumstances of the particular case, a general practitioner or surgeon has been held liable in cases involving the treatment of cancer, neck and shoulder injuries, or negligent post-operative treatment, while in cases involving the treatment of fractured or broken bones or injuries and conditions of the eye, the decisions have gone both ways") (footnotes omitted).

Company Act of 1940[141] prohibits an affiliate[142] of an investment company (with some exceptions) from receiving as agent any compensation in connection with transactions related to the companies' assets. In *United States v. Deutsch*[143] the Second Circuit interpreted the word "agent" very broadly to include a person who was in a fiduciary relationship with an investment company and received benefits from third parties in connection with a transaction of the investment company, although this "agent" had no authority to affect, and did not affect, the transaction.

b. Limits to the Class of Entrustors In the case of professional services entrustors may include not only particular persons or groups of persons but also the public and society. Members of the professions are expected to use their entrusted power to meet society's needs as well as the needs of particular entrustors or other professionals. A private hospital and its medical membership may have fiduciary relationships to needy patients in the area in which the patients live, if no other hospital exists in the area.[144]

But surgeons' duty to persons who donate their organs to the surgeons' patients is not as clear. If the donors are known to the surgeons and the surgeons perform the operations on the donors as well, then the donors are entrustors, and the surgeons are their fiduciaries. But when the donors are unknown and the surgeons do not treat them, then the question is whether these anonymous donors have entrusted their organs to the surgeons and thus bound them to a fiduciary duty. This answer is especially difficult when the donors are coerced in foreign countries to "donate their organs."[145] On this score the issue may have moved from the legal sphere to the ethical.

The fiduciary relationship of corporate directors to their corporation sometimes includes a relationship to the community in which the corporation operates.[146] The fiduciary relationship of financial intermediaries may sometimes

141. 15 U.S.C. § 80a-17(e) (2006).

142. 15 U.S.C. § 80a-2(a)(3) (2006) (defining affiliates).

143. United States v. Deutsch, 451 F.2d 98 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019 (1972).

144. Greisman v. Newcomb Hosp. 192 A.2d 817 (N.J. 1963). Roscoe Pound, *The Professions in Society Today*, New Eng'd J. Med., Sept. 8, 1949; Roscoe Pound, The Lawyer from Antiquity to Modern Times 4–5 (1953).

145. *See generally* Cindy Chan, *Revised Report into Allegations of Organ Harvesting: Chinese Officials Still Killing Falun Gong for Organs*, Epoch Times, Feb. 1, 2007, http://en.epochtimes.com/news/7-2-1/51181.html (last visited June 7, 2008) (organs forcefully extracted from prisoners of dissident group in China implanted in foreigners).

146. Gregory S. Crespi, Redefining the Fiduciary Duties of Corporate Directors in Accordance with the Team Production Model of Corporate Governance, 36 Creighton L. Rev. 623 (2003).

include a relationship to the financial system.[147] Arguably, these statements are too broad, for they apply to the duties of the fiduciaries rather than to the relationships. Yet, a relationship can be less direct, sufficient to impose duties to communities and society in general rather than to the specific entrustors.[148]

c. Impact of Fiduciary Services on the Entrustors The limits of entrustment depend on its impact on the specific entrustor. Entrustment to professional experts may have an impact on entrustors beyond the particular service. "The market exchange is 'merely' *transactional* . . . in the sense that it serves only to meet the self-perceived, stated wants of the customer. The professional exchange is *transformational* in the sense that it serves the 'deeper needs' of the client."[149] This impact on the 'deeper needs' of the client affects the view of fiduciary relationship and consequently, the magnitude of the fiduciaries' duties. For example, a psychiatrist is held to be a fiduciary of a patient in a broader sense than a surgeon.[150] The surgeon affects the patient's body. The psychiatrist affects the "deeper needs" of the patient. This distinction, however, is not always valid, but the principle is: the impact of fiduciary services on the entrustor plays a role in determining the range of fiduciary duties.

147. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1259 (1995) (stating that the viability of the securities markets depends on the participation of small investors, and small investors will withdraw from the markets if they perceive any losses to be the result of an unfair market system. Thus, financial intermediaries have a fiduciary duty of acting honestly. This will keep all investors involved and the system running smoothly).

148. *See* Pepper v. Litton, 308 U.S. 295, 307 (1939) (stating that in event of corporation's bankruptcy, corporate "fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders") (footnote omitted); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communs. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, *108 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."); *id.* n.55 (stating that corporation represents "community of interests"; "circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act").

149. David P. Schmidt, *Quilting Professional Identities in Business*, *in* Religion, Morality and the Professions in America 27, 27, 36–37 (1998), http://poynter.indiana.edu/publications/m-rmpa.pdf (endnotes omitted).

150. Linda J. Demaine, *"Playing Doctor" with the Patient's Spouse: Alternative Conceptions of Health Professional Liability*, 14 Va. J. Soc. Pol'y & L. 308 (2007) ("The courts' consistently different resolutions . . . bespeaks (*sic*) an intriguing mind-body divide in this area of health care law. In psychologist- or psychiatrist-affair cases, it is undeniable that the defendants are responsible for their patients' mental health. In physician-affair cases, where the connection between the defendant's duty and the plaintiff's injury is one step removed, the courts deny recovery to the plaintiff.").

d. Legal Signals The limitations of fiduciary relationships are affected by the ability of the entrustors to protect their entrusted property and power from abuse. For example, investors cannot blame their advisers or brokers for losses that the investors sustained if the investors knew the risks, were sophisticated enough to understand it, "and simply made . . . bad decision[s]."[151] No fiduciary relationships would be recognized in such cases. If, however, brokers benefited themselves by giving their trusting clients bad advice, the relationship might be recognized as fiduciary. In the opinion of Professor Langevoort, courts are likely to determine the existence of the brokers' fiduciary relationship by resorting to "some rough heuristics to decide the merits of each case. They will invoke social constructs drawn from their own experience and imagination about the ways in which brokers normally deal with their customers, and how customers normally choose investments."[152]

"[T]he issue of trust emerges as the pivotal consideration." If a broker gained the client's trust, writes Professor Langevoort, the broker may not be shielded by the client's sophistication. The "broad-based trust" does not apply solely to unsophisticated investors. Sophisticated investors may need to rely on the broker as well.[153] Thus, the test of the existence of a broker's fiduciary relationship with a customer and resultant liability is the extent of the client's trust in the broker, and far less the client's sophistication.

However, the client's trust must be reasonable. A gullible client that unreasonably trusts a broker in the face of clear warning facts ought not to be protected. The law is designed to balance trust with self-protection and responsibility for oneself.[154] It should be noted, however, that self-protection is a mistrusting posture. It may involve costs of verification and guarantees to substitute for trust. In contrast, there may be a social objective in inducing people to trust brokers, similar to the objective underlying fiduciary relationships. Trust is efficient. It avoids the necessity to prove the truth of statements and reliability of promises. A fiduciary relationship may be recognized when the entrustors' self-protection involves cost of verification and guarantees that are higher than the benefits from the relationship. This disparity of costs may be sufficient to introduce legal constraints to ensure trustworthiness.

151. Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 Cal. L. Rev. 627, 627–31 (1996) (footnotes omitted).

152. *Id.*

153. *Id.*

154. *See, e.g.*, Hunt v. Miller, 908 F.2d 1210 (4th Cir. 1990) (holding that attorney was entitled to jury instructions on contributory negligence where there was evidence that investors in real estate venture failed to make reasonable inquiry into particulars of investment, to request basic transactional documents and to examine the documents they were given.); *see also* Tamar Frankel, Trust and Honesty 52 (2006).

e. Limits on Entrustors' Risks by Self-Protection When a party can reasonably protect itself from abuse by the other party the law is unlikely to add the protection of fiduciary law. For example, in *United States v. York*,[155] the government sued York for violations of its fiduciary duties to Ginnie Mae. York was a buyer of mortgage-backed securities that Ginnie Mae created. York also serviced these loans, by collecting the borrowers' payments and distributing the payments to the investors in the securities that were backed by the mortgages.

The mortgage loans are guaranteed by the full faith and credit of the U.S. government. Information on whether a borrower is likely to default on the loan is valuable to investors because, upon the borrower's default, investors receive from Ginnie Mae the entire amount of the loan pursuant to its guarantee, rather than periodic payments from a low-credit mortgage borrower. York bought mortgage-backed securities when it discovered, as a servicer, that the mortgagor defaulted (and the Ginnie Mae guarantee was going to kick in), but before the information about the default was public. Therefore, the price of the securities backed by such loans could be lower than their price after it became known that the loans would be paid in full earlier than the maturity date. York often offered select investors this information, for a price.

Ginnie Mae sued York, claiming that York violated its fiduciary duty to Ginnie Mae by misappropriating the information entrusted to it as a servicer, and creating conflicting interests for itself. The Court of Appeals held that there was no legal basis for holding York to be a fiduciary of Ginnie Mae. Therefore, York did not misappropriate the information it received as a servicer and as a buyer of the mortgages.

In fact, this problem did not require the recognition of a fiduciary relationship. By inserting appropriate conditions in the contracts with the servicers, Ginnie Mae could prevent York and other servicers from using the information that they received as servicers. The prohibition could apply to the use of information for any purpose other than servicing, and bar them from trading on the information or giving or selling it to others. The prohibition could be clear, and the breach of contract could be an effective deterrent. Hence, there was no need for declaring the relationship as fiduciary.

Another example involves the relationship between corporate directors and the corporation's creditors. "A corporation's directors and officers owe no fiduciary duty to creditors under California law until the corporation becomes insolvent. 'Because a director's fiduciary duties to creditors do not arise until the corporation is insolvent, the timing of the insolvency is critical.' The time of insolvency as determined under California law is the point at which the corporation is unlikely to be able 'to meet its liabilities . . . as they mature.'"[156] Corporate

155. United States v. York, 112 F.3d 1218 (D.C. Cir. 1997).

156. Carramerica Realty Corp. v. NVIDIA Corp., No. C 05-00428 JW, 2006 U.S. Dist. LEXIS 75399 (D. Cal. Sept. 29, 2006), *aff'd in part, remanded in part*, Nos. 06-17109, 07-15077, 2008 U.S. App. LEXIS 26777 (9th Cir. Nov. 25, 2008) (citations omitted).

directors have fiduciary duties to shareholders but not to its creditors.[157] Once the corporation files for bankruptcy, however, its directors owe a fiduciary duty to the creditors.[158] The bankruptcy proceedings are for the creditors' benefit.[159] The duty commences once the bankruptcy proceedings are filed[160] but not before. Corporate directors have no fiduciary duty to corporate creditors when the corporation is on the brink of insolvency. The directors' fiduciary duties to the creditors arise when the corporation is actually insolvent. At this point the directors would be liable if they violated their fiduciary duties, such as wasting and unduly risking corporate assets. [161]

Creditors have not received the protection of fiduciary law. Courts consistently held that corporate creditors do not have a common law cause of action against directors of a corporation on the verge of bankruptcy. This holding applied even if the directors authorized unlawful distribution of corporate assets. The exception, however, is when the directors acted for their own benefit or friends' benefit, at the expense of the corporation.[162] However, in bankruptcy proceedings, a

157. William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 849 (perm. ed. 2002) (citing Conway v. Bonner, 100 F.2d 786 (5th Cir. 1939)); Floyd v. Hefner, No. H-03-5693, 2006 U.S. Dist. LEXIS 70922 (S.D. Tex. Sept. 29, 2006) ("A corporation's directors owe shareholders, not creditors, [fiduciary] duties 'so long as [the corporation] continues to be a going concern, conducting its business in the ordinary way, without some positive act of insolvency, such as the filing of a bill to administer its assets, or the making of a general assignment.'"). *See also* F. Hodge O'Neal et al., O'Neal and Thompson's Close Corporations and LLCs: Law and Practice (rev. 3d ed. 2004 & Supp. 2009).

158. Helm Fin. Corp. v. MNVA R.R., 212 F.3d 1076, 1081 (8th Cir. 2000) ("When a corporation is insolvent, or on the verge of insolvency, its directors and officers become fiduciaries of the corporate assets for the benefit of creditors."); Travis v. Kurron Shares of Am. Inc., 272 F. Supp. 2d 816, 821 (D. Minn. 2003).

159. William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations §6:06 (Cum. Supp. 2005) ("Chapter 7 proceedings with respect to corporate debtors are essentially for the benefit of creditors").

160. 11 U.S.C.S. §1102(a)(1) (2009) ("as soon as practicable *after the order for relief under chapter* 11 *of this title*, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.").

161. Berg & Berg Enters., LLC v. Boyle, 100 Cal. Rptr. 3d 875 (Ct. App. 2009).

162. Helm, 212 F.3d at 1080 ("The officers and directors of an insolvent corporation breach their fiduciary duty owed to creditors if they approve a transfer of corporate assets under which the officers and directors recover more than general creditors of the corporation. Corporate officers and directors cannot grant themselves a preference over creditors."); Lopez v. TDI Servs., 631 So. 2d 679, 684 (La. App. 1994) ("[O]fficers of a corporation owe a fiduciary duty to the corporation and its shareholders, but not to its creditors, unless fraud is alleged.").

number of courts have held the directors to be trustees for the creditors.[163] Unless they acted in conflict of interest to the corporation's interests, it was irrelevant that directors were shareholders of the corporation, and their interests conflicted with the interests of the creditors.[164] The rationales for this holding are, first, that creditors can protect themselves by specific contract provisions, and second, that creditors, such as banks, are usually in strong positions to bargain for such protections. In fact, these creditors can demand ongoing information from the corporations and require the corporations to open the corporate accounts with the banks. These accounts can be viewed often to determine the transfers of money to and from the corporations and provide fairly accurate information about the corporations' financial situation.

Thus, even if their corporations are on the verge of bankruptcy, their directors have no fiduciary duty to corporate creditors until the corporation files for bankruptcy.[165] However, creditors can file an involuntary petition for bankruptcy, forcing the corporation into bankruptcy if the total corporate indebtedness reaches a certain amount, and if there are twelve or more creditors, at least three of whom join the petition. Further, when the corporation is on the verge of bankruptcy, creditors can form a committee to ensure the preservation of corporate property and the use of the property to pay off its debts. In fact, the committee members are creditors that turned into shareholders in bankruptcy proceedings.[166]

163. *In re* County Green Ltd. P'ship, 438 F. Supp. 701, 707 (W.D. Va. 1977) ("A director or a dominating and controlling shareholder has a fiduciary duty to creditors in dealing with the corporation and with them."); Am. Honda Fin. Corp. v. Francis, No. 92-0085-B, 1993 U.S. Dist. LEXIS 442, *9, 5 Bankr. Ct. Rep. 307, 315 (W.D. Va. Jan. 14, 1993) ("It is well established that corporate officers occupy a fiduciary relationship to . . . its creditors.").

164. Storetrax.com, Inc. v. Gurland, 915 A.2d 991, 1001 (Md. 2007) ("[D]irectors of a corporation 'are entrusted with powers which are to be exercised for the common and general interest of the corporation, and not for their own private individual benefit.'"); Coffee Break Café, Inc. v. Mattison, No. 31358-VA, 2001 Va. Cir. LEXIS 502 (Va. Cir. Ct. May 10, 2001) ("The dealings of directors or controlling stockholders are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged, the burden is on the director or stockholder not only to prove the good faith of the transaction, but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.").

165. Helm Fin. Corp. v. MNVA R.R., 212 F.3d 1076, 1081 (8th Cir. 2000) ("When a corporation is insolvent, or on the verge of insolvency, its directors and officers become fiduciaries of the corporate assets for the benefit of creditors."); Travis v. Kurron Shares of Am., 272 F. Supp. 2d 816, 821 (D. Minn. 2003).

166. William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 7368 (perm. ed. 2002); Love v. Clayton, 134 A. 422, 424 (Pa. 1926) ("The law does not prevent a composition by creditors or the creation of a protective committee to preserve corporate property and thus insure payment of debts; but they cannot openly disregard creditors on the basis of preference and be protected by the law.").

Difficult issues arise when fiduciaries are entrusted with some powers concerning entrustors' investments but the entrustors retain certain powers with respect to the choice of their investments. In *Hecker v. Deere*[167] the main issue involved the rights of participants in 401(k) plans to sue their Plan Fiduciary on the ground that it benefited from its chosen adviser to the participants' plan. The participants claimed that these benefits were indirectly charged to them. Should the freedom and responsibility of the Plan-participants extend to the behavior of the Plan Fiduciary in its relationship to the Plan adviser that Plan Fiduciary chose for the participants? The Seventh Circuit held that the participants had no right to interfere in the Plan Fiduciary's relationship with the chosen advisers.

D. EXAMPLES OF FIDUCIARY RELATIONSHIPS AND THEIR BOUNDARIES

1. The Traditional Fiduciaries

Even conservative courts that reject or limit the creation and recognition of fiduciaries in new circumstances, agree that trustees, corporate directors and officers, partners, and agents are fiduciaries. To this group we might add the professionals: lawyers, physicians, money managers, and advisers. However, the agreement focuses on the functions of these traditional fiduciaries. Trustees of private trusts are no doubt fiduciaries. But bank trustees under a trust indenture may be viewed somewhat differently, and are often regulated only by the Trust Indenture Act of 1939, relating to their specific functions.[168]

Today, partners and agents can specify many of their duties in an agreement to a greater extent than in the past.[169] Investment advisers are subject to particular statutory provisions, such as the Investment Advisers Act of 1940.[170] Thus, the specific functions that these categories of traditional fiduciaries perform and the directives under which they are entrusted can limit or expand their duties, even though the starting point is that they are fiduciaries.

Each of the traditional fiduciaries fits the elements of fiduciary relationships outlined above. For example, directors serve an important public service, and are

167. Hecker v. Deere & Co., 556 F.3d 575 (7th Cir. 2009), *reh'g denied by, reh'g, en banc, denied by, supplemented,* 569 F.3d 708 (7th Cir. 2009).

168. 15 U.S.C. §§ 77aaa-77bbbb (2006).

169. *See* UNIF. P'SHIP ACT § 103 (1997) (generally allowing partners to specify rights and duties in partnership agreement); *id.* § 404(a) (limiting partners' fiduciary duties to limited duties of loyalty and care); *id.* § 404(b), (c) (specifying limited duties); RESTATEMENT (THIRD) OF AGENCY Introduction (2006) ("The common law of agency also governs the legal consequences of the relationship of the agent and the principal with each other, which is in many respects defined and governed by any agreement between them."); *id.* § 8.06(1) (2006) (allowing principal to consent to conduct that would otherwise be breach of duty of loyalty if certain conditions are met).

170. 15 U.S.C. §§ 80b-1 to -21 (2006).

entrusted with control over other people's money. Their use of entrusted power cannot be detailed; they cannot be controlled by the owners of the money that was entrusted to them, nor can they be controlled by others, without eliminating the value of their services.

a. Professionals: Physicians and Lawyers Professionals have expertise that most entrustors do not possess. Their services may involve entrustment of property, and in most cases—entrustment of power. Thus, surgeons must be entrusted with power over the patient's body. Lawyers must be entrusted with power to represent clients in courts.

A number of characteristics are more unique to professionals than to other fiduciaries. First, they are experts in the services they offer. This characteristic may include other fiduciaries, such as financial managers. Second, traditionally, professionals offer a public service. As noted later, the emphasis on public service has been muted in the past few decades and the emphasis on fiduciary service as business has become louder. Nonetheless, the image and expectation of fiduciaries who are professionals has not disappeared. These professional services are crucial to society and the power of these professionals both on entrustors and on society cannot be exaggerated. Unlike other fiduciaries, it is difficult for entrustors to "exit" the fiduciary relationships, and far more difficult to protect themselves against abuse of entrusted power.[171]

In litigation, lawyers may occupy a fiduciary position not only toward their clients, and not only to clients that they do not know (in a class action) but also to clients of other lawyers and to the conduct of the judicial process. In this context, the pressures on lawyers are recognized by Vice Chancellor Leo Strine. He noted: "Particularly in the representative litigation context, where there are deep concerns about the agency costs imposed by plaintiffs' attorneys, our judiciary must be vigilant to make sure that the incentives we create promote integrity and that we do not, by judicial doctrine, generate the need for defendants to settle simply because they have no viable alternative, even when they have done nothing wrong. This vigilance is appropriate not because the representative litigation process is not important to our corporate law's ability to protect stockholders against fiduciary wrongdoing, but precisely because it is so important. That process should not be one that we permit to be seen as lacking in integrity and therefore vulnerable to elimination."[172] "By requiring lead plaintiffs to take responsibility for the course of the litigation, courts and legislatures can reduce

171. *See* TAMAR FRANKEL, TRUST AND HONESTY, AMERICA'S BUSINESS CULTURE AT A CROSSROAD 136–51 (2006).

172. *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 643 (Del. Ct. Ch. 2005) (per Judge Leo Strine).

frivolous claims, leaving more judicial energy for meritorious claims that can deter future corporate wrongdoing."[173]

b. Trustees A trustee is a fiduciary in a trust relationship. A trust, as the term is used in the Restatement, is a "fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee."[174] Historically, most trusts were personal. For example, persons entrusted a bank or a lawyer with property for a certain purpose, such as taking care of their family after their death. But trustees have been used to achieve certain purposes for the benefit of members of the public such as bondholders, or members of particular groups, such as trustees in bankruptcy charged with collecting the debtors' property and distributing it to the creditors. Thus, the use of trustees has diversified. Yet, even with the trustees' heritage and even with its familiar form, new issues arise as the trustees' entrustment and directives have been changing. Not only the trustees, but also their regulators and the beneficiaries are changing. Therefore, although the status of trustees as fiduciaries is rarely questioned, the variety of trustees and, as shown in the next chapter, the resulting regulatory systems and court decisions, have remained vibrant and changing with circumstances.

c. Financial Managers Financial managers are similar to trustees, corporate directors, and officers. Like most trustees, financial managers are entrusted with investors' money for investment, generally in financial assets. But unlike corporate directors, financial managers have less freedom to determine how they should invest. This freedom is usually curtailed by entrustors' directives, and by statutes. For example, the Investment Company Act of 1940 requires that the registration statement of investment companies describe generally the investment policies of the companies.[175] And if the name of a company mentions a type of investment such as "equity," then a high percentage of the company's assets must be invested in this type of investment.[176] The financial managers' discretion is not as limited as that of most trustees and not as broad as that of most corporate managers. While the directives of private trustees vary, depending on the desires and needs of the trustors, the directives of investment companies managers leave more space for the managers' discretion, but not as much as the discretion left to corporate directors.

173. Amy M. Koopmann, Note, A *Necessary Gatekeeper: The Fiduciary Duties of the Lead Plaintiff in Shareholder Derivative Litigation*, 34 IOWA J. CORP. L. 895 (2009).

174. RESTATEMENT (THIRD) OF TRUSTS § 2, at 17 (2003). "Resulting" or "constructive" trusts are different, and should not be included. *See* Chapter 6.A.2.

175. 15 U.S.C. § 80a-8 (2006).

176. 15 U.S.C. § 80a-34 (2006).

Notwithstanding the strict regulation, managers of large pools of investors' money have been beset by conflicts. One reason for the conflicts has been the fee structure of these managers. Since they receive a percentage of the assets under management, they seek to increase the assets by sales, rather than performance only. Sales promise larger increases as compared to performance. Payments to brokers and others who offer pools for management (e.g., pension fiduciaries that choose the money managers) have in the last analysis come from the investors, directly and indirectly.[177]

d. Intermediaries: Brokers and Dealers Brokers bring together people who seek partners for a specified purpose. The purposes may differ but the brokerage function is essentially the same. Thus, brokers include stockbrokers,[178] real estate brokers, mortgage brokers, business sales-and-purchase brokers, marriage brokers. Sometimes brokers become dealers—the other party to the deal. Brokers, such as securities brokers, are also bailees of the customers' money or assets. Some brokers can be agents, authorized to bind the customers to a legal obligation. Others, such as real estate brokers, serve as escrow agents for the parties, but have no authority to bind their customers to a legal obligation. And some brokers, such as mortgage brokers, serve as a "go-between" to two parties and advise the parties about the deal. They claim to be "independent contractors" and not fiduciaries to any of the parties they bring together.

Thus, various brokers present different degrees of entrustment, from bailment (possession of the customers' assets), to agency (power to bind the customer to legal obligation), and bearer of information to two parties with a view of helping them to reach an agreement. To that end, all brokers must be entrusted with information about the parties and the deal they wish to reach. Unless this information is given in advance, brokers cannot provide their services. Therefore, the so-called "independent contractors" may well be fiduciaries as well. Finally, brokers often are experts in the area of their services. After all, as specialists they gather information about market conditions and the substance of recent deals. Brokers expect, advertise, and invite clients to rely on the brokers' expertise and sources of information.[179] Therefore, brokers are fiduciaries with respect to

177. John C. Bogle, *The Fiduciary Principle: No Man Can Serve Two Masters*, J. PORTFOLIO MGMT., Fall 2009, at 14.

178. *See generally* NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION (4th ed. 2007).

179. *See also* 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 13:2 (2d ed. 2001 & Supp. 2002) ("The policy underlying these acts is based on the belief that trustworthy advisers and investment companies benefit investors, the industry and the economy, that lack of trust may deter investors from using advisory services and thereby harm the economy, and that law can strengthen advisers' trustworthiness. Like all other provisions dealing with securities frauds, the antifraud provisions of the Advisers Act and the 1940 Act are designed to protect the integrity and smooth operation of the securities markets.").

(1) the integrity of entrusted assets; (2) the execution of the transaction on behalf of their principals; (3) reliance on their advice; and (4) the use of the information that is entrusted to them by the parties they serve.[180]

For example, a marriage brokerage agency that induced a woman to come from a foreign country to the United States and marry a man who was physically abusive was deemed a fiduciary of the woman. Having known the nature of the recommended husband, the agency was held to have breached its fiduciary duties to the woman and was liable to pay her damages.[181] And even though securities brokers are paid to sell to or buy securities from others, under certain circumstances courts have held that securities brokers are fiduciaries not only to those who paid them to sell or buy but also to the parties that bought or sold the securities.[182]

In the years 2008 and 2009 the status of securities brokers has been subject to heated debates. Securities brokers reject their classification as fiduciaries (except perhaps with respect to the performance of their services, but not with respect to conflicts of interest). Securities broker-dealers claim to be governed by their self-regulatory organization subject to the Securities and Exchange Commission's supervision.[183] Traditionally, they were deemed salespersons, subject to a high

180. For a discussion of these fiduciary functions see Boss v. La Salle Bank, N.A., 84 F. Supp. 2d 947, 950 (N.D. Ill. 1999) ("a mutual fund manager owes a fiduciary duty to its individual clients: what such a manager does is in effect make the investment decisions for customers who are typically innocent of financial knowledge in exchange for a fee. If that does not create the conditions for a fiduciary duty, nothing does."); 7 Louis Loss & Joel Seligman, Securities Regulation § 8-C-4 (3d ed. 2007) (stating that there is a "delicate fiduciary nature of an investment advisory relationship") (noting the quoted language cited in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)); *see* Securities Investor Protection Corp. v. Stratton Oakmont, Inc., 234 B.R. 293, 329 (Bankr. S.D.N.Y. 1999) (finding that officer of brokerage firm had fiduciary duty with respect to his knowledge of one party's poor financial condition); *see also* 2 Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers: Mutual Funds and Advisers § 13:2 (2d ed. 2001 & Supp. 2002) ("The policy underlying these acts is based on the belief that trustworthy advisers and investment companies benefit investors, the industry and the economy, that lack of trust may deter investors from using advisory services and thereby harm the economy, and that law can strengthen advisers' trustworthiness. Like all other provisions dealing with securities frauds, the antifraud provisions of the Advisers Act and the 1940 Act are designed to protect the integrity and smooth operation of the securities markets.").

181. Fox v. Encounters Int'l, Nos. 05-1139, 05-1404, 2006 U.S. App. LEXIS 9269 (4th Cir. Apr. 13, 2006).

182. United States v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) ("[A fiduciary relationship] exists in situations in which a securities broker has discretionary authority over the customer's account. . . .").

183. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2006) (the agency also is responsible for registering and establishing rules for the conduct of market participants and for exchanges and self-regulatory organizations).

level of fair treatment of their customers.[184] Under the law at the beginning of the year 2010, these brokers may, but need not, become fiduciaries as advisers and financial planners to customers that rely on them.[185] The issue, however, is not yet closed.

Securities brokers play multiple roles. Brokers, who trade on behalf of customers as agents, also deal with customers as principals. As traders they can offer clients liquidity and also create markets in particular securities. These multiple roles make economic sense, but can raise difficult legal issues when the actors' relationships with clients combine contractual and fiduciary relationships and present serious conflicts of interest.

As dealers, these brokers are no longer fiduciaries and become sellers or purchasers. The securities and cash that the dealers receive are not entrusted to them but given to them in an exchange. As agents, brokers are entrusted with the customers' money or assets. They may represent both buyers and sellers or issuers.[186] Some brokers offer investment advice and financial planning as well. Yet, their advice and planning may be sales talk and "free lunches" to induce customers to trade in particular securities that are lucrative for the brokers and those who pay them to sell (or buy). Yet with all these conflicting interests the brokers view themselves as salespersons, independent contractors, and parties who deal with customers as contract parties.

184. *See* 8 Louis Loss & Joel Seligman, Securities Regulation 3814 (3d ed. rev. 2004) (stating that under the "shingle theory," "even a dealer at arm's length implicitly represents when he or she hangs out a shingle that he or she will deal fairly with the public."). This is a contract theory, not a fiduciary theory. *See id.* ("[C]harging a price that does not bear [a reasonable relation to the market price] is a breach of the dealing of implied representation and works as a fraud on the customer."). *See also* DeRance, Inc. v. PaineWebber, Inc., 872 F.2d 1312, 1321 (1989) (citing Chipser v. Kohlmeyer & Co., 600 F.2d 1061, 1066–67 (5th Cir. 1979)). *See generally* Commodity Futures Trading Comm'n v. Heritage Capital Advisory Servs, Ltd., 823 F.2d 171, 173 (7th Cir. 1987).

185. Investment Advisers Act of 1940, § 201(a)(11), 15 U.S.C. § 80b-2(a)(11) (2000).

186. In fact, brokers perform a very useful role in preventing either transacting party from reneging on the deals. In the securities markets, the transactions are not executed immediately upon the clients' orders. In these markets volatility is the name of the game. Therefore, when prices move up or down either sellers or buyers are likely to regret their decision. Brokers, however, would regret transactions only if they did not occur; because execution of the transactions is a condition for the brokers' payment. Therefore, brokers have an incentive to execute the transactions; the more the merrier. Hence brokers are willing to comply with the rules that require them to prevent the parties from reneging. Brokers must control the clients' cash or securities and prevent clients from changing their minds. This is one reason why notwithstanding securities markets' volatility there are very few court cases on breach of agreements and these occur usually when the parties negotiate directly and not through a broker. *See, e.g.*, Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962).

Broker-dealers' structure of compensation has diversified with their services. Traditionally broker-dealers lived off transactions and collected a percentage of the assets involved in the transactions. This form of payment indicated their incentive: to cause the parties to close a deal. Since the 1990s some broker-dealers charge a percentage of the clients' assets that they hold (even though the assets are not traded). Brokers may share in the advisory fees collected by advisers of investment companies, calculated as a percentage of the investment companies' assets that the brokers brought by selling these companies' shares. Forms of payment may muddy their image and salespersons cast shadows on their incentives.

When broker-dealers serve as brokers as well as advisers and financial planners their legal status is increasingly ambiguous. They hold themselves out to advise clients and plan the clients' financial affairs but view themselves as securities' salespersons. Some clients seek the broker-dealers' advice; some are entirely dependent on their advice, and some may entrust their assets to the broker-dealers for management. Yet, while they serve in these capacities, broker-dealers are also engaged in their main business—securities sales. Thus, broker-dealers act as agents, advisers, and financial planners for clients, as well as salespersons to clients and traders with clients on behalf of third parties.

The rules that apply to broker-dealers demonstrate their ambiguous status. For example, the Securities and Exchange Commission imposed on broker-dealers duties that seem to derive from contract law rather than fiduciary law. For example, the Commission's "shingle theory" stated that when broker-dealers hang out their shingles and offer services to the public, they promise the public a fair treatment.[187] Thus, duties have been imposed on broker-dealers not on fiduciary law grounds but on misrepresentation grounds. For example, the following were held to be misrepresentations: a broker who did not disclose that he was a broker but claimed to be an adviser,[188] real estate investment advisers that misrepresented themselves as registered real estate brokers,[189] a radio show host who misrepresented himself as a consultant but who was in fact a paid spokesperson,[190] a newsletter writer who misrepresented himself as an investment adviser but was never registered as such.[191]

Even so, there are cases in which brokers' fiduciary duties are not waivable and disclosure is insufficient to relieve them of these duties. For example, when clients obviously act as uncontrolled gamblers, and require brokers to execute

187. 8 Louis Loss & Joel Seligman, Securities Regulation 3814 (3d ed. rev. 2004) (quoting Charles Hughes & Co., Inc., v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944)).

188. Laird v. Integrated Res., 897 F.2d 826 (5th Cir. 1990).

189. Transamerica Mortg. Advisors ("TAMA") v. Lewis, 44 U.S. 11 (1979).

190. SEC v. Omnigene Devs., 105 F. Supp. 2d 1316 (S.D. Fla. 2000).

191. SEC v. Blavin, 760 F.2d 706 (6th Cir. 1985).

transactions that are "economically suicidal," brokers must at some point stop complying and cease trading on the clients' behalf. In that respect the brokers are similar to the bartenders who must stop serving drunken customers prepared to drive.[192]

Broker-dealers who hold the clients' assets and cash are not required to segregate them as trustees would. However, brokers are required to be financially sound[193] and to carry compulsory insurance.[194] Unless clients ask broker-dealers to execute specific transactions for them, broker-dealers are subject to a "suitability rule."[195] They must give clients "suitable" investment advice, depending on the clients' circumstances.

If broker-dealers offer clients free advice, the brokers are excluded from the definition of adviser under the Advisers Act of 1940.[196] But when brokers offer free "financial planning" but not free brokerage services to implement the planning, their status is more complicated. They are not subject to the Advisers Act of 1940 as financial planners are. Thus, broker-dealers' relationships with clients present a mix of contract and fiduciary law subject to regulation. Moreover, broker-dealer-adviser-planners are advertising free fiduciary services while charging for transactions that they advise (either as salespersons or as advisers).

The legal classifications reflect the regulatory scheme. For example, hedge funds are not regulated under the Investment Company Act of 1940.[197] Their advisers need not register with the Securities and Exchange Commission so long

192. *See, e.g.*, Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 Ann. Rev. Banking & Fin. L. 375, 412–14 (2005); Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 Cardozo L. Rev. 991, 1041–42 (2002); Robert N. Rapp, *Rethinking Risky Investments for that Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 Ohio N.U. L. Rev. 189, 212–13 (1998). *See generally* Barbara Black, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. Pitt. L. Rev. 483 (2003).

193. 17 C.F.R. § 240.15c3-1 (2007) (net capital rule).

194. 15 U.S.C. § 78ccc(a)(2)(A) (2000) (members of Securities Investor Protection Corporation (SIPC) generally include all registered brokers and dealers).

195. NASD Manual (CCH) Rule 2310(a) (Mar. 2007).

196. *See* 15 U.S.C. § 80b-2(a)(11) (2000) (definition of "investment adviser" requires that person advises "for compensation").

197. 15 U.S.C. § 80a-3(c)(1) (2000) (excluding from definition of "investment company" "[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities"); 15 U.S.C. § 80a-3(c)(7)(A) (2000) (excluding from definition of "investment company" "[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities").

as they have fewer than 15 clients.[198] But these unregistered advisers are subject to the antifraud provision of section 206 of the Investment Advisers Act of 1940.[199] That section authorizes the Securities and Exchange Commission to promulgate rules under various conditions.

The Commission adopted a Rule that prohibits such advisers from defrauding investors.[200] While the Rule does not classify advisers as fiduciaries[201] it authorizes the Commission to prosecute advisers who have violated their fiduciary duties under state laws.[202] In this case federal law did not absorb the common law but provided federal enforcement of common law fiduciary duties, when the violators are advisers as defined by the federal law. The current law is as confusing as the current diverse services that broker-dealer-adviser-financial planners offer.

e. Directors and Officers of Organizations The fiduciary status of corporate directors and officers has been recognized since the emergence of the corporation as a legal entity. At the outset, the directors and officers were analogized to trustees. Then, in light of the differences between trustees and corporate directors, corporate law evolved to establish the rights of corporate creditors and shareholders, and change the model which the courts have followed. For example, early on, case law adopted a "trust fund" doctrine, awarding creditors of a corporation priority over the stockholders and the corporation's freedom to put its assets at risk.[203] The doctrine was expanded in the late nineteenth century.[204]

198. 15 U.S.C. § 80b-3(b)(3) (2000).

199. 15 U.S.C. § 80b-6(4) (2000). On the problem of what brokers say they are and their conflicting incentives see Tara Siegel Bernard, *Trusted Adviser or Stock Pusher? Finance Bill May Not Settle It*, N.Y. TIMES, Mar. 4, 2010 at B1, LEXIS, News Library, Nyt File.

200. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628 (Aug. 3, 2007), 72 Fed. Reg. 44,756 (Aug. 9, 2007) (to be codified at 17 C.F.R. § 275.206(4)-8)).

201. *Id.* at 72 Fed. Reg. 44,760.

202. *Id.*

203. Upton v. Tribilcock, 91 U.S. 45, 47–48 (1875). ("[The capital stock] is a trust fund, of which the directors are the trustees. It is a trust to be managed for the benefit of its shareholders during its life, and for the benefit of its creditors in the event of its dissolution. This duty is a sacred one, and cannot be disregarded. Its violation will not be undertaken by any just-minded man, and will not be permitted by the courts. The idea that the capital of a corporation is a foot-ball to be thrown into the market for the purposes of speculation, that its value may be elevated or depressed to advance the interests of its managers, is a modern and wicked invention. Equally unsound is the opinion, that the obligation of a subscriber to pay his subscription may be released or surrendered to him by the trustees of the company. This has been often attempted, but never successfully. The capital paid in, and promised to be paid in, is a fund which the trustees cannot squander or give away.").

204. Upton v. Tribilcock, 91 U.S. 45, 47–48 (1875) (a subscriber to corporate stock who paid 20% of the face value of the shares had to pay the rest of the price). In reaction par—initial subscription price—was reduced. While in the 1800s, the par value signified the value of the corporation (compared, e.g., to "penny stock"). But the fixed par value—the value of the corporation at subscription—did not continue to be accurate. The value of the shares could be higher or lower. Today, par value is a cent or less, and stock prices are determined by the market price or a valuation of the corporate business at any particular time. Hence, the aggregate par value of corporate shares no longer supports the creditors' claims as a "trust fund."

Yet, state courts have usually provided that "until all of the capital (as measured by par value)[205] was paid in, stockholders were doubly liable on their stock." In addition, states often provided that "stockholders were liable for debts due from the corporation to its employees."[206] Shareholders' limited liability developed later, when some states softened their corporate law provisions to attract corporations and their investors to their jurisdiction.[207]

As the courts have become less protective of creditors, the development of fiduciary law has been moving to regulation and legislation.[208] Nonetheless, Robert W. Hillman[209] noted that the courts' impact should not be ignored. There is a continuing influence and citation of Justice Cardozo's statement in *Meinhard v. Salmon*:

> Joint adventurers, like copartners, owe to one another . . . 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. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct

205. Par value was the price that the promoters decided to require for the corporation's shares. During the 1800s, the par value signified the value of the corporation as compared, for example, to "penny stock." It later became clear that the par value, which may have represented the value of the corporation accurately at one point, did not continue to be accurate. The value of the shares could be higher or lower. Today, par value is a cent or less, and stock prices are determined by the market price or a valuation of the corporate business at any particular time. Hence, the aggregate par value of corporate shares no longer supports the creditors' claims as a "trust fund."

206. HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS § 355 (rev. ed. 1946) ("In addition to the widespread liability for employee claims, shareholders of banking corporations incurred double or triple liability to depositors under national and state law").

207. STEPHEN PRESSER, PIERCING THE CORPORATE VEIL § 1.03[1] (2000).

208. John H. Langbein, *Why Did Trust Law Become Statute Law in the United States?*, 58 ALA. L. REV. 1069 (2007).

209. Robert W. Hillman, *Closely-Held Firms and the Common Law of Fiduciary Duty: What Explains the Enduring Qualities of a Punctilio?*, 41 TULSA L. REV. 441 (2006).

for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[210]

Although the influence of these words has remained, their impact is far weaker. In fact, the Delaware courts have reduced their interference in directors and officers' misbehavior and directed management to the court of public opinion.[211] The courts' reluctance to interfere with managements' decisions can be explained by their lack of business expertise and by public corporations' shareholders' ability to sell their shares. As weak as courts' interference might be, there was no question that these directors and officers are fiduciaries.

The issues that arose since the beginning of the 1900s related more to the question to whom corporate management owes fiduciary duties. The corporation-shareholders bifurcation started with the recognition of the diversity of shareholders (sometimes shareholders of different classes). As corporations grew in size and in influence over Americans' life, there were arguments that management had a fiduciary relationship to the employees and communities in which the corporations operated, as well as to the nation. Yet, when investors escape share-ownership *en masse*, and securities markets dry up, courts are likely to tighten their supervision over corporate management.

f. Debtors in Possession of a Bankrupt's Estate Fiduciary relationships may arise with changed circumstances. When an enterprise is bankrupt the prior equity owners no longer have the ownership—equity—of the estate. In fact, the creditors are then the equity holders. Therefore, the debtors—the previous owners—hold the estate as fiduciaries for the benefit of the creditors. "Debtors in possession and those who control them owe fiduciary duties to the bankruptcy estate. Thus, the partners in a bankrupt partnership, acting as a debtor in possession, must run the business as agents of the bankruptcy estate, and not for their own personal gain. The fiduciary obligation consists of two duties: the duty of care and the duty of loyalty."[212] The fiduciary law duty of loyalty comes into play when there appears to be a conflict between the interests of this fiduciary and the entity to which he owes loyalty. For a debtor in possession, this duty "includes an obligation to refrain from self-dealing, to avoid conflicts of interests and the appearance of impropriety, to treat all parties to the case fairly and to maximize the value of the estate." [213] Thus, the shift of the equity risk from the debtors-owners to the creditors, while the debtors remain entrusted with the enterprise property, imposes fiduciary duties on the previous owners and managers. "Courts have held that managers of debtors in possession breached their [fiduciary] duty of loyalty [to the creditors—new owners] by . . . participating as

210. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (citation omitted).

211. *See* Chapter 4.

212. Lange v. Schropp (*In re* Brook Valley VII), 496 F.3d 892, 900 (8th Cir. 2007) (citations omitted).

213. *Id.* at 900–01.

an undisclosed bidder at an auction of [bankrupt] estate property."[214] In this case entrustment occurs as a result of change of ownership before transfer of possession.

2. Emerging Fiduciary Relationships

The process of recognizing new fiduciary relationships is ongoing, depending on the terms of their services, their entrustment of property or power, the temptation that they face, and the ability of individuals and institutions as well as the markets to control these power holders and their temptation to abuse the trust in them. Fiduciary relationships need not arise at once but may creep slowly into recognition by the law. The following are a few select examples of fiduciary relationships in the making.

a. Spouses[215] Traditionally, family relationships are mostly left outside the realm of the law. Marriage is viewed as an "affective-based" relationship, involving emotions, in contrast to "cognitive-based relationship"—the product of logic and experience—and involving mainly economic/market transactions. In American law, affective relationships hardly ever involve fiduciary duties. Even though marriage and family relationships are at the heart of the national culture,[216] feelings are hard to regulate. Therefore, law has rarely played a role in the domain of emotions. At the same time the law has intruded into the family, establishing the status of women in society and in the family. Thus, the government did and does play a role in "fostering persons' capacity for democratic and personal self-government."[217]

Historically, a husband and wife were treated as one person and that person materialized as the husband. In contrast to single women, married women could not legally hold property, or sue or be sued. The woman's personal property at the commencement of the marriage, and thereafter during the marriage, vested absolutely in the husband. Marriage relationships were status-based rather than consent-based.

This view of marriage has been slowly shifting toward a more fiduciary structure.[218] As women have acquired the right to hold property, issues concerning finances in marriages have surfaced. With increasing divorces, the laws have imposed fiduciary duties on spouses that controlled the couple's property, when the couple was on the "brink of divorce." Early on, California recognized that at that stage of their relationship, spouses may act unfairly toward each other.

214. *Id.* at 901.

215. *See generally* 1 HOMER H. CLARK, JR., THE LAW OF DOMESTIC RELATIONS IN THE UNITED STATES §§ 7.1, 7.2–.6 (2d ed. 1987).

216. *See* LINDA C. MCCLAIN, THE PLACE OF FAMILIES: FOSTERING CAPACITY, EQUALITY, AND RESPONSIBILITY (2006).

217. *Id.* at 15.

218. HENRY JAMES SUMNER MAINE, ANCIENT LAW (C. K. Allen ed. 1931) (1861).

Therefore, California established spousal fiduciary duties.[219] This high standard was limited to property settlement by the California Court of Appeal,[220] and developments in this area raised fiduciary duties in business matters. Other states have followed a similar transformation of fiduciary relationships in the business context when the spouses may be bonded in law but not in reality.[221] Courts have interfered in marriage relationships when they are on the verge of termination. But recently courts have imposed on spouses fiduciary relationships during the marriage, for example, when a spouse deceitfully and recklessly mismanaged the couple's assets.[222]

This area of the law is evolving. Marriage as a fiduciary relationship raises the questions of who entrusts what to whom. Not only during divorce proceedings but also during the marriage, when one of the spouses controls the couple's

219. *See* Vai v. Bank of Am., 364 P.2d 247 (Cal. 1961) ("because of his management and control over the community property, the husband occupies the position of trustee for his wife in respect to her one-half interest in the community assets.").

220. *See* Bank of Calif. v. Connolly, 111 Cal. Rptr. 468 (Ct. App. 1973). The legislature further narrowed the duty with the enactment of former Civil Code § 5125, providing for a spousal duty to a "good faith" standard and the Supreme Court further limited spousal duty to the period prior to filing a petition for divorce. *In re* Marriage of Connolly, 591 P.2d 911 (Cal. 1979) ("From the time that wife filed her petition seeking dissolution of the marriage . . . her relationship with her husband was an adversary one. Any obligation of trust between them [is] terminated."). In 1991 the California legislature broadened the standard, in reaction to judicial ambiguity and the massive influx of divorce litigation. The legislature explicitly amended the pertinent statutes to replace the good faith standard with more concrete rules governing fiduciary relationships. CAL. CIV. CODE §§ 5103, 5125, 5125.1 (West 1991) (repealed 1994) (current versions at CAL. FAM. CODE §§ 721, 1100, 1101 (West 2004)). *But see In re* Marriage of Brewer & Federici, 93 Cal. App. 4th 1334 (2001) (shifting evidentiary and proof burdens onto the spouse with control in the transaction and superior position to obtain records or financial information). The legislature amended California Family Code § 721 to determine the standard. The statute specifically excluded California Probate Code § 16040, which is synonymous with the "prudent investor rule." CAL. PROB. CODE § 16040 (West 1991 & Supp. 2007) (requiring a trustee to administer a trust with "reasonable care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity would use"). See later developments in CAL. CORP. CODE § 16404 (West 2006).

221. UNIF. MARITAL PROPERTY ACT § 2(a), 9A Part I U.L.A. 114 (1998) ("Each spouse shall act in good faith with respect to the other spouse in matters involving marital property or other property of the other spouse.").

222. Dunkin v. Dunkin, 986 P.2d 706, 849 (Or. Ct. App. 1999). Note, however, that courts and legislatures continue to recognize the intimate bond among spouses and avoid disrupting the necessary high level of mutual trust on which a good marriage is grounded. Hence, for example, Federal Rule of Evidence Rule 501 "continues to recognize a marital communications privilege as effective by common law." MCCORMICK ON EVIDENCE § 78, at 143 (Kenneth S. Brown et al. eds., 6th ed. 2006) (citing FED. R. EVID. 501). In most jurisdictions the privilege is afforded to both spouses. *Id.* § 83, at 146.

property, one might view the part that belongs to the spouse as entrusted, and raising a fiduciary relationship.[223]

b. Mediators Mediators resemble brokers, except that brokers serve to bring the parties to agree on a transaction or a relationship, while mediators serve to bring the parties to agree on another type of transaction—resolution of a dispute. Mediation is a "method of nonbinding dispute resolution." A mediator is expected to be a neutral third party who assists the parties to settle their disputes.[224] It is the parties, not the mediator, that decide whether and how to settle.[225] In the past, mediators were rarely sued.[226] This dispute resolution form has been growing in many areas of disputes, including the courts' forums.[227] The certification of mediators has grown accordingly.[228] With its expansion came regulation. In 1990 Congress passed two laws that encouraged mediation. The Civil Justice Reform Act[229] (CJRA) required the district courts to create and implement programs that would reduce cost and delay. The intent of Congress is to "facilitate deliberate adjudication of civil cases on the merits, monitor discovery, improve litigation management, and ensure just, speedy, and inexpensive resolutions of civil disputes."[230] Mediation soon became the dominant form of ADR to be used by the federal courts.[231] By 1996 more than half of the federal courts had a mediation

223. *See* LINDA C. MCCLAIN, THE PLACE OF FAMILIES: FOSTERING CAPACITY, EQUALITY, AND RESPONSIBILITY (2006).

224. BLACK'S LAW DICTIONARY 1070 (9th ed. 2009).

225. Ronald J. Hedges, *Mediation Developments & Trends*, 2005 AM. L. INST.–CLE (conducted on Jan. 19–21, 2005).

226. Michael Moffitt, *Suing Mediators*, 83 B.U.L. REV. 147, 148 (2003); AM. BAR ASS'N ET AL., MODEL STANDARDS OF CONDUCT FOR MEDIATORS 2 (2005) (the Model Standards of Conduct for Mediators, adopted by the American Bar Association, American Arbitration Association, and Association for Conflict Resolution, set forth the following purposes of mediation: "providing the opportunity for parties to define and clarify issues, understand different perspectives, identify interests, explore and assess possible solutions, and reach mutually satisfactory agreements, when desired."), http://www.abanet.org/litigation/standards/docs/mscm_standards.pdf; STEPHEN B. GOLDBERG ET AL., DISPUTE RESOLUTION 147 (5th ed. 2007).

227. Paula M. Young, *Rejoice! Rejoice! Rejoice, Give Thanks, and Sing: ABA, ACR, and AAA Adopt Revised Model Standards of Conduct for Mediators*, 2006 APPALACHIAN J.L. 196, 206 (2006) (today every state has at least one court-connected mediation program).

228. UNIF. MEDIATION ACT, Prefatory Note (2001), http://www.law.upenn.edu/bll/archives/ulc/mediat/UMA2001.htm.

229. Civil Justice Reform Act (CJRA), 28 U.S.C. § 471 (1990).

230. *Id.* at § 473 (encouraging the courts to incorporate alternative dispute resolution methods into their policies).

231. Richard Birke & Louise Ellen Teitz, *U.S. Mediation in 2001: The Path That Brought America to Uniform Laws and Mediation in Cyberspace*, 50 AM. J. COMP. L. 181, 193 (2001).

program in place.[232] In 1990 Congress also passed the Administrative Dispute Resolution Act[233] (ADRA). The ADRA forced the executive branch of the government to submit to ADR.[234]

A mediator makes important decisions throughout the mediation process, similar to the court's decisions in the litigation process. The mediator determines who will be present, who speaks first, and what discussion subject matter is permissible. These are entrusted powers and can determine the outcome of the mediation.

Some mediators may make mistakes or violate the trust in them. Yet, mediators are rarely sued and even more rarely found liable. "The few courts that have considered the idea of mediator liability, and specifically fiduciary liability, have rejected the idea."[235] No court has yet accepted the view that a mediator is in a fiduciary relationship with his clients. It is difficult to establish such a legal relationship when there are few acceptable standards that mediators are expected to follow. Mediators are free to take different approaches, and mediation contracts rarely establish the details of mediators' duties. Besides, damages on violation of mediators' duties are likely to be very difficult to prove. In addition, monitoring the mediators' performance is costly. Arguably, fiduciary law would be a poor method to protect clients from mediation abuse.

However, in the future, fiduciary law may apply to mediators. They meet the basic features of fiduciaries. They provide a socially valuable service. As demand for their services rises so may the number of unqualified number of people offering their services. "An increasing number of [states] require mediators to carry liability insurance"[236] and courts are considering mediators' fiduciary status more often.[237] After all, the parties entrust mediators with significant powers[238] to determine the details of the mediations' process. Parties become exposed to the mediators' possible conflicts of interest, or neglect in proper use of their power and absence of good faith. It may well be that, if problems arise, the

232. *Id.*

233. Administrative Dispute Resolution Act (ADRA), 5 U.S.C. § 581 (1991).

234. *Id.;* ADRA at § 651; Richard Birke & Louise E. Teitz, *U.S. Mediation in 2001: The Path That Brought America to Uniform Laws and Mediation in Cyberspace,* 50 AM. J. COMP. L. Sec II, 182, 194 (2001).

235. Richard Birke & Louise E. Teitz, *U.S. Mediation in 2001: The Path That Brought America to Uniform Laws and Mediation in Cyberspace,* 50 AM. J. COMP. L. 182, 193 (2001).

236. Michael Moffitt, *Ten Ways to Get Sued: A Guide for Mediators,* 8 HARV. NEGOTIATION L. REV. 81, 83 (2003).

237. Rebekah Ryan Clark, Comment, *The Writing on the Wall: The Potential Liability of Mediators As Fiduciaries,* 2006 B.Y.U.L. REV. 1033, 1051, 1073 (2006).

238. Mediators determine the agenda, decide the structure of the mediation sessions, choose who will be present, determine the questions discussed and the order of presentation, fix the deadlines, the presentation of expert opinions, and many other issues.

mediators' status as fiduciaries will be recognized with respect to their entrusted power.

c. Friends Friendship is a social relationship that might rise to the status of a fiduciary relationship. That is especially so if a long-term friendship leads to abuse of trust in a business context. For example, in one case a woman confided in her friend about an idea she had developed. The friend sold the idea to a third party and excluded her confiding friend from the business.[239] The court seems to have relied in this case on entrustment in the sense that the disclosure was made on an understanding that the use of the idea would benefit the inventor. Like other determination of fiduciary relationships, the determination in this case is fact-specific. However, a Texas court took another view. It did not "justify imposing a fiduciary duty based on the fact that, for four years," the parties "were friends and frequent dining partners" even though they conducted joint businesses under contracts.[240] Another Texas court "recognize[d] an informal fiduciary duty that arises from 'a moral, social, domestic or purely personal relationship of trust and confidence.'" [241] But this informal duty was limited when the parties in fact had a contractual relationship, laced with friendship but did not go further. Thus, the courts grapple with the line to be drawn in cases that are not clearly accepted as fiduciary relationships.

d. Mortgage Brokers A special type of broker that appeared in the mid-2000 is the mortgage broker. The fiduciary status of mortgage brokers is controversial. They connect prospective homebuyers who are in need of financing with lenders. "Some courts hold that mortgage brokers do not owe their borrowers a general fiduciary duty, reasoning that the loan transaction is conducted at arm's length," similar to the relationship between the borrower and the lender.[242] If the brokers are "the long arm" of the lenders, and the lenders are not the borrowers' fiduciaries, then the brokers occupy the same status.

Yet, courts have imposed on mortgage brokers fiduciary duties when the brokers failed to disclose to the borrowers loan terms and loan fees; or failed "to provide the most favorable loan terms or lowest loan fees."[243] According to the

239. *See* Holmes v. Lerner, 74 Cal. App. 4th 442 (Ct. App. 1999) (two friends created a new nail polish color, and orally agreed to start up a cosmetics company together, but one of the friends took over the entire process and denied the other's rights to the products, trying to give her only a 1% ownership in the company); *see also* Ethan J. Leib, *Friendship and the Law,* 54 UCLA L. REV. 631 (2007).

240. *See* Crim Truck & Tractor Co v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 595 ("[T]he fact that the relationship has been a cordial one, of long duration, [is not] evidence of a confidential relationship.").

241. Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 287 (Tex. 1998); *see also* Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171, 176 (Tex. 1997).

242. David Unseth, Note, *What Level of Fiduciary Duty Should Mortgage Brokers Owe Their Borrowers?,* 75 WASH. U. L.Q. 1737, 1741 (1997).

243. *Id.*

California Supreme Court a mortgage broker was a fiduciary when the broker was customarily serving "as the borrower's agent in negotiating an acceptable loan."[244] In such cases the borrower entrusted to the broker the power to bind the borrower to legal obligations. If the broker failed to inform the borrower about the implications of the mortgage loan terms (including the small print), the broker may be liable to the borrower. But if the broker is the lender's agent, and the lender does not owe fiduciary duties to the borrower, then the lender's broker may be sheltered from liability, unless the broker committed fraud or misrepresented facts or answered questions untruthfully, and generally acted in violation of the contract with the borrower.

e. Check-Cashing Institutions[245] The main business of check cashing involves cashing government checks or paychecks, although in some states the business might include cashing personal checks, as loans to those who would then present future paychecks. These services are viewed as short-term loans or check cashing. These activities are not subject to the statutes that limit charges on consumer loans. The charges cover the costs of check-cashing business and profits.[246] Before the establishment of the ATM machines, check-cashing services offered the convenience of business hours and locations, for which consumers were willing to pay. Today, consumers pay mostly for the offer of the check cashers to take risks, which the banks are more reluctant to take, that the checks will not be honored. That may or may not justify the enormous interest that the consumers pay. And yet, the relationship between the consumers and the check-cashing institutions is unlikely to be fiduciary. The transactions do not involve any entrustment; they are clear and simple, even if the check cashers do not make the calculation that they might pay an annual interest rate of, for example 785 percent.

H & R Block's tax preparation is similar to the check-cashing services, [247] yet it differs in that its services involve a more "advisory tinge" than does an automatic check-cashing service. This advisory tinge may bring a touch of fiduciary relationship with customers. However, the advice does not relate to investments of the customers' tax refund but to the preparation of tax returns. The two services are related but fundamentally different. As compared to check cashing, H & R Block services are distinguishable by timing. H & R Block provides the service once a year while check cashing is far more frequent, and may be monthly.[248]

There are consumer protection statutes that prohibit charging consumers excessive service fees, and require relevant disclosure to consumers.[249] For example, a car dealership that sells cars by installment payments must disclose the APR "clearly and conspicuously," e.g., in bold print.[250] These laws are better suited to protect H & R Block customers than fiduciary duties, if protection is found necessary.

f. Inventors and Commercial Developers of Inventions Inventors usually have a valuable asset that may carry high risk. The invention may be tremendously lucrative or bring nothing after significant expense. Inventors have little experience in converting their invention into a profitable enterprise, and few financing resources and management expertise to develop their invention. Commercial developers of inventions and venture capitalists know the financial aspects of developing inventions commercially, and need inventions to develop. When the two get together, the inventors have a unique, if risky asset while the developers have money that others might have as well. Their cooperation and bargaining positions cry for cooperation.

However, once inventors hand over their invention (or spend time and resources with the commercial developers to bring the invention to fruition), the balance of interests and power among the parties radically changes. The inventors no longer have a valuable asset to offer. They have already handed over all of it, and the developers no longer need the inventors.

In the typical arrangements among these parties inventors are entitled to a specific percentage of the profits from the commercialized invention, but do not retain control over the use of the invention or over the accounts of the developers concerning the invention. Not surprisingly, the developers' feelings change as well. It is natural for them to feel that they have created the source of income and as time goes by, may downgrade the value of the invention they receive and upgrade their own contribution to the profits. This change of balance of value is

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244. *Id.* at 1742 (citing Wyatt v. Union Mortg. Co., 598 P.2d 45, 50 (Cal. 1979) (en banc)).

245. John P. Caskey, Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor 30, 55, 57–59, 61 (1994) (footnote omitted).

246. *Id.* (a survey of the Consumer Federation of America in 1989 covering 60 check-cashing outlets in twenty major cities across the United States found that charges for cashing local payroll checks were 0.9 percent of the check amounts to 3%. The average rate was 1.74%. Charges for cashing government assistance checks were 0.9 percent to 3.25 percent (average: 1.73 percent) and personal check cashing: 1.66 percent to 20 percent of the checks' amounts (average: 7.7 percent)).

247. John P. Caskey, Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor 30, 55, 57–59, 61 (1994) (footnote omitted); *id.* at 80–81 (citation omitted) (citing Scott R. Schmedel, *A Special Summary and Forecast of Federal and State Tax Developments*, Wall St. J., Mar. 20, 1991, at A1, LEXIS, News Library, Wsj File). Clients pay at least $20 for electronic filing of their returns and another $30 for an anticipated refund loan. "[T]he average refund was $916 for the 1990 year. Therefore, the typical H & R Block customer who [used the service] pa[id] an annual interest rate of [85%] on the loan."

248. For the problems raised by H & R Block see John P. Caskey, Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor 80–83 (1994).

249. Truth in Lending Act, 15 U.S.C. §§ 1601–1667f (2006); Fair Credit Reporting Act, 15 U.S.C. §§ 1681–1681u (2006); Fair Credit Billing Act, 15 U.S.C. §§ 1666–1666j (2006).

250. Truth in Lending Act, 15 U.S.C. § 1632(a) (2006); Federal Reserve System, Truth in Lending, 74 Fed. Reg., 54,124 (Oct. 21, 2009) (proposed new rules).

likely to happen especially when the amounts that the patented invention brings are very large, and the invention is very successful.

In *City of Hope v. Genentech*,[251] the inventors handed their invention to developers-financiers, who, after working together with the inventors for a number of years, developed an extraordinary patented device that helped control the growth of human cells. The agreement among the parties, which was not very clear, awarded the inventors 2 percent. The disagreement that arose was: 2 percent of what? In addition, the developers did not provide full information to the inventors regarding the enormous amounts that they began to collect for licensing the patented invention. The 2 percent due to the inventors, which seems to have been left in the hands of the developers, amounted to over $300 million.

The developers argued that under their interpretation of the contract (which, in their opinion, they had the right to do) the 2 percent did not cover the license payments. The inventors sued the developers and the jury awarded the inventors over $300 million in damages, as well as $200 million in punitive damages, based on the ground that the relationship among the parties was fiduciary. On this point, the California Supreme Court overruled the decisions of the lower court and the Court of Appeal.

The Supreme Court held that the parties' relationship was contractual. Mere disclosure of the invention was insufficient to create an entrustment. The parties' contract clearly stated that they were not partners. Under the contract, the arrangement constituted an exchange of the invention for 2 percent of the various amounts to be collected under the contract. Hence the Court awarded the inventors damages for amounts due and unpaid, but overruled the award of punitive damages.

The court relied on *Wolf v. Superior Court of Los Angeles County*[252] for the characterization of the relationship as contract rather than fiduciary, and limited the impact of a somewhat similar case (*Stevens v. Marco*) that recognized a fiduciary relationship between an inventor and commercial developer of the invention.[253] The case of *City of Hope* raised an enormous interest among commercializers of inventions, ideas as well as book publishers. The reason most if not all contracts with inventors deny partnership is precisely to avoid the commercializers' fiduciary duties to the inventors, even though at some point the commercializers control the inventions, their commercial exploitations as well as the accounts representing the amounts due to the inventors. Focusing on entrustment is only partly helpful in this case. One image of the relationship may be as described by the court: An exchange of the idea and invention for 2 percent of the proceeds of its use. Another image is entrustment of the invention that converts into entrustment of the 2 percent of the proceeds. And while in the

251. City of Hope Nat. Med. Ctr. v. Genentech, Inc., 181 P.3d 142 (Cal. 2008).

252. Wolf v. Superior Court, 130 Cal. Rptr. 2d 860 (Ct. App. 2003).

253. Stevens v. Marco, 305 P.2d 669 (Cal Dist. Ct. App. 1957).

Wolf case the commercializer (Disney) did not promise to commercialize at all, in the *City of Hope* case the parties' agreement noted that if the commericalizer does not perform within a certain number of years, the invention would revert back to the City of Hope. Similarly, both in the *Wolf* case and in the *City of Hope* case the commercializer promised a percentage of the receipts from the invention's commercial use payment while it held all the power to determine when, how and to whom to grant the use and for how much. It would be in the interests of both parties to collect the highest amounts. But it is not in the interests of the commercializer to disclose the amounts to the inventors.

Inventors and commercializers have a joint interest in the collected amounts, and a clear conflict of interest on the amounts paid to inventors. Inventors are unable to verify the amounts they receive. The issue in cases such as *City of Hope* is whether the commercializers are fiduciaries of the inventors with respect to the 2 percent due to the inventors.

Arguably, the inventors can claim accounting under a contract. The *City of Hope* case was described as "an important stand to provide much-needed clarity for this area of law, stopping fiduciary duty 'creep' and, perhaps more broadly, the 'tortification' of contract law." There is great value in the "freedom of sophisticated parties to define their relationships through contract" and avoid "punitive measures" when they breach the contract. The argument is also based on efficiency of contract in the marketplace. There was no fiduciary duty here, since the parties did not undertake to work unselfishly for the other as is required in fiduciary law. Further, the imposition of unknown, unanticipated, and new legal consequences on commercializers when the parties disagreed, would endanger the welfare of the state (of California) that depends on technology and start-ups commercialization. City of Hope, a not-for-profit organization, may suffer if its funding will be reduced.[254]

Arguably, however, there are reasons to impose a fiduciary duty on commercializers for the following reasons. The commercializers have a full and unaccountable control over the payments due to the inventors. They are, as has happened in the *City of Hope* case, exposed to the temptation of hiding or interpreting the contract provisions so as reduce the amounts due to the inventors. In the case of *City of Hope* the jury simply did not believe the commercializer's witness's explanations for reducing the payments to inventors by $300 million throughout a number of years. It shows a systematic rather than a one-time reduction. It started with an attempt to buy ½ percent of the 2 percent for less than the amounts collected. This is the reason for imposing fiduciary duties on commercializers. The opportunities for deception and fraud are so high as to

254. Reed C. McBride, Note, *City of Hope v. Genentech: Keeping Fiduciary Duties Where They Belong*, 24 BERKELEY TECH. L.J. 179 (2009) (footnotes omitted).

impose an additional deterrent on commercializers to seek ways for reducing the amounts due to the inventors.

Money is an important contributor to encouraging inventions. But inventors can and do invent without significant contributions while commercializers can commercialize nothing without inventions. Therefore, it may be in society's interests to strengthen the inventors' protections rather than those of the commercializers. To be sure, financiers may compete for inventions by showing their trustworthiness. In addition, in such cases the difference between entrustment and exchange may depend on the contract terms of the agreement among the parties.[255] Thus, the decision in the *City of Hope* case might be revisited if inventors decide to move from California to a more welcoming and protective jurisdiction; the threat of withholding financing from inventors who demand better protection for their rights may backfire as well.

E. HOW DO THE COURTS RECOGNIZE FIDUCIARY RELATIONSHIPS?

1. General

Courts have taken a number of approaches to recognizing fiduciary relationships. "'Where the underlying facts are undisputed, determination of the existence, and breach, of fiduciary duties are questions of law, exclusively within the province of the court.'"[256] "In certain formal relationships," such as an attorney-client or trustee relationship, "fiduciary duties arise as a matter of law."[257]

a. Applying the Principles of Fiduciary Relationships Some courts have resorted to the principles on which fiduciary relationships are based and emphasize the important public policy aspect of trusting relationships, extending fiduciary relationships to somewhat new situations. For example, in *Lash v. Cheshire County Savings Bank, Inc.*, a bank made a loan to the plaintiff, Lash. Lash received part of the loan and the rest was applied, without Lash's permission, to satisfy Lash's debt to a third person—Pappas. Pappas in turn owed money to the bank. The bank covered some of Pappas' debt to it with the rest of Lash's loan.[258] Upon discovering what was done with his loan money, Lash sued the bank for breach of its fiduciary duty.

The court defined a fiduciary relationship as "a comprehensive [term that] exists wherever influence has been acquired and abused or confidence has been reposed and betrayed."[259] It noted that many banks' names include words such as "Trust," "Security," or "Guarantee" because they "hold themselves out as a safe and responsible place to entrust people's funds." The court stated: "The legislature has provided for detailed and extensive regulation of savings banks since 1895. . . . The hundreds of pages of statutes and regulations affecting such banks clearly place them in a different category from all of the other corporations in this State who are not held to the high level of conduct we expect of a bank."[260] Thus, this court emphasized the importance of public trust in banking, and extended fiduciary law protection to bank customers who trusted bank officials and entrusted them with confidential information.

However, the court noted the principles that apply when the law is silent:

> A fiduciary relation does not depend upon some technical relation created by, or defined in, law. It may exist under a variety of circumstances, and does exist in cases where there has been a special confidence reposed in one who, in equity and good conscience, is bound to act in good faith and with due regard to the interests of the one reposing the confidence. In this case, the bank retained the plaintiffs' funds, disbursed them without authorization, and now demands that the plaintiffs repay the loan. We conclude that a jury reasonably could have found this action to be a breach of a fiduciary duty. The jury was instructed that if it found that the Lashes failed to prove a breach of the contract but instead prevailed on the fiduciary duty count it could award damages for that count alone. The jury was instructed to measure damages the same

255. *See* Rafael Chodus, The Law of Fiduciary Duties (2001) (cited by the court).

256. Nat'l Med. Enters. v. Godbey, 924 S.W.2d 123, 147 (Tex. 1996) (quoting Lacy v. Ticor Title Ins. Co., 794 S.W.2d 781, 787 (Tex. App. 1990), *writ denied per curiam,* 803 S.W.2d 265 (Tex. 1991)).

257. Johnson v. Brewer & Pritchard, P.C., 73 S.W.3d 193, 199 (Tex. 2002); *see also* Ins. Co. of N. Am. v. Morris, 981 S.W.2d 667, 674 (Tex. 1998).

258. Lash v. Cheshire County Sav. Bank, Inc., 474 A.2d 980 (N.H. 1984) (citing Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 275 (1983)) (other citations omitted) (the plaintiffs operated a small business and became obligated both to the defendant bank and to another person, Pappas. Pappas was indebted to the bank as well. He helped the plaintiffs receive a $35,000 loan from the bank, secured by trucks and a second mortgage on their home. At the closing of the loan, the bank disbursed $5,622.94, and the plaintiffs later ratified additional disbursements of $5,086.38. The plaintiff did not receive the remaining amount of the loan to the tune of $24,290.68. That amount was unilaterally credited by the bank to Mr. Pappas' account to reduce his debt, even though the plaintiffs' debt to Pappas was lower and they never authorized the bank to reduce the loan to Pappas by that amount. The plaintiffs sued the bank for breach of contract as well as a breach of fiduciary duty).

259. *Id.* ("In doubtful cases, whether the conduct of two parties was such that a fiduciary relationship existed between them is a question of fact for the trier of fact. . . ." The court refused to "set aside such a jury's determination unless it is not sustainable on the evidence.").

260. *Id.* ("The Uniform Commercial Code sections of Article 4 devoted to bank deposits and collections goes so far as to make illegal any attempt by a bank to enter into an agreement to 'disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care' or to 'limit the measure of damages for such lack or failure.' Where a bank exercises 'bad faith' in handling an item, consequential damages are awarded. While these sections of the law do not explicitly govern the instant facts, they are indicative that the laws of the market place do not set a high enough standard for the financial institutions to which we entrust our financial security.").

way under either the contract or fiduciary duty count. Because no double damages were awarded, there being a defendant's verdict on the contract count, we find no inconsistency in those two verdicts.[261]

Another court noted: "The measure of whether a person is a fiduciary is not whether that person is formally designated as such[262] [but whether the person] 'in fact performs any of the functions described in the statutory definition, regardless of the formal relationship, if any, that person has with the plan.'"[263] And if the contract is specific with respect to the function but not with respect to the manner in which a decision is made,[264] the contract involving the service might give rise to fiduciary duties.

A similar approach was taken in *Martinelli v. Bridgeport Roman Catholic Diocesan Corp.*[265] It recognized a new species of a fiduciary relationship when a "parishioner suffered sexual abuse as a minor by a church priest. Almost 25 years after reaching the age of majority, the parishioner filed an action against the church for the church's failure to investigate, warn, and take remedial action following its knowledge of the sexual misconduct. [T]he court held that neutral principles could be applied to evaluate the church's conduct and response to the minors in its care, and the jury's determination regarding the church's duty, breach, proximate cause, and resulting damages were reasonable."[266]

The court noted that this author "has urged courts to resist the urge to develop fiduciary law through analogy to the prototypical fiduciary relations, and instead follow an approach in which it is the power relationship and its potential for abuse that is examined. Guided by this model as well, it is apparent that a party who has critical information available to it by virtue of its position, and yet unavailable to anyone . . . has tremendous opportunity to abuse the power relationships here, by dissembling and nondisclosure."[267]

Roberts v. Sears, Roebuck & Co.[268] reached a similar conclusion in different circumstances. In this case Sears, Roebuck & Co. (Sears) acquired "through deceit the monetary benefits of an invention of a new type of socket wrench created by one of its sales clerks during his off-duty hours." The clerk, aged 18,

261. *Id.*

262. Ruiz v. Cont'l Cas. Co., 400 F.3d 986, 990 (7th Cir. 2005) (footnotes omitted).

263. *Id.* (quoting ABA Section of Labor and Employment Law, Employment Benefits Law 626 (2d ed. 2000)).

264. Bodnar v. John Hancock Funds, No. 2:06-CV-87 PS, 2008 U.S. Dist. LEXIS 3366 (N.D. Ind. Jan. 15, 2008) (denying the defendant's motion for summary judgment).

265. Martinelli v. Bridgeport Roman Catholic Diocesan Corp., 10 F. Supp. 2d 138 (D. Conn. 1998).

266. *Id.* (LEXIS overview).

267. *Id.* at 156 (citing Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795, 836 (1983)).

268. Roberts v. Sears, Roebuck & Co., 573 F.2d 976 (7th Cir. 1978).

began work on a special ratchet, to create a prototype tool far more suitable for use, and filed an application for a U.S. patent. The clerk, who had a high school education and no business experience, showed his invention to his manager at the Sears store, and was "persuaded to submit formally his invention as a suggestion to Sears" which he did. He then moved with his parents to Tennessee.

The jury found that "Sears appropriated the value of the plaintiff's invention by fraudulent means." The company persuaded the inventor that his invention could not be patented and paid him $10,000; then proceeded to produce the prototype he submitted. "Within days after the signing of the contract, Sears was manufacturing 44,000 of plaintiff's wrenches per week—all with plaintiff's patent number prominently stamped on them—and within three months, Sears was marketing them as a tremendous breakthrough. Within nine months, Sears had sold over 500,000 wrenches and paid plaintiff his maximum royalty, thereby acquiring all of plaintiff's rights. Between 1965 and 1975, Sears sold in excess of 19 million wrenches, many at a premium of one to two dollars profit because no competition was able to market a comparable product for several years. To say the least, plaintiff's invention has been a commercial success." [269]

Sears argued that no confidential relationships could exist in this case because the plaintiff failed to prove that (1) Sears had knowledge of the confidential relationship upon which plaintiff was relying and (2) the plaintiff retained counsel to guide him, and therefore, did not rely on Sears. The court rejected both reasons as insufficient to "justify overturning the jury's verdict on this issue. [Although] a confidential relationship cannot be thrust upon an unknowing party [it does not mean] that a plaintiff must demonstrate by direct evidence that the defendant actually was aware of the confidential relationship. All that must be proved is that the parties engaged in activities under circumstances that created a confidential relationship and that defendant breached that relationship," notwithstanding the plaintiff's use of counsel. The court distinguished between arm's length transactions and the facts of the case, affirming the judgment on all three counts of the plaintiff's complaint.[270]

The court listed the factors relevant to the law, such as disparity of age, education, and business experience between the parties; the existence of an employment relationship and the exchange of confidential information from one party to the other. All these five factors existed in this case. In addition, there was an aura of deception: "one of Sears' witnesses admitted that the company expected plaintiff to 'believe' and to 'rely' on various representations that Sears made to him."

b. Applying Similarities to Traditional Fiduciary Relationships Another approach, taken by some courts, is to recognize fiduciary relationships when they are similar to traditional fiduciary relationships. In such cases the courts

269. Roberts v. Sears, Roebuck & Co., 573 F.2d 976 (7th Cir. 1978).

270. *Id.*

require a heavier burden of proof to show that fiduciary relationships in new contexts existed.

In *Wolf v. Superior Court of Los Angeles County*[271] an author of a novel (*Who Censored Roger Rabbit?*) assigned to Disney Corporation the rights to the novel and its characters for a fixed compensation plus "a percentage of the 'net profits,' as defined by the parties, from a motion picture based on the novel; and additional, contingent compensation in the amount of 5 percent of any future gross receipts Disney earned from merchandising or other exploitation of the Roger Rabbit characters." But Disney was not obligated to "exercise any of the rights" and could assign or license the rights as it saw fit. The motion picture was produced, and another contract was signed. The author sued Disney for breach of the contract and breach of fiduciary duties on the ground that Disney failed to provide him with certain records of revenues to which he was entitled under the contract.

The plaintiff claimed that the fiduciary relationships arose from Disney's "exclusive control over the books, records and information concerning the exploitation [of the Roger Rabbit characters] and the revenue and Gross Receipts Royalties derived therefrom." The Appeals Court affirmed the trial court's holding that the contract did not constitute a fiduciary relationship as a matter of law. It defined "fiduciary relationship" as "'any relation existing between parties to a transaction wherein one of the parties is in duty bound to act with the utmost good faith for the benefit of the other party. Such a relation ordinarily arises where a confidence is reposed by one person in the integrity of another, and in such a relation the party in whom the confidence is reposed, if he voluntarily accepts or assumes to accept the confidence, can take no advantage from his acts relating to the interest of the other party without the latter's knowledge or consent. . . .'"

Because the author did not assert a traditional relationship of "agency, trust, joint venture, partnership or other 'traditionally recognized' fiduciary relationship" the court rejected the author's argument that his "contractual right to contingent compensation necessarily required [him] to repose 'trust and confidence' in Disney to account for the revenues received, and because such revenues and their sources are in the exclusive knowledge and control of Disney, [he] claims the relationship is 'confidential' in nature and necessarily imposes a fiduciary duty upon Disney, at least with respect to accounting to [him] for the gross revenues received." A "contingent entitlement to future compensation does not, alone, give rise to a fiduciary relationship. . . . [T]he contractual right to contingent compensation in the control of another has never, by itself, been sufficient to create a fiduciary relationship where one would not otherwise exist." Neither does the necessity to repose "trust and confidence" in Disney "to account for and

271. Wolf v. Superior Court, 130 Cal. Rptr. 2d 860 (Ct. App. 2003).

pay" the contract's contingent compensation create a fiduciary duty. Some trust is required by every contract. That issue is met by the contract law requirement of good faith. Profit-sharing and the right to accounting do not give rise to fiduciary relationships. This right to accounting can derive from a debt. But in light of Disney's exclusive possession of the records the court drew on public policy and shifted the burden of proof to Disney to show completeness of records.

The dissenting judge disagreed that Disney was not a fiduciary of the author as a matter of law. Disney could be a fiduciary with respect to the maintenance of honest and accurate books if for example facts would show that there was a joint venture between the author and Disney: "[N]o amount of contractual disclaimers avowing this was a debtor-creditor relationship instead of a joint venture can turn it into something it was not. . . . '[T]he conduct of the parties may create a joint venture despite an express declaration to the contrary.'"[272] Disney might be a fiduciary when it undertook to "accurately account to the author of the intellectual property for the receipts earned from the intellectual property on which that author's compensation is based." Disney had the services of accountants and bookkeepers, and full control over the facts and numbers. Disney had full control, opportunity, and temptation to cheat the author: the ingredients that are present "in the trustee-beneficiary, partnership, or other traditional fiduciary relationships."[273]

Thus, good faith alone may not constitute the basis for fiduciary relationship, but it abuts the fiduciary law area. "In applying the duty of good faith and fair dealing in the close corporation context, courts often draw a distinction between procedural and substantive application of the duty of good faith and fair dealing . . . Stating that not all breaches of the duty of good faith and fair dealing would support a tort recovery, the court nevertheless concluded that because a 'special relationship' existed, which it called 'quasi-fiduciary,' the remedy in tort was justified."[274] The concept of good faith, which some have argued satisfies fiduciary duties, has been questioned by others, who contend that good faith belongs to the

272. *Id.*

273. *Id.*

274. Robert M. Phillips, *Comments, Good Faith and Fair Dealing Under the Revised Uniform Partnership Act*, 64 U. Colo. L. Rev. 1179 (1993). For the same theme and conclusion see Larry A. DiMatteo, *Policing Limited Liability Companies Under Contract Law*, 46 Am. Bus. L.J. 279 (2009) ("The rules seeking to preserve a minimal core of fiduciary duties can be best understood as intent-implementing or contract-enforcing. . . . Just as doctrine of unconscionability prevents grossly one-sided contracts, core fiduciary duties will prevent overreaching by a member-manager. . . . This is a middle ground between applying the full corporate and partnership-like duties found in most states and the elimination of all fiduciary duties allowed under the Delaware Act. . . . The middle-ground approach includes the recognition of a minimum core of fiduciary duties and the use of good faith to prevent the repetitive use of manager-member contract rights to oppress minority interests.").

realm of contract. Fiduciary duties, which are grounded in entrustment, cannot be relieved by mere good faith.[275] On the other hand, good faith is an element of defense by fiduciaries. For example, good faith is an element in the courts' use of the business judgment rule.[276]

c. Analogizing to Rules Does Not Always Work Well Because their circumstances differ, analogies to the rules that apply to existing fiduciaries may not bring effective results. One example is courts' treatment of directors' removal from office. The approach blends trust and agency rules and applies the concoction to corporate directors. Trust beneficiaries can remove their trustees only after proving in court that the trustees are incapacitated or have substantial conflicts of interest.[277] Under agency law each party may terminate the relation, even in breach of contract (with some exceptions). These rules fit the purpose and structure of each relation. A trustee is chosen by the trustor to manage trust assets independently of the beneficiary's control. In contrast, an agent is chosen by the principal, and is subject to the principal's control. Corporate directors do not fall squarely into the category of either trustee or agent. Like trustees, corporate directors should manage the corporate business without the frequent interference of shareholders. Unlike trustees, and like agents, directors are elected by the shareholders. Therefore, the shareholders should be able to terminate the directors' tenure in the appropriate circumstances. But the decision-making process of shareholders in a publicly held corporation is different from that of a court or a principal. Therefore, the analogy by the judicial process did not work well.[278] In fact, directors are rarely removed during their terms, with or without cause. Rather they are terminated informally by consent, through a takeover—a market mechanism—or by an election process—a proxy fight. The solution may be found in evaluating the severity of the problem, the available models, and market solutions to be followed by the courts.

275. Reza Dibadj, *The Misguided Transformation of Loyalty into Contract,* 41 TULSA L. REV. 451 (2006).

276. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments,* 153 U. PA. L. REV. 1399 (2005).

277. Tamar Frankel, *Fiduciary Law,* 71 CAL. L. REV. 795, 805–06 (1983) (citing 2 A. SCOTT, THE LAW OF TRUSTS § 107.3 (3d ed. 1967)).

278. A director's removal superficially resembles that of a trustee because in a judicial proceeding, a director must be given notice of the charges against him and should have an opportunity to be heard. The power to terminate a director's position, however, is vested not in the courts but in the shareholders, the "principals" under the agency model. The courts further adjusted the rules by providing a "mixed" standard for removal that was neither the trust law standard of incapacity or conflict, nor the agency law standard of arbitrary termination. Instead, corporate directors can be removed by the shareholders only for cause, but the standard of cause—some wrong or injury to the corporation that need not amount to a legal wrong or an incapacity to act—is less strict than that applied to trustees.

2. Deferring to the Parties

The general principle is that while the parties determine the terms of their relationships, by contract, behavior, or other means,[279] the courts determine the legal classification of the relationship. After all, if courts follow the parties' legal classification of their relationships then the courts abdicate an important part of their function and delegate the power to the parties. Thus, the courts rather than the parties determine the legal definition of the parties' relationship.[280] For example, in *Martin v. Peyton,* the issue was whether an arrangement, which was framed as a loan, was in fact a partnership.[281] The result of the classification was to make the "lenders" responsible for the partnership debts (rather than to impose on them fiduciary duties). However, the court discusses the extent to which it would consider the parties' classification of their relationship, and that part is of interest to us here.

> 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. In passing upon it effect is to be given to each provision. 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. On the other hand, if it be less than this no partnership exists. Passing on the contract as a whole, an arrangement for sharing profits is to be considered. It is to be given its due weight. But it is to be weighed in connection with all the rest. It is not decisive. It may be merely the method adopted to pay a debt or wages, as interest on a loan or for other reasons.[282]

The court examined not only the agreement and legal relationship established (e.g., a trust vesting power in the lenders) but also the surrounding

279. Note that under certain conditions the courts heed the parties' choice of law, but that does not include the application of that law to the parties' relationship or to events. *See* Tamar Frankel, *Fiduciary Duties as Default Rules,* 74 OR. L. REV. 1209 (1995).

280. Wolf v. Superior Court, 130 Cal. Rptr. 2d 860 (Ct. App. 2003) (citing April Enters, Inc. v. KTTV, 147 Cal. App. 3d 805, 819 (1983)) ("no amount of contractual disclaimers avowing this was a debtor-creditor relationship instead of a joint venture can turn it into something it was not. . . . The conduct of the parties may create a joint venture despite an express declaration to the contrary.").

281. Martin v. Peyton, 158 N.E. 77 (N.Y. 1927) (citations omitted).

282. *Id.* at 78.

environment—the days just before the final 1929 crash, the lenders' long-term friendship with the borrowers, and the risky transactions in which the borrower firm had engaged. Therefore, the relationship was declared a loan; yet under different circumstances a court might declare the same relationship terms to be fiduciary.

There are cases in which the courts embrace the parties' legal classification of their relationships, especially if the entrustors were sophisticated and had significant bargaining power.[283] Many fiduciary rules are default rules.[284] If the parties can "contract out of" specific fiduciary rules, why should they not be able to contract out of all fiduciary law rules and consequently out of the fiduciary category altogether? In such cases fiduciary rules are viewed as "form contracts" subject to changes by the parties.[285] Thus, the Federal Court of Australia[286] conceded to the parties' greater power to determine the legal effect of their relationships. It considered the sophistication of the parties, Citigroup Global Markets Australia Pty. Ltd. (Citigroup) the Australian arm of Citigroup Inc, on the one hand and its client, Toll Holdings Ltd. (Hollings). Citigroup advised its client and specified in their agreement that Citigroup was not a fiduciary of Hollings. Consequently, the government argued that Citigroup was the fiduciary of Hollings and violated insider trading rules by using its insider information for its own benefit.

The court noted that "the question of whether a fiduciary relationship exists, and the scope of any duty, will depend upon the factual circumstances and an examination of the contractual terms between the parties. . . . Apart from the established categories, perhaps the most that can be said is that a fiduciary relationship exists where a person has undertaken to act in the interests of another and not in his or her own interests but all of the facts and circumstances must be carefully examined to see whether the relationship is, in substance, fiduciary. . . . The critical matter in the end is the role that the alleged fiduciary has, or should be taken to have, in the relationship. It must so implicate that party in the other's affairs or so align him with the protection or advancement of that other's interests that foundation exists for the 'fiduciary expectation.[']"[287]

Noting the possible coexistence of contractual and fiduciary relationship, the court wrote that "if a fiduciary relationship is to exist between parties to a contract, the fiduciary relationship must conform to the terms of the contract. . . . 'The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction.'" One judge stated that "a contractual term may be so precise in its regulation of what a party may do that there is no scope for the creation of a fiduciary duty."[288] The court concluded that the parties may exclude the applicability of fiduciary relationships except for "liability for fraud or deliberate dereliction of duty." Therefore, "where a fiduciary relationship is said to be founded upon a contract, the ordinary rules of construction of contracts apply. Thus, whether a party is subject to fiduciary obligations, and the scope of any fiduciary duties, is to be determined by construing the contract as a whole in the light of the surrounding circumstances known to the parties and the purpose and object of the transaction. . . ."[289]

Yet, fully delegating to the parties the power to determine the legal status of their relationship can lead to unacceptable results that affect the legal system. If the parties' ability to classify their legal relationship is binding and unlimited, the legal system would follow various parties' interests rather than develop a more coherent legal system. Most importantly, such classification might develop in disregard of society's interests following only the private parties' interests.[290]

283. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1240 (1995); *see also* Alison Grey Anderson, *Conflicts of Interests: Efficiency, Fairness, and Corporate Structure*, 25 UCLA L. REV. 738, 760 (1978) ("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.").

284. *See* Chapter 4.

285. Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (2007) ("[C]orporate rules ultimately are and, from an efficiency perspective, should be the product of private ordering, not government regulation. Even where liability rules are appropriate, they should be regarded as standard form contractual provisions that can be drafted around.").

286. Australian Sec. & Inv. Comm'n v Citigroup Global Markets Australia Pty. Ltd., [2007] FCA 963 (June 28, 2007).

287. *Id.* (citing P.D. Finn, *The Fiduciary Principle*, *in* EQUITY, FIDUCIARIES AND TRUSTS (T. Youden ed., 1989)) ("What must be shown, in the writer's view, is that the actual circumstances of a relationship are such that one party is entitled to expect that the other will act in his interests in and for the purposes of the relationship. Ascendancy, influence, vulnerability, trust, confidence or dependence doubtless will be of importance in making this out, but they will be important only to the extent that they evidence a relationship suggesting that entitlement. The critical matter in the end is the role that the alleged fiduciary has, or should be taken to have, in the relationship. It must so implicate that party in the other's affairs or so align him with the protection or advancement of that other's interests that foundation exists for the 'fiduciary expectation.'").

288. *Id.* (citing Breen v. Williams (1996) 186 CLR 71, 106).

289. *Id.*

290. Some people might applaud this result; others may lament it. Before taking such a drastic change in our jurisprudence, however, its consequences should be further studied. *See, e.g.*, STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 320–24 (2004) (law will override contracts that are not in the public interest, such as contracts with harmful externalities, contracts for human organs, contracts for babies, or contracts for voting rights).

If this type of parties' private law-making is not acceptable, then courts must have the last word to determine the categories of legal relationships.[291]

3. Fairness of Extending Prospectively the Definition of Fiduciary Relationships

The application of fiduciary duties to new situations raises a fundamental issue of fairness to the fiduciaries.[292] Under the rule of law in the United States people ought to know whether they are subject to prohibitions.[293] People should be free to engage in non-prohibited activities.[294] Liability should not be imposed without prior notice, and that includes fiduciary status and attached duties. Even though this section deals with the definition of fiduciary relationships, a similar problem arises in any judicial declaration of wrongful acts that did not clearly exist before.

However, imposing new legal constraints to situations that occurred before the passage of the law or court decision is not limited to fiduciary law. Samuel Buell has dealt with a similar but more serious problem of expanding the definition of

291. For example, the courts may classify some hybrid relationships as contracts, even though the parties used the word "trust" in their agreement. *See, e.g.*, Banco Espanol de Credito v. Security Pac. Nat'l Bank, 973 F.2d 51, 53 (2d Cir. 1992); First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A., 919 F.2d 510 (9th Cir. 1990) (agreement by the lead bank to hold notes and any collateral in trust for the participants who bought parts of the loans, did not in and by itself result in a fiduciary relationship. The relationship here will not be inferred "absent unequivocal contractual language similar to that discussed in [another case]"); Corestates Bank, N.A. v. Signet Bank, No. 96-3199, 1996 U.S. Dist. LEXIS 12673 (E.D. Pa. Aug. 23, 1996) (sale of loan participations. Contract allocated the risk of fraud involving the loans to the buyers. The assignment was without recourse and the buyers of the participations provided a warranty that relieved the lead bank of liability). For a further discussion *see* 2 Tamar Frankel, Securitization § 18.3 (2d ed. 2006). For a discussion of whether courts should defer to parties' legal classification of their relationship, *see* Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1246–51 (1995).

292. *See* Martinelli v. Bridgeport Roman Catholic Diocesan Corp., 10 F. Supp. 2d 138 (D. Conn. 1998).

293. *See* Ann Woolhandler, *Public Rights, Private Rights, and Statutory Retroactivity*, 94 Geo. L.J. 1015 (2006).

294. The issue is similar to the constitutional the principle against retroactive laws. 16B Am. Jur. 2d *Constitutional Law* § 696 (2007) ("A constitutional provision prohibiting retrospective laws covers laws which create a right where none before existed and which relate back so as to confer on a party the benefit of such right, and also all such laws as take away or impair any vested right acquired under existing laws, create a new obligation, impose a new duty, or attach a new disability in respect of transactions or considerations already past. The purpose of the constitutional prohibition against retroactive laws is to safeguard rights not guaranteed by other constitutional provisions such as the impairment of the obligation of contracts."); Jan G. Laitos, *Natural Resources Interests and Retroactive Laws*, 32 Rocky Mtn. Min. L. Inst. 3 (1992).

the crime of fraud.[295] Because market actors are free to innovate, the law tends to provide general prohibitions of fraud. Yet criminal law requires specificity and prohibits retroactively punishable crimes.[296] Buell notes that this tension in criminal law was reduced by weighing the "actor's observable awareness of the wrongfulness of her actions. This mechanism is a coping device, not a means of settling the unending contest over novel fraud. Novelty never ceases; neither will doubt about criminality."[297]

Two strands of decisions in fiduciary law demonstrate similar disagreements. One view is that when a relationship embodies the features of fiduciary relationship, then the absence of a specific rule should not matter. The circumstances dictate whether the relationship is fiduciary or not. The other view is that if there are no rules declaring a relationship to be fiduciary, then a relationship is not a fiduciary one. A third view takes the middle ground, suggesting that a new fiduciary relationship may be recognized when there is evidence of a similarity of the relationship with traditional fiduciary relationships as well as evidence of wrongfulness. Wrongfulness might tilt the scales toward recognizing a new fiduciary relationship.

F. THE DARK SIDE OF FIDUCIARY RELATIONSHIPS

Fiduciary relationships can be used for good and for evil. For example, a legal trust can be used for legitimate goals, such as, "for successive ownership, to avoid [the costs of] probate, to protect spendthrifts other than the grantor, to provide management for grantors who later become mentally incompetent, to save some taxes, and to obtain professional investment 'management.'"[298] A trust, however, can be used for illegitimate purposes, such as hiding the identity of the real shareholders who control the corporation, hiding the identity of the true owners, and avoiding taxes.

On this issue, history teaches a lesson. Before the "use" was eliminated by the Statute of Uses in 1535, England recognized special (or "active") trusts and general (or "passive" or "simple") trusts. The special trust was for a "temporary purpose, such as for the care or management of the property."[299] For example, when the Crusaders left for the Holy Land, some Crusaders transferred title to their lands to trusted persons temporarily, on the understanding that the trustees'

295. Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U.L. Rev. 1971 (2006) (there are an increasing number of new general anti-fraud provisions in criminal statutes).

296. *Id.*

297. *Id.*

298. Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or, We Don't Have to Think of England Anymore*, 62 Alb. L. Rev. 543 (1998).

299. See Chapter 2.G.4.

ownership would expire when the real owners returned home. Similarly, the "use" could be used to overcome the legal prohibition on transferring land by a will. Instead, land was transferred to a trusted person, the trustee, for the donor's benefit and by the trustee—to the donor's heirs. And because a daughter was disqualified from holding land, the "use" enabled her father to give her the beneficial ownership by transferring property to a trusted person who vowed to use the property for her benefit. The "use" was also useful as a means of tax evasion.[300] Thus, one could view the "use" as a means of evading rigid law, remindful of Roman law.

"The more common general trust, otherwise known as the use, entailed the transfer of legal title (enfeoffment) to a person who was to hold the property (the feoffee to uses) for the benefit of another (the cestui que use)."[301] The use was a method of escaping the burdens of the English feudal system. The system imposed burdens on the holders of legal title to land, limited property transfers during the owner's life, and prohibited property transfers after the owner's death. Moreover, if the property holder committed certain offenses they would try to avoid forfeiture of their property by transferring the property title to third parties. Debtors would transfer title to others to avoid repayment of their debts while continuing to use the property. In addition, the transfer of use did not involve publicity, while transfer of legal title did. And the use was also useful as a means of tax evasion.[302] The use enabled people to circumvent these limitations and alleviate the burdens by transferring legal title to their property to third parties, and helped overcome the prohibition of transferring land by will. Land was transferred to a trusted person for the donor's benefit and by the trustee—to the donor's heirs. Under common law uses were not enforceable. If the trusted person refused to return the land or reaped the land's profits, the true owners had no recourse. But in the early fifteenth century, such unfaithful trustees could be sued in the Court of Chancery and forced to abide by their promises.[303]

The Statute of Uses put an end to the "use" in 1535. F.W. Maitland noted that the preamble to the Statute lists "the evil effects of the system and legal writers of a later day have regarded the words of this preamble as though they stated a generally admitted evil. As a matter of historical fact this is not true. The Statute of Uses was forced upon an extremely unwilling parliament by an extremely

300. *See* Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 QUINNIPIAC L. REV. 61, 92 (2004). *See also* GEORGE T. BOGERT, TRUSTS § 2, at 6, 7–8 (6th ed. 1987).

301. Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 QUINNIPIAC L. REV. 61, 92 (2004).

302. *See also* GEORGE T. BOGERT, TRUSTS § 2, at 6, 7–8 (6th ed. 1987).

303. Avisheh Avini, *The Origins of the Modern English Trust Revisited*, 70 TUL. L. REV. 1139, 1143–45 (1996) (summarized) (footnote omitted). *See also* J.H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 283–87 (3d ed. 1990) (discussing origins of the use); *id.* at 288–89 (the use provided "an escape" from feudal law and allowed flexibility).

strong-willed king. It was very unpopular and was one of the excuses, if not one of the causes, of the great Catholic Rebellion. . . . It was at once seen that it would deprive men of that testamentary power, that power of purchasing the repose of their souls, which they had long enjoyed. The king was the one person who had all to gain and nothing to lose by the abolition of uses.[304] The statute abolished the power of devising a use which men had heretofore enjoyed."[305] The result of the Statute of Uses was to convert uses into legal estates, which forced the use into the old order and its limitations on making wills, for example, just as an "estate" was limited. The Statute legitimized illegal uses by recognizing the transfers as binding transfers. The trustee became the true recipient of the property. The true owners could no longer be hidden.

Our judgment of the "uses" depends on how we view their employment. Were they employed for "good causes" or were they employed to circumvent the law (no matter whether the law was good or bad)? Most importantly, "uses" demonstrate the way in which law can be avoided by interpositioning third parties between the true actors and the outside world. This is a feature of many fiduciary relationships today as well. Owners could use a trust or agency to avoid paying taxes, or hide the identity of the voters who truly control a corporation (whether upright citizens or members of the Mafia). Just as fiduciary relationships could be used for good and for evil in the year 1500 they can be used for good or for evil today. However, modern fiduciary law solutions were not as drastic as the Statute of Uses and the "bad use" of fiduciary relationships is limited or eliminated, depending on its impact.[306]

Modern fiduciary law has not swung the draconian sword of the Statute of Uses. Instead the law has aimed at allowing fiduciary relationships to flourish while curbing their abusive use. An 1892 case demonstrates the use of a fiduciary relationship to hide the real owners. In *Watteau v. Fenwick*[307] a hotel manager seemed to be the hotel owner; his name was posted on the hotel's entrance door and his name appeared on the license to sell liquor in the bar. In fact, he was an agent of the owners. These owners authorized the manager to buy only certain kinds of drinks. He violated their directive and bought other goods as well, which remained unpaid. The supplier sued the hotel manager-agent for the price, and when he discovered the true owners, the supplier sued them as well. The court held that the owners-principals were liable for the price of the unauthorized goods. The court analogized the liability of undisclosed principals

304. F.W. MAITLAND, EQUITY: A COURSE OF LECTURES 34 (1936).

305. *Id.*

306. *See generally* AM. JUR. *Corporations* § 985 ("[v]oting trust statutes frequently prescribe the maximum permissible term or duration for such a trust. In order to comply with such a statute, a voting trust agreement must expressly be limited to the prescribed period or less, or it must be clear from the terms of the agreement that it will terminate within that time.") (footnote omitted).

307. *Id.*

for the acts of their agents to the liabilities of dormant (undisclosed) partners for their partnership's debts. Partners are liable for these debts regardless of whether the creditors know of the partners' existence. A similar rule should apply to undisclosed principals. Even though the supplier-creditor received a windfall, that is, an additional (and better) debtor from whom to collect the debt, the principals should pay the debt because they enabled their agent to masquerade as owner.[308] Similarly, a voting trust allows the use of fiduciary relationships to hide the true shareholders. It is usually used by few shareholders who unite and vote together and wish to ensure that their agreement will be carried out or to hide their identity for good or bad reasons.[309]

Similarly, the courts and legislatures viewed voting trusts with disfavor, but did not ban them altogether.[310] Rather, they regulated them to reduce their negative effect. The Delaware legislature imposed conditions on voting trusts, including a ten-year limitation, and publicity.[311] Similarly, when trusts were used to establish monopolies Congress promulgated antitrust laws.[312]

308. *Id.* ("Here the defendants have so conducted themselves as to enable their agent to hold himself out to the world as the proprietor of their business, and they are clearly undisclosed principals. . . . All that the plaintiff has to do, therefore, in order to charge the principals, is to shew that the goods supplied were such as were ordinarily used in the business—that is to say, that they were within the reasonable scope of the agent's authority.").

309. "The shareholders transfer their shares to a trusted person to be their trustee, and direct him on how to vote the shares. The trustee must transfer to the shareholders all benefits from the shareholdings, such as dividends; all benefits except the power to vote. No one need know who the real owners are."

310. *See, e.g.,* Watts v. Des Moines Register & Trib., 525 F. Supp. 1311 (S.D. Iowa 1981).

311. Smith v. Biggs Boiler Works Co., 91 A.2d 193, 197 (Del. Ch. 1952) (citations omitted) (citing DEL. CODE ANN. tit. 8, § 218) (the agreement was held invalid and the trustee was ordered removed. The supplemental agreement, which was conditioned on a refunding agreement and an option to purchase, failed to comply with § 18 of the General Corporation Law. The bitter relationship between plaintiff and defendant trustees prevented them from managing the corporation properly. The court noted that "[n]o voting trust may now be created in this state unless it complies with that statute. [Legislation] occupied the whole field." "*Sec.* 18 [required]: (1) that the stock must be deposited with the voting trustee or trustees; (2) that the trustee or trustees may vote said stock for a period not exceeding ten years; (3) that a copy of the agreement shall be filed in the principal office of the corporation in the State of Delaware; (4) that certificates of stock shall be issued to the voting trustees to represent any stock so deposited with them; (5) that in the certificates so issued it shall appear that they are issued pursuant to the voting trust agreement; and, (6) that in the entry of such voting trustees as owners of such stock in the proper books of the issuing corporation that fact shall be noted.").

312. . *See* William H. Page, *Ideological Conflict and the Origins of Antitrust Policy*, 66 TUL. L. REV. 1 (1991).

The use of trusts for tax avoidance has been addressed. In *United States v. Scherping*[313] the government sought to foreclose on property that the taxpayers transferred to two business trusts. The court accepted the government's argument that these trusts were the taxpayers "alter egos"–"sham entities"—and that the transfers were fraudulent. Therefore, these trusts were liable for the sole beneficiary's tax liabilities. The policy reasons for the holding were to avoid fraud and collect delinquent federal taxes.[314] Trusts were not prohibited altogether. In each case, the use and abuse of trust was noted, and attempts were made to avoid the abuses while keeping the beneficial uses available.[315] Thus, the test of legitimacy in the use of fiduciary relationships is focused on the legitimate economic and other purposes of the use rather than the form.

G. THE DEBATE

The discussions and materials in this chapter can be confusing. There are so many actors, so many situations, and so many controversies.[316] One cannot find a clear answer to a question of whether a relationship is fiduciary. Rather, bunching fiduciary relationships looks like a "grab bag" of situations with little clear directives.

This view is understandable if we search for an answer from the "bottom up," that is, finding clear answers by clear classifications. But a focus on the features that all fiduciaries have in common and on the fundamental and gradual differences among them can present a fairly straightforward picture and a helpful classification.

To summarize, the features are (1) services; (2) entrustment of property and power; (3) inability of the entrustor to specify the power of the fiduciaries without undermining the utility of the relationship; (4) inability of the entrustor to monitor the fiduciaries closely and make sure that the fiduciary complies with

313. . United States v. Scherping, 187 F.3d 796 (8th Cir. 1999).

314. *Id.* (the court held the transfers to be fraudulent conveyances under state law as well).

315. A similar issue arises in corporate law, when the form is abused and used to perpetrate fraud. In such cases courts "pierce the corporate veil." *See* United States v. Bestfoods, 524 U.S. 51 (1998).

316. DEBORAH DEMOTT, FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP: DUTIES IN ONGOING BUSINESS RELATIONSHIPS 3 (1991). *See also* Robert Flannigan, *The Fiduciary Obligation*, 9 OXFORD J. LEGAL STUD. 285 (1989); J.C. Shepherd, *Towards A Unified Concept of Fiduciary Relationships*, 97 L.Q. REV. 51 (1981); Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1 (1975). Eileen A. Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. ILL. L. REV. 897 (1993).

the terms of the entrustment. Moreover, the problems that fiduciary law addresses are different from other areas of the law, and can be mastered if one examines the particular facts in light of these problems.

To be sure, each of the features of fiduciary law is surrounded by gray areas on which courts and practicing lawyers disagree. In addition, even though fiduciary relationships are valuable to society, these relationships may have a more seamy side. In both cases the legislatures and the courts deal with these gray areas and negative aspects as they arise. In addition, because fiduciary law is "porous" and less rigid, it can accommodate developing situations that pose "fiduciary problems." Most importantly, fiduciary relationships are the foundation of people's reliance and trust on which social systems are built. Fiduciary law is attuned to human nature. When human nature can undermine beneficial social relationships and systems the law must interfere.

2. WHERE DOES FIDUCIARY LAW COME FROM?

A. INTRODUCTION

The roots of fiduciary law are ancient. The following materials summarize a very short, and far from complete, survey of fiduciary relationships and the rules that regulated these relations over the past three thousand years. The purpose of this survey is to highlight the problems that brought about fiduciary duties, the laws that addressed these problems and the importance of the social rules and cultures on which these legal solutions were based. Perhaps surprisingly, ancient fiduciary laws are not very different from our laws today. The differences are shaped by economic environments and social cultures of the periods. But it seems that throughout the centuries the problems that these laws were designed to solve are eternal, etched in human nature, derived from human needs, and built into human activities.

Experience of interaction with others may teach us to mistrust because most, if not all, humans are not always trustworthy. Opportunities and temptations, absence of enforcement and education, among other reasons, can tilt the scales toward abuse of trust. Not only personal relationship but culture and social mores shape the balance between trust and mistrust; trustworthiness and abuse of trust. The balance can move as forces gather to affect one side of the equation or the other.

Yet we must rely on others to survive. Very few humans can live alone. A developed society is grounded in specialization and interdependence. Hence in war or peace, commerce or private life, we seek to meet our needs by interacting with others. The select summaries below highlight a number of the relationships that reflect today's fiduciary relationships and laws. These select relationships present benefits and risks to the actors. The legal rules that govern the relationships can be explained as the attempts of society to maintain the benefits and reduce, if not eliminate, the risks.

Basically, we trust others. Often we have no choice, as when in childhood we depend on our parents and other adults to help us survive. We must rely on others to survive. Very few humans can live and survive alone long-term. In fact, not only emotional tendencies induce trust. A recent discovery shows that our body contains a hormone that induces trust.[1] We trust in relationships of

1. *How the "Trust Hormone" Works*, WORLD SCIENCE, Dec. 8, 2005, http://www.world-science.net/othernews/051208_trustfrm.htm (last visited Oct. 21, 2009).

interdependence and reciprocity; under the pressures of social dictates; in commercial relationships; camaraderie in war and suffering; and within the family. Or, as economists suggest, we trust when trusting is more efficient than verifying the truth of other people's statements and reliability of their promises. With this background, the same fiduciary relationships and rules seem inevitable.

B. THE LAWS OF HAMMURABI AND ESHNUNNA

1. Agency

In ancient Mesopotamia (currently Iraq), agency law developed with commerce, and reflected the environment in which it developed. Thus, a *tamkarum*, or principal merchant, gives a *samallum*, or agent, either money for travel and investments, or goods for trading. The principal's weak controls over the agent are reflected in the rules. Hammurabi's laws imposed on agents heavy responsibilities similar to the duties of guarantors. An agent was required to generate for the principal profits of at least double the amount originally entrusted to the agent. An agent had to pay the principal interest on the entrusted money over the period of the agency.[2] Yet an agent who incurred losses through no fault of his own had to return only the amount of the entrusted capital; not more.[3] Further, the laws excused agents who had to abandon the entrusted goods of the principal when the agents were attacked. Basically, agents were excused from performing when failure to perform or the losses were not the agents' fault.[4] In addition, the rules required agents to keep written receipts of the executed transactions, to tabulate the loans that are due, and present the documents upon the agents' return. These accounting rules are quite similar to modern agency laws and accounting duties of fiduciaries.

2. Bailment

Under Hammurabi's laws bailment usually took place "when an owner of personal property (the bailor) temporarily transfers the property to another person (bailee)."[5] For a bailment contract to be valid, the "the agreement had to be in writing, and the [property being bailed] had to be shown to witnesses."[6] Thus, if a person claimed to own property in the possession of another, the burden of proof was on the claimant. The bailee's liabilities under Hammurabi's laws rise

2. Russ VerSteeg, *Early Mesopotamian Commercial Law*, 30 U. Tol. L. Rev. 183, 202 (1999).

3. *Id.*

4. *Id.*

5. Russ VerSteeg, *Early Mesopotamian Commercial Law*, 30 U. Tol. L. Rev. 183, 196 (1999).

6. *Id.*

in case of fault and negligence.[7] A bailee who negligently or by physical abuse, caused the death of a rented animal was legally bound to replace the animal.[8] A renter of an ox had to pay damages if the rented ox was injured. The amount of compensation varied depending on the seriousness of the injury.[9] But if a rented ox was killed by a lion, for example, or by some another "act of god" event, the bailee was not liable.[10]

Andrew Simmonds describes the Laws of Eshnunna that predated the laws of Hammurabi and Moses. Eshnunna's Laws concerning the goring ox rule[11] "offer[] the closest parallel between Biblical law and another ancient Near Eastern code."[12] Under the Laws of Eshnunna, a bailee was liable for goods that were stored in a house if he was unable to prove that the house had been broken into and the goods stolen.[13] If, however, the bailee could prove the theft and could show that some of the bailee's own property was stolen as well, the bailee would not be liable to the bailor. This rule was changed in Hammurabi's Laws, which made a bailee of grain strictly liable to his bailor.[14] Perhaps the reason for the change was the fact that grain is fungible. Or perhaps too many incidents of such losses had occurred. Another rule applied to a careless bailee who resided in another person's house. This bailee was required to restore lost property that

7. *Id.* at 197.

8. *Id.*

9. *Id.* at 196–97.

10. *Id.*

11. Andrew R. Simmonds, *Indirect Causation: A Reminder from the Biblical Goring Ox Rule for Fraud on the Market Securities Litigation*, 88 Ky. L.J. 641, 644–46 (2000) ("Eshnunna was an independent city-state, near modern Baghdad." Under the rule, found in Exodus, "if an ox (not known to be a habitual gorer . . .) [i.e., a 'tame' ox] gores and kills another ox, the live ox is sold and the proceeds of the sale together with the meat of the dead ox are divided equally between the two owners." "[I]n the case of a [tame ox]one pays [one-] half damages from the body of [the animal], whereas in the case of a [habitual gorer] one pays full damages from the . . . [choicest of the owner of the [gorer's] properties]." "[T]he case of the [tame] ox that gores another ox . . . is the famous rule of one-half damages." A literal interpretation of the rule could lead to anomalies, as if the gorer killed an ox worth more than twice its value, "the owner of the gorer would make a profit," and if the gorer killed a much less valuable ox, "the owner of the inexpensive dead ox might make a profit." Consequently, in the Talmud version of the rule, "damages were half the value of the victim, rather than half the value of the gorer." "The Talmudic modification was sensible in that damages should be viewed from the perspective of the injury done to the victim.").

12. *Id.* at 646–47.

13. Russ VerSteeg, *Early Mesopotamian Commercial Law*, 30 U. Tol. L. Rev. 183, 198 (1999).

14. *Id.*

was given to him for safekeeping.[15] Further, in parallel to current laws, Hammurabi's code included punitive damages.[16]

3. Remedies

A negligence rule in Hammurabi's Code is similar to modern negligence rules. For example, if a man fills a boat with goods, such as clothes and corn, and hires a sailor to bring the boat to a certain destination, and the sailor negligently causes the boat and the goods to be damaged, the sailor must compensate the man for the entire damage.[17]

The trustee's duty of loyalty is an ancient concept as well. The prohibition on misappropriation is similar to modern rules. The Babylonian Code of Hammurabi provided that a man's hand will be cut off if the man was hired to manage another person's farm and stole seed grain or fodder. However, the owner's burden of proof was heavy. The stolen good had to be found in the manager's hands.[18] If a herdsman, hired to take care of cattle or sheep, falsely accounted for the natural growth of the herd or fraudulently sold the newborn cattle or sheep, the herdsman had to pay the owner ten times the owner's loss of the newborns.[19] In this case, if the owner had to gain information about newborn cattle or sheep, the owner's cost of such information would have been very high. In fact, the very usefulness of the arrangement would have been undermined. Therefore, the penalty on the manager, who abused his trust, is quite high.

The remedy of restitution was known in ancient times. "Restitution is an 'act of restoring; restoration of anything to its rightful owner; the act of making good or giving equivalent for any loss, damage or injury; and indemnification.'"[20] "Payment for wrongs committed in the form of restitution to victims has a long history. It has always been closely intertwined with conceptions of punishment and justice. The law of Moses required fourfold restitution for stolen sheep and fivefold for the more useful ox; the Middle Eastern law Code of Hammurabi (c. 1700 B.C.), which focused on implementing deterrent measures through

15. *Id.* (quoting Laws of Hammurabi, ¶ 125, at 105, *in* MARTHA T. ROTH, LAW COLLECTIONS FROM MESOPOTAMIA AND ASIA MINOR (1995)).

16. David G. Owen, *Problems in Assessing Punitive Damages Against Manufacturers of Defective Products*, 49 U. CHI. L. REV. 1, 9–10 (1982).

17. Russ VerSteeg, *Early Mesopotamian Commercial Law*, 30 U. TOL. L. REV. 183, 197–98 (1999).

18. Daniel Jack Chasan, *A Trust for All the People: Rethinking the Management of Washington's State Forests*, 24 SEATTLE UNIV. L. REV. 1, 33 (2000) (citing H.L. MENCKEN, A NEW DICTIONARY OF QUOTATIONS 1220 (1960)) (the city lost its independence to Hamurabbi).

19. Interfaith Online, http://www.interfaith.org/ancient/mesopotamia/law-code-of-hammurabi/code-of-laws-3.php. (last visited Jan. 30, 2009).

20. United States v. Ferranti, 928 F. Supp. 206, 220 (E.D.N.Y. 1996) (citing BLACK'S LAW DICTIONARY 1477 (4th ed. 1968)).

severe and cruel punishments and imposition of restitution for property offenses, could demand up to thirty times the value of damage caused."[21] It should be noted that those rules that seem very cruel today may have aimed at fairness in ancient times. For example, it seems that "[T]he 'eye for an eye and tooth for a tooth' formulation in the Hammurabi Code" was a benign punishment. It was "intended to restrict revenge by requiring a measured, proportional response."[22] Anyone familiar with a blood feud culture, in which harm of offense could eliminate entire tribes, will agree.

C. THE NEW TESTAMENT

The New Testament emphasizes the obligations of the rich as well as the poor servants. In the book of James, "the unpaid wages of exploited workers cry out against unjust and greedy employers," and wealthy people are exhorted to be rich in good deeds, and to be generous and willing to share, in order to lay up treasure for a future age.[23]

Many examples in the New Testament reflect fiduciary relationships. A manager is a fiduciary. If he relieved the master's debtors of some of their debts without attempting to collect from the debtors as much as they could pay, he was acting improperly. Moreover, if he was trying to gain favor with the debtors, he violated his fiduciary duty under current trust law "to administer the trust solely

21. *Id.* at 219–20 (citing CHARLES F. ABEL & FRANK H. MARSH, PUNISHMENT AND RESTITUTION, A RESTITUTIONARY APPROACH TO CRIME AND THE CRIMINAL 25–30 (1984); Tamar Frankel, *Lessons from The Past: Revenge Yesterday and Today*, 76 B.U. L. REV. 157, 158 (1996); STEPHEN SCHAFER, COMPENSATION AND RESTITUTION TO VICTIMS OF CRIME 4 (1970); Daniel W. Van Ness, *Restorative Justice*, *in* CRIMINAL JUSTICE, RESTITUTION, AND RECONCILIATION 7–14 (Burt Galaway & Joe Hudson eds., 1990)). *See also* 928 F. Supp. at 221 ("The Roman Law of the Twelve Tables (449 B.C.) required thieves to make restitution payments to their victims starting at double the value of the stolen goods. The value of the payment due would increase depending on the circumstance in which such stolen goods were found or confiscated. In England, prior to the Middle Ages, elaborate and detailed systems of victim compensation were developed by the Anglo-Saxons, placing the victim's right to compensation at the forefront of punishment considerations.") (citations omitted) (citing Daniel W. Van Ness, *Restorative Justice*, *in* CRIMINAL JUSTICE, RESTITUTION, AND RECONCILIATION 7 (Burt Galaway & Joe Hudson eds., 1990)).

22. Robert E. Scott & Paul B. Stephan, *Self-Enforcing International Agreements and the Limits of Coercion*, 2004 WIS. L. REV. 551, 569 n.48 (2004) (citing THE HAMMURABI CODE AND THE SINAITIC LEGISLATION 61–62 (Chilperic Edwards trans., Kennikat Press ed. 1971) (1904)).

23. Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 QUINNIPIAC L. REV. 61, 88 (2004).

in the interest of the beneficiary."[24] The attitude concerning fiduciary relationships is expressed by Jesus: "Whomever is faithful in small matters will be faithful in large ones; whoever is dishonest in small matters will be dishonest in large ones. If then, you have not been faithful in handling worldly wealth, how can you be trusted with true wealth? And if you have not been faithful with what belongs to someone else, who will give you what belongs to you?'"[25]

D. THE SHARIA ISLAMIC LAW

Islamic law (Sharia) recognizes and regulates fiduciaries. The Sharia is a division of the "Divine Islamic Law."[26] The Koran, the "Holy Book," is the most important source of Muslim law,[27] and other rules of law must be consistent with it.[28] Even though the Sharia is subject to different interpretations,[29] the differences relate to particulars that are anchored in similar principles of fiduciary relationships.

1. Agency

One division of the Sharia pertains to agency (*wakalat*).[30] Under the Sharia, an agent is not responsible for damage to entrusted property if the "agent is not careless in looking after the property . . ., nor does he exercise such discretion

24. Austin W. Scott, *The Fiduciary Principle*, 37 CAL. L. REV. 539–40 (1949) (citing RESTATEMENT OF TRUSTS § 170 (1935)), quoted in DEBORAH DEMOTT, FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP: DUTIES IN ONGOING BUSINESS RELATIONSHIPS 3 (1991)).

25. *Id.*

26. Richard E. Vaughan, *Defining Terms in the Intellectual Property Protection Debate: Are the North and South Arguing Past Each Other when We Say "Property"? A Lockean, Confucian, and Islamic Comparison*, 2 ILSA J. INT'L & COMP. L. 307, 351 (1996).

27. NAGATY SANAD, THE THEORY OF CRIME AND CRIMINAL RESPONSIBILITY IN ISLAMIC LAW 46 (1991), cited in Carolyn Ratner, *Book Note*, 18 B.C. THIRD WORLD L.J. 137, 141 (1998). The other sources of Muslim law are the Sunna, Ijma, and Qiyas. The Sunna consists of sayings and records of Islam's founder. Ijma is a consensus of legal scholars, and Qiyas is "the concept of deduction by analogy." Carolyn Ratner, *Book Note*, 18 B.C. THIRD WORLD L.J. 137, 142 (1998) (citing NAGATY SANAD, THE THEORY OF CRIME AND CRIMINAL RESPONSIBILITY IN ISLAMIC LAW 38 (1991)).

28. NAGATY SANAD, THE THEORY OF CRIME AND CRIMINAL RESPONSIBILITY IN ISLAMIC LAW 38 (1991), cited in Carolyn Ratner, *Book Note*, 18 B.C. THIRD WORLD L.J. 137, 142 (1998).

29. *See* Nicholas Pengelley, *Faith-Based Arbitration in Ontario*, 9 VINDOBONA J. INT'L COM. L. & ARB. 111, 114 (2005) (noting different schools of interpretation under sources of Sharia), cited in Michael C. Grossman, *Note, Is This Interpretation?: Religious Tribunals, Judicial Review, and Due Process*, 107 COLUM. L. REV. 169, 179 (2007).

30. Islamic Laws ¶¶ 2265–2280, http://www.al-islam.org/laws/transactions3.html#2265 (last visited Feb. 27, 2009).

over it for which permission was not granted."[31] However, if the agent was "careless about looking after the property," or "treat[ed] it in a manner which was different from the one allowed by the principal," (e.g., if the agent is authorized to sell an article of clothing but wears it), the agent was responsible.[32] Therefore, the agent's liability will arise only if the agent has been negligent or has dealt with the property in an unauthorized manner, e.g., for his own benefit.

2. The Trust

The trust (*waqf*) is an important institution in Islamic law and serves as an alternative to the institution of corporations.[33] Timur Kuran noted[34] that the need for a long-term corporate-type legal structure to house the mosques and schools, among others, existed in the Islamic world. While Europe adopted the corporation, the Islam adopted the *waqf*. The choice was successful in some respects but did not easily suit commercial and business activities.[35]

There was a "dazzling variety of waqfs," dedicated to a variety of uses.[36] The *waqf* was based on the concept of a trust in Roman law. Muslims may have selected it over the corporation perhaps because "the waqf accords with Islam's communal vision," and indication of "generosity and prestige," as well as self-interest in providing money for the "founder and his family." By appointing the founder as the "mutawalli (manager-trustee)," collecting salary for himself and his relatives, and appointing his successors, the *waqf* allowed "bypassing Islam's inheritance regulations" and protected the trust assets from expropriation.[37] "[W]aqfs were designed as inflexible in order to mitigate the agency problem inherent in delegating implementation of the founder's instructions to successive individuals liable to divert assets to their own uses. . . . The 'static perpetuity' principle of the waqf emerged, then, as part of an implicit social bargain between rulers and the owners of private property."[38] The result of this objective, however, was to limit the use of *waqf* for commerce and trade in its assets, and thus it was an inefficient mechanism for trade.

"The early universities of Europe, such as Paris (1180) and Oxford (1249), were founded as trusts resembling the waqf. But they quickly became

31. *Id.* ¶ 2278.

32. *Id.* ¶ 2279.

33. See Islamic Laws ¶¶ 2685–2702, http://www.al-islam.org/laws/waqf.html (last visited Feb. 27, 2009) (governing *waqfs*).

34. Timur Kuran, *The Absence of the Corporation in Islamic Law: Origins and Persistence*, 53 AM. J. COMP. L. 785 (2005).

35. See *Id.* at 799–802.

36. *Id.* at 799 (citing 1 IBN BATTUTA, THE TRAVELS OF IBN BATTUTA (A.D. 1325–1354), esp. 64–65, 148–49 (Hamilton A.R. Gibb ed., 1958); 2 IBN BATTUTA, THE TRAVELS OF IBN BATTUTA (A.D. 1325–1354), esp. 450 (Hamilton A.R. Gibb ed., 1962)).

37. *Id.* at 800.

38. *Id.* at 801.

self-governing and self-renewing organizations through incorporation."[39] For our purpose it is important to note the ancient origin of the institution of trust, its positive commitment to God and community, and its flip side, of enabling the trustees to benefit at the expense of the beneficiaries, with the support of the civil rulers and the law.

3. Remedies

It seems that the Sharia law deals with entrustment (deposit); the depositors are not liable for damage to entrusted property unless they are negligent or breach their duty of loyalty (trespass), which involves misappropriation of the entrusted property. Finally, a relationship whose terms provide for violation of Islamic law is not allowed,[40] and presumably is not enforceable. This rule is similar to a rule that agreements in violation of the law are not enforceable.

E. JEWISH LAW

1. Agency and Business Organizations

"Fiduciary duties in the biblical tradition begin in the Genesis creation account. The human mission on earth is to be a fiduciary, a steward of God's and other's property. Israel is a fiduciary. So is Jesus Christ... [A]fter creating the world, God appoints man and woman as agents. They steward the world, exercise dominion, and are fruitful."[41]

It has been suggested that the origins of agency law are the "use" or "trust," which defined the fiduciary duties, such as the duty of loyalty and care. In business associations, employees, partners, officers, and sometimes directors are considered agents. "Many cases and commentators in the 1800s identified an agent's 'trust-like' and equitable fiduciary duties" (e.g., the duties of loyalty and care).[42]

Agency, like all fiduciary relationships, poses the problem of entrusting power while maintaining control to prevent its abuse.[43] An agent for a for-profit

39. *Id.* at 803 (footnote omitted).

40. *See* Shaykh Yusuf Talal DeLorenzo, *Shari'ah Compliance Risk*, 7 Chi. J. Int'l L. 397, 405 n.14 (2007) (noting that certain contracts ("nominate contracts") are specifically mentioned; other contracts are allowed if not contrary to Islamic law) (citing Wahba al-Zuhayli, 4 al-Fiqh al-Islami wa Adillatuh 242 (Dar al-Fikr 1989)).

41. Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 Quinnipiac L. Rev. 61, 87 (2004) (footnotes omitted).

42. *Id.* at 100–01; see also Michael B. North, Comment, *Qui Facit Per Alium, Facit Per Se: Representation, Mandate, and Principles of Agency in Louisiana at the Turn of the Twenty-First Century*, 72 Tul. L. Rev. 279 (1997).

43. Harrison C. White, *Agency as Control*, *in* Principals and Agents: The Structure of Business 188 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (In Jewish law, an

corporation has a duty to maximize the principal's profits.[44] This idea is remindful of Hammurabi's laws. An agent may deviate from profit maximization only if the principal clearly directs the agent to do so.[45] Therefore, generally an agent may not act to promote a socially desirable cause, unless it also maximizes the principal's profits.[46] Further, the law provides for the agent's identity with the principal's interests: "a man's agent is like himself." A principal can generally do through a representative anything that the principal could do in person.[47] These rules are quite similar to the current American rules of agency.

As to partnership and corporations, most Jewish law authorities "characterize a corporation as partnership."[48] Actors for a corporation serve as agents for the partners. Agents "must act in the manner desired by" the partners, or principals.[49] These rules, too, are similar to the current rules in the United States.

2. Advisory and Other Fiduciary Relationships

The Bible states "You shall not curse the deaf nor place a stumbling block before the blind; you shall fear your God—I am your Lord."[50] "The blind was interpreted to include ignorant and unknowing. . . . Thus, one should not advise another party that it is in his interest to sell his field in order to buy a donkey, when his true intention is to buy the field for himself. By concealing the ulterior motive of his advice, he has violated the principle. . . ."[51] "Accountants and auditors that are not careful with financial statements and thereby mislead others,

agent is known as Shaliah, or "one who is sent," and the sender is known as the Sholeah, or "one who sends."). *See also* Israel Herbert Levinthal, *The Jewish Law of Agency*, 13 Jewish Q. Rev. (n.s.) 117, 125 (1922). Agency relationship is called Shelihut, which can mean agency.

44. Steven H. Resnicoff, *Jewish Law and Socially Responsible Corporate Conduct*, 11 Fordham J. Corp. & Fin. L. 681, 691–92 (2006).

45. *Id.*

46. *Id.*

47. Israel Herbert Levinthal, *The Jewish Law of Agency*, 13 Jewish Q. Rev. (n.s.) 117, 133 n.486 (1922).

48. Steven H. Resnicoff, *Jewish Law and Socially Responsible Corporate Conduct*, 11 Fordham J. Corp. & Fin. L. 681, 691 (2006) (authorities differ on the identity of the partners. They view as partners all shareholders or those with voting rights as partners or controlling shareholders).

49. *Id.* at 691–92.

50. Leviticus 19:14, cited in Hershey H. Friedman, PhD, *Placing a Stumbling Block Before the Blind Person: An In-Depth Analysis*, © 2002, http://www.jlaw.com/Articles/placingstumbling.html (last visited Oct. 21, 2009).

51. Midrash Sifra, Leviticus 19:14, cited in Hershey H. Friedman, PhD, *Placing a Stumbling Block Before the Blind Person: An In-Depth Analysis*, © 2002, http://www.jlaw.com/Articles/placingstumbling.html (last visited Oct. 21, 2009).

e.g., investors or creditors, are guilty of violating this principle."[52] They may be liable for breach of a fiduciary duty for non-disclosure to investors.[53]

F. INFLUENCE OF MORAL THEMES AND RELIGION

1. Moral Themes

The laws of Hammurabi regulated the interest rate imposed on borrowers. The rules did not prohibit charging of interest, as the Moslem and Catholic Middle Ages rules did. Rather, in 1750 B.C. the rules limited annual interest rates "to about 20% . . . for loans on silver and 33% on loans of grain."[54] Even though silver and grain are commodities it seems that at that time they represented money and charges in these commodities were subject to legal limits.[55]

There were rules concerning ownership of abandoned land. Hammurabi's Code contains a rule about abandoned land that has been used by another. If the landowner abandoned his land because of a misfortune, such as capture in battle, the landowner could reclaim the land upon his return.[56] This rule is based on a principle of fairness that disallows a person who did not pay for the land to benefit from the owner's misfortune.

Hammurabi's laws prohibited bribery.[57] After all, he was a successful ruler who seemed to fight against the corruption of his officers and managers. Further, Mesopotamian merchants were sensitive to ethical principles. A Mesopotamian letter, discovered in Ur, was written by a merchant that reminded another merchant "of the obligation of being a mar awelim[,] i.e., to adhere to certain ethical and social standards in business transactions."[58] "Very similar phrases can be found in the correspondence of the Old-Assyrian merchants . . ., such as . . . 'act as gentleman!', . . . [and] 'act according to your status as gentleman!'"[59]

Like most ancient laws, Hammurabi's Code consists of a series of statements, based on circumstances and not necessarily on principles. Its structure reflects the common law focus on court decisions and developing by analogy, in contrast to the civil law design by Code and focusing on legislation. Yet, Hammurabi's Code's introduction or preamble refers to the Gods in the Babylonian pantheon and recognizes the notions of good and evil; right and wrong. The Code reflects a desire to protect the weak and the oppressed, and the mission "to further the welfare of the people."[60] The themes of fairness, prohibition of corruption, ethical behavior, and consideration of the common good reverberate in this ancient fiduciary law.

2. Influence of Religion

Mary Szto notes that fiduciary duties have both "religious and secular roots." The mission of a human is to serve as a fiduciary, "a steward of God's."[61] "Within this creative-redemptive-consummative framework, business people in the Bible have fiduciary duties to God and others.[62] . . . In Christian theology, Christ is the perfect fiduciary. He is the selfless steward who lays down his life for others."[63]

The parties' freedom to design their relationships as they wish is recognized in the Sharia, subject, however, to the rules of the Koran.[64] For example, the

52. Hershey H. Friedman, PhD, Placing a Stumbling Block Before the Blind Person: An In-Depth Analysis, © 2002, http://www.jlaw.com/Articles/placingstumbling.html (last visited Oct. 21, 2009).

53. Bloor v. Dansker (In re Investors Funding Corp. of N.Y. Sec. Lit.), 523 F. Supp. 533 (S.D.N.Y. 1980).

54. Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act,* 55 FLA. L. REV. 807, 815–32 (2003).

55. In the Hebrew language the word for money and silver is "Kessef." It seems that Kessef is a garbled version of Keves—sheep, which were used as a standard money measure.

56. The quoted materials are translations, derived from a text on Google, summarized and edited. The Code of Hammurabi (L.W. King trans., Richard Hooker ed., 1996), *available at* http://www.wsu.edu/~dee/MESO/CODE.HTM (last visited Aug. 26, 2007).

57. Philip M. Nichols, *The Fit Between Changes to the International Corruption Regime and Indigenous Perceptions of Corruption in Kazakhstan,* 22 U. PA. J. INT'L. ECON. L. 863, 876 n.38 (2001) (proscription of public bribery existed in "the most ancient laws" such as the Code of Hammurabi and the Edict of Harmab) (citing The Code of Hammurabi 4 (Robert F. Harper trans., 1904); JAMES HENRY BREASTED, A HISTORY OF EGYPT: FROM THE EARLIEST TIMES TO THE PERSIAN CONQUEST 405–06 (2nd ed. 1919)).

58. A.L. Oppenheim, *The Seafaring Merchants of Ur,* 74 J. AM. ORIENTAL SOC. 6, 12 (1954).

59. *Id.* at 12–13.

60. Nelson P. Miller, *The Nobility of the American Lawyer: The Ennobling History, Philosophy, and Morality of a Maligned Profession,* 22 T.M. COOLEY L. REV. 209, 275–77 (2005).

61. Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context,* 23 QUINNIPIAC L. REV. 61 (2004).

62. *Id.* at 87.

63. *Id.* at 88.

64. See Ahmad E. Nassar, *Developments, The International Criminal Court and the Applicability of International Jurisdiction under Islamic Law,* 5 CHI. J. INT'L L. 587, 591 (2003) (noting freedom of contract in Islamic law) (citing YUSUF AL-QARADAWI, THE LAWFUL AND THE PROHIBITED IN ISLAM (Al-Halal Wal-Haram Fil Islam) 136–41 (American Trust 1999) (Kamal El-Helbawy, M. Moinuddin Siddiqui, and Syed Shukry, trans., reviewed by Ahmad Zaki Hammad)).

agreement may not involve a prohibited payment of interest on a loan.[65] The prohibitions of Koran rules may not be waived.[66]

A major theme in Jewish law is the morality of activities. Jewish law forbids a person from harming another, either directly or indirectly. In addition, a person must take steps to make sure that no injury is caused by himself or others.[67] A person is forbidden from aiding others or allowing others to violate Jewish law and must take affirmative actions to prevent others from violating the law.[68]

These rules apply to professionals who, under secular law, may be judged by a different set of morals.[69] Lawyers, for example, may not assist their clients in wrongful actions. In such cases they may be bound to reveal their clients' confidences, because the lawyers' responsibilities to their clients do not trump their preexisting duties to protect prospective victims.[70] Arguably, Jewish law forbids a corporation from doing business with a corrupt government, because by doing so the corporation would be aiding corruption or allowing corruption to happen.[71] Agents do not escape these rules. Agents may not justify a violation of Jewish law by claiming that they were acting as agents for others.[72]

Thus, Hammurabi's rules, Christian, Muslim, and Jewish law all deal with people who provide others with services, and in order to provide these services must control other people's assets or money or influence others in significant ways. All these legal systems introduce themes of morality, ethics, reliability, and trust as well as barriers to negligence and dishonesty of the fiduciaries.

G. ROMAN LAW

1. Agency[73]

Roman law demonstrates another aspect of fiduciary rules. It is the use of fiduciary law to circumvent rigid legal rules that are either unfair or do not respond to a new evolving environment. Roman slavery law posed a problem for slave owners who wished to use their slaves' abilities to shop and bargain. Slaves could

65. *See* Islamic Laws ¶ 2063(iv), http://www.al-islam.org/laws/transactions1.html#2063 (last visited Feb. 27, 2009) (prohibiting "[a]ny transaction which involves interest").

66. Maurits S. Berger, *Conflicts Law and Public Policy in Egyptian Family Law: Islamic Law Through the Backdoor*, 50 AM. J. COMP. L. 555, 571 (2002) (citing authorities).

67. Steven H. Resnicoff, *Jewish Law and Socially Responsible Corporate Conduct*, 11 FORDHAM J. CORP. & FIN. L. 681, 685 (2006).

68. *Id.* at 686.

69. *Id.*

70. *See id.* at 686–87.

71. *Id.* at 686.

72. *Id.* at 688.

73. *See generally* DAVID JOHNSTON, THE ROMAN LAW OF TRUSTS (1988).

not enter into binding contracts because they were considered property rather than persons. How, then, could slaves bargain and conclude contracts for their masters in the masters' absence? The solution was to render the slave transparent by allowing the slave to bind the master to legal obligation, even though the slave himself was incapable of entering into a binding contract.

Modern agency law has retained an aspect of Roman law. Today, agency is defined as: "the fiduciary relation, which results from the joint manifestation of consent by one person that another shall act on his behalf and subject to his control, and of consent by that other so to act."[74] The agent has the power to bind another person to legal obligations, generally, without binding himself.[75] Liability for the obligations that he undertook for the master will be imposed on the agent only in special circumstances. He binds both the party with whom he negotiated and his master to a legal obligation, while he himself is not liable for these obligations (with some exceptions).

2. The Trust

Roman fiduciary law may have risen as a reaction to the laws of property and inheritance.[76] "Roman law developed the fideicommissum [and] fiducia [that] allowed fiduciaries to hold property [for others]." The *fideicommissio*, or trust, permitted Roman testators to leave property to a beneficiary who could not otherwise inherit the property, such as a criminal or a foreigner. The testator would leave a legacy to a legally qualified beneficiary. His obligation to obey the request was moral.[77] Thus, Roman law recognized situations in which ownership was held in "suspended animation." It is ownership in the hands of persons who seem to be the owner, and may even act as owners, but who were not the true owners. Like agents, described below, these persons could deal with specific property but had to act in accordance with the requirements of the previous (and future) true owners. The rights and duties of the creditors that held the collateral were similar to those of modern trustees.

74. Nelson v. Serwold, 687 F.2d 278, 282 (9th Cir. 1982) (citing Grace Line, Inc. v. Todd Shipyards Corp., 500 F.2d 361 (9th Cir. 1974); RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958)); see also RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). "The agent acts for or on behalf of the principal. . . ." 687 F.2d at 282 (citing NLRB v. United Brotherhood of Carpenters, 531 F.2d 424 (9th Cir. 1976)); see also RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

75. *See, e.g.*, Griffin v. U.S., 588 F.2d 521, 528 (5th Cir. 1979) (stating that "an essential characteristic of an agency is the power of the agent to commit his principal to business relationships with third parties").

76. Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 QUINNIPIAC L. REV. 61, 89 (2004).

77. *Id.* (also, because a creditor, who received collateral from a debtor, had to return the collateral upon payment, the creditor was prohibited from selling the collateral).

3. Business Organizations

Henry Hansmann, Reinier Kraakman, and Richard Squire[78] discuss the commercial forms of organizations that developed in Rome. One form of organization was the *societas* (partnership)—an agreement to share profits and losses. However, unlike in the modern partnership, partners were not the agents of each other and were not jointly and severally liable for all the partnership debts. They were liable only on a pro rata basis for the partnership's losses. In addition, the *societas'* assets were not distinguished from the assets of its members.

Another organizational structure in Roman law was the *familia* (family)—an entity composed of "the oldest living male in the male line of descent" (*pater familias*), his children and slaves, and his adult male descendants and members of their households. The *pater familias* formally owned entity property, but members were liable for debts incurred on behalf of the entity.

The *peculium* was an organization consisting of assets provided by a master to a slave for business use. The master was the formal owner of the asset, and was liable as owner for the *peculium* debts, but only up to the *peculium* value and any distributions that he received. However, it is believed that the *peculium* assets were not protected from the master's creditors.

There was also an organization called *societas publicanorum*. This entity invested in public contracts. The lead-investor pledged personal assets as security. General partners had control over the business and were personally liable for entity debts. Limited partners had no control, and had limited liability. It is believed that limited partners in large *societates publicanorum* were trading their interests, and that the entity's assets were protected from the limited partners' creditors.[79]

These ancient structures and rules demonstrate the roots of many of the current forms of organizations and rules of fiduciary law. These old forms and rules aimed at objectives that are similar to the current objectives: Encouraging commerce and finance that required a high degree of trust by rules that are appropriate for the period.

H. HIGH MIDDLE AGES

1. Agency

Historically, agency law is a solution to the problem "of how to attain and maintain control over another person in the performance of the person's service. Rules establishing the extent of the master's liability for the wrongdoing of his

78. Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1356–61 (2006) (summarized).

79. *Id.*

agent and cases in which the agent exceeded his authority existed throughout the ages and to this day, adjusted to the period.[80] For example, in early England the

> servant was a member of the family or of the mercantile household . . . The father of a family was, as a matter of course, the master of all those rendering services for it, including the minor children. But as England became a mercantile country . . . the unity of the family or other organization was frequently lost. It became more and more difficult to apply to all those who participated in the work the fundamental fiction that "he who acts through another acts for himself" . . . The conception of the master's liability to third persons appears to be an outgrowth of the idea that within the time of service, the master can exercise control over the physical activities of the servant.[81]

Consequently, the rules of agency changed to spell out the conditions under which the master would be liable for the agent's actions, and the extent to which the agent would be liable for his actions.

2. Partnership

During the High Middle Ages, Europe "emerged from manorial society and developed commercial trading markets and organizations to respond to the pressures of rapid urbanization and a world that now stretched beyond the local village."[82] But the villages' customary law followed the villagers.[83] At the same time, throughout the Middle Ages, the Catholic Church had great influence, serving to create social and legal norms.[84] "Canon law provided the normative framework for canonists and theologians, and together with the comprehensive Roman law formed the foundation" of the new, separate discipline of law.[85] The ecclesiastical courts claimed "virtually limitless" jurisdiction[86] and hence became the courts for the merchants as well.[87]

80. Cavic v. Grand Bahama Dev. Co., Ltd, 701 F.2d 879 (7th Cir. 1983); Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049 (2007).

81. RESTATEMENT (SECOND) OF AGENCY § 219 cmt. a, at 482–83 (1958); see also RESTATEMENT (THIRD) OF AGENCY § 2.04 cmt. b, at 140 (2006).

82. Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 CARDOZO L. REV. 215, 229 (2004) (citing 1 SCOTT ROWLEY, THE MODERN LAW OF PARTNERSHIP 1–6 (1916)).

83. *Id.* at 220–21.

84. David J. Gerber, *Prometheus Born: The High Middle Ages and the Relationship Between Law and Economic Conduct*, 38 ST. LOUIS L.J. 673, 683–84 (1994); Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 CARDOZO L. REV. 215, 222 (2004).

85. Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 CARDOZO L. REV. 215, 222 (2004) (footnote omitted).

86. *Id.* at 222 (citing THEODORE F. T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 271 (2d ed. 1936)).

87. *Id.* at 223.

The traders' need to cooperate brought about partnership law. Medieval Europe based its partnership law on Roman law.[88] However, the Church had reservations in accepting this partnership form (*societas*)[89] because this relationship served to circumvent the prohibition on usury. Partnership could include investing partners that contributed only capital but no labor, and received profits, being "money partners," like lenders.[90]

In Roman law, a *societas* was created for the members' certain rights of fraternity. It could not exist unless all partners were exposed to equal burdens and risk of losses.[91] Membership in the fraternity determined the partners' fiduciary duties.[92] Partners had to "share[] loss and gain in proportion to their contributions"[93]; they "were liable in common for harm done in the conduct of partnership business"[94]; partners "owed each other a duty of forthcomingness." And if a partner withheld the partnership's profit and used it for his benefit "before restoring it to the common fund," he had to "pay his partner for the damages caused by this delay."[95] Finally, while Roman law "limited [partners'] money liability to [their] capital investment, the . . . partnership form of the canonists allowed partners to bind each other to contracts (a fiduciary model)."[96]

The church imposed its historical communal values on economic and market organizations.[97] For example, following church law's prohibition on charging interest, the Church prohibited business partners from breaching their duties,[98] imposed communal values of justice and fairness on the international trading community,[99] disallowed "disproportionate allocations of risk or profit," and limited "a partner's liability at the expense of other partners, self-dealing in the distribution of partnership profits, and binding partners to contracts outside the scope of the partnership."[100] All these rules and underlying values are prevalent in fiduciary law today, although, as we shall see, there are arguments that the time has come to ignore them.

88. John T. Noonan, Jr., The Scholastic Analysis of Usury 133 (1957), cited in Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 Cardozo L. Rev. 215, 230 (2004).

89. David J. Gerber, *Prometheus Born: The High Middle Ages and the Relationship Between Law and Economic Conduct*, 38 St. Louis L.J. 673, 703 (1994) (The prohibition on usury was not, in the opinion of the writer, the main reason for the rise of partnership, even though that prohibition was considered "the single most important economic conduct norm during this period and for centuries afterward.").

90. John T. Noonan, Jr., The Scholastic Analysis of Usury 134 (1957), cited in Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 Cardozo L. Rev. 215, 229–30 (2004).

91. *Id.* at 231 (quoting John T. Noonan, Jr., The Scholastic Analysis of Usury 141 (1957) (citing R. H. Tawney, Introduction to Thomas Wilson, A Discourse Upon Usury 128 (2d ed. 1963 (1925)).

92. Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 Cardozo L. Rev. 215, 232 (2004).

93. Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 Cardozo L. Rev. 215, 232 (2004) (quoting John T. Noonan, Jr., The Scholastic Analysis of Usury 147 (1957)).

94. *Id.* (quoting John T. Noonan, Jr., The Scholastic Analysis of Usury 134 (1957)).

95. *Id.* (quoting John T. Noonan, Jr., The Scholastic Analysis of Usury 106 (1957)).

96. Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 Cardozo L. Rev. 215, 232 (2004).

97. *Id.* at 233.

3. The "Reliable" or "Trusted Person" Relationship Regulated Under the "Salic Law"

Other forms of fiduciary relationships developed very early, subject to useful rules. "Salic law influenced [the] development of the use" in England. Under Sixth century Salic law, a trusted person (Salman or Treuhand) could become a trustee by receiving "property from a grantor on behalf of beneficiaries. Usually grantors held on to their property until death and the Salman transferred the grantor's property after the grantor's death," although he might not have been legally required to do so.[101]

4. The "Use" and "Trust" in Medieval England

The "use" dates from about the Ninth century, and was influenced by the doctrine of *utilitas ecclesiae*.[102] The "use" and its attendant fiduciary rules developed in England during the Middle Ages to address specific problems. For example, vows of poverty prohibited Franciscan Friars from owning land. Therefore, charitable persons transferred houses to trusted persons for the use of the Friars. The trusted persons were bound by good conscience to devote the houses they legally owned, to the exclusive use of the beneficiaries. The trusted persons' duties constituted a social practice, which the equity courts enforced on the grounds of trust and confidence related to good conscience.[103] The Middle Ages

98. *Id.*

99. *Id.*

100. *Id.*

101. Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 Quinnipiac L. Rev. 61, 93–94 (2004) (footnote omitted).

102. *Id.* at 93. The term "ad opus" in 9th century England "referred to a fiduciary relationship in favor of a beneficiary with no legal enforcement." The term "use" was drawn from Gallic "*al os*" and "*ues*" in the Laws of William the Conqueror and the Domesday Book and became "use." In addition, the French term "*cestui a qui oes le feffement fut fait*" became "*cestui que use*," a term for a beneficiary. Thus, the use was drawn from secular sources (Roman and Salic law) and religious sources (including the Franciscans, who popularized it).

103. J.H. Baker, An Introduction to English Legal History 284 (3d ed. 1990); *see* Michael Walzer, Spheres of Justice: A Defense of Pluralism and Equality 9 (1983) ("Social meanings are historical in character. . . .").

Church doctrine of *utilitas ecclesiae* allowed clerics to possess stewardship or beneficial ownership of church property for personal use, but prevented the passing of the property to the clerics' relatives after the clerics' death.[104]

The "use" allowed owners to circumvent legal burdens. For example, by transferring the legal title to their property the owners could avoid paying the dues to their "lord." Similarly, if the holders committed certain offenses they might try to avoid the forfeiture of their property by transferring title to third parties. Debtors could do the same to avoid repayment of their debts, while they continued to use the property. In addition, one could transfer a "use" without publicity, as required by transfer of legal title.[105] The "use" came to an end in 1535 under the Statute of Uses,[106] converting all "uses" into legal estates. The true owners lost the right to their property.

I. RECENT U.S. HISTORY

Corporate Law

As private corporations became more dominant in the United States economy by the late nineteenth century, corporate law generally developed to allow corporations and their management more freedom to act.[107] As some states prohibited investments of state assets in private corporations, corporations sought private capital to expand. The market for private capital was largely unregulated, and some promoters cheated shareholders and their lawsuits brought about new doctrines. Corporate case law borrowed from trust law. Officers and directors were analogized to trustees, prohibited to engage in self-dealing and required to account for illicit profits.

Corporate law adopted fiduciary principles that derived from trust law. However, corporations are different from trusts. Corporate managers have the power to direct corporate use of assets but do not have the legal ownership of the assets.[108] Further, corporate managers have more discretion to deal with corporate assets than trustees do because the objectives of corporations are open-ended, while those of trusts are usually more specific and can be described in the trust documents.[109]

104. Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 QUINNIPIAC L. REV. 61, 92 (2004) (footnotes omitted).

105. *Id.*

106. F.W. MAITLAND, EQUITY: A COURSE OF LECTURES 34 (1936).

107. LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 446–52 (1973) (summarized).

108. *Id.*

109. *Id.* at 880–81 (footnotes omitted).

Thus, in an 1891 case, directors and officers purchased stock at par value, knowing that the stock was worth far more. The Kansas Supreme Court held that "[t]he officers and directors of a corporation are trustees of the shareholders, and in securing to themselves an advantage not common to all the stockholders, they commit a plain breach of duty."[110] In an 1889 case, the officers and directors of a bank neglected to supervise the bank's affairs while the bank sustained losses by fraud and improvident loans. Holding the bank officers and directors personally liable for the losses, the Virginia Supreme Court stated: "The high degree of confidence and responsibility resting upon directors of corporations has often led the courts to regard them as trustees, and to declare the relationship existing between them and the stockholders to be that of trustees and cestuis que trust [entrustor], respectively."[111] Yet, the adoption of fiduciary duties in corporate law may have been insufficient to prevent abuses. Lawsuits were expensive; often the corporation or the director or officer had no assets to satisfy the judgment.[112] Hence, States began to pass stricter corporate laws, and federal legislation passed the securities laws. However, doctrinally little has changed. In *The Law of Fiduciary Duty in New York, 1920–1980,* William E. Nelson concluded that fiduciary law of the 1980s did not differ much from that of the 1920s, although the context of the law has broadened to include public policy considerations.[113]

J. THE DEBATE

Arguably, ancient laws should not be resurrected in modern society. Even if the needs of humans were similar, societies were fundamentally different. The confusing rules of the past need not be left alive in the present. Today we have transportation, markets, automated instantaneous information, and connections with the world that did not exist in Hamurabbi's time. Even though we follow religions they do not play the role that was played in the middle ages.

In ancient times, agents and principals may have balanced the benefits and losses from the relationships differently than they do today. Yet, at all times, the balance has followed similar needs and incentives; and the law has offered similar guidelines, reflecting similar objectives. Laws balanced the discretion and freedom, which fiduciaries needed to perform their services, and the trust which

110. Ark. Valley Agric. Soc'y v. Eichholtz, 25 P. 613, 613 (Kan. 1891) (upholding an equitable injunction).

111. Marshall v. Farmers' & Mechs.' Sav. Bank, 8 S.E. 586, 589 (Va. 1889).

112. *See* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 446–52 (1973).

113. William E. Nelson, *The Law of Fiduciary Duty in New York 1920–1980,* 53 SMU L. REV. 285, 285 (2000), LEXIS, Lawrev Library, Smulr File (the author noted that "[n]o explicit changes in doctrine occurred over the course of the century in the black-letter law of fiduciary duty.").

they must command, against the fiduciaries' temptations to abuse the entrusted property or discretion and trust. These two conflicting drives lead to fiduciary rules. For example, ancient law required an agent to guarantee the principal's profits on the one hand, and relieved an agent of all liability in the case of non-negligent loss, on the other hand. The context of Muslim law was less commercial, and the division of power, liability, and trust differed from the same issues in other contexts. Yet, overlaying all rules is a theme of morality and fairness—protection of entrustors from serious injury from the relationship. And while law may have been rigid, strict and specific, the roots of ancient and religious laws have permeated fiduciary law, and have not relinquished their hold even today.[114]

Roman law demonstrates another strand of fiduciary law which enables the actors to circumvent rigid laws by installing a third party to "stand in" for the real party. Both in England and in Rome fiduciary rules were used to circumvent the strict laws of inheritance. Fiduciary relationships were used for honorable purposes, such as taking care of a daughter's security (even against a husband) or taking care of land while the owner went to fight a holy war. Fiduciary relationships were also used for less admirable purposes, such as circumventing tax laws and other laws. This duality exists today. The King of England resolved circumvention of his laws by prohibiting fiduciary relationships altogether. The modern solutions are less drastic. The courts often determine whether fiduciary relationships are in violation of public policy or perpetrate deception and allow some such relationships while prohibiting others.[115]

Culture and social mores affect both the substance and the classification of law. In the opinion of some authors, by comparing standard contract practices, one can observe "the level of trust inherent in a given society: its store of social capital [and] help determine how parties to a commercial transaction will" behave toward each other. Contract terms in "a low-trust environment . . . may be comparatively inefficient" even in large transactions.[116] Contract terms in the United States and South American countries, for example, can reflect the "relationship between trust, social capital, and the normative and behavioral presuppositions of different legal traditions and how they may reinforce or help rationalize alternative contract practices."[117]

114. Note that Muslim Sharia rules have spawned current banking and investment laws and a governing supervisory body to approve or disapprove compliance with the religious law. *See* Rushdi Siddiqui, *Shari'ah Compliance, Performance, & Conversion: The Case of the Dow Jones Islamic Market Index*, 7 Chi. J. Intl. L. 495 (2007).

115. *See* Chapter 6.

116. Ruben Kraiem, *Leaving Money on the Table: Contract Practice in a Low-Trust Environment*, 42 Colum. J. Transnat'l L. 715 (2004).

117. *Id.*

Similarly, "[a]mong the obligations of the Japanese to each other is the duty to forebear from exploiting the vulnerabilities of (Japanese) partners. The mutual expectation of such forbearance is trust, and in those few and fortunate places where historically there happens to exist a culture of trust, that culture, by definition, protects the dealings of those it embraces from the shadows of opportunism that normally darken transactions among the mutually vulnerable."[118]

I close this very short debate by repeating the introduction to this chapter. Human nature and interaction, circumstances that require trusting and trustworthiness, and the intervention of society's rules to prevent harm to society, follow a similar path. Fiduciary law is not a unique and modern invention. It has ancient roots reflecting moral, ethical, legal, and social needs to maintain societies, help humans rely on each other, and live.

118. Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 Colum. L. Rev. 267, 306 (1998) (footnotes omitted) ("From another perspective, the peculiarities of the Japanese were institutional.").

3. THE DUTIES OF FIDUCIARIES

A. INTRODUCTION

1. Much Is About Human Nature

Like most legal rules, fiduciary duties are based on assumptions about human nature and past experience of human behavior. It turns out that some persons, who are entrusted with property or power for the purpose of serving and benefiting others, are tempted to benefit themselves or other than the entrustors, especially when there are no police around. Further, some fiduciaries may fail to perform the services they promised in a reasonably expected way, or to follow the instructions that they received with respect to the use of entrusted property or power.

Three major mechanisms limit the temptations of humans to benefit by harming and deceive others. One is ethics or morality—imposed self policing—which leads fiduciaries to do the right thing, as their society defines it. A second mechanism is policing imposed and enforced by law, which deters fiduciaries from abusing the trust in them by threat of punishment. The third mechanism is the other parties, the entrustors, individually or together through organizations and the markets, that protect themselves from the fiduciaries' ability to succumb to temptations. The balance between these three mechanisms and the definition of what the "right thing" is, depends to a great extent on the society's culture, institutions, and values. Thus, the level of legal intrusion into fiduciary relationship depends in part on whether and the extent to which, morality on the one hand and the entrustors themselves and the markets, on the other hand, prevent fiduciaries from violating their entrustment. The more effective these preventive mechanisms are, the less intrusive the law should become. The less effective the preventive mechanisms are, the greater the intrusion of the law should be.

During the past thirty years, the balance between morality, law, and entrustors' self-protection has shifted. During these years the role of morality has been reduced. American culture has drifted toward fiduciaries' and entrustors' self-interest. More persons believed that if everyone acted for their own benefit, society as a whole would richly benefit as well. In addition, there is no limit to the benefits which everyone should seek. The more benefit everyone sought for himself or herself, the better off everyone and society will be. Hence the word "greed," which used to denote despicable insatiable hunger, has lost much of its negative aura. "Greed is good," half-jokingly uttered, does not degrade the person who

utters it. Accompanying this movement were pressures to degrade the law and let self-protection take its place. If people should seek benefits for themselves, they must also protect themselves from everyone else who seeks benefits for themselves. And regardless of people's assurances, one should watch one's back for possible breach of these assurances. Hence entrustors and the markets, assisted by legally required information, should deter abuse of entrustment. It has taken a financial and economic crisis of some magnitude to bring the law and government back into better focus. But morality is still taking the back seat: money is presumed to be the main motivator of people, especially talented people, who seek power and money, such as corporate executives, physicians, and innovators.

As is the case in other areas of law, the design and even existence of fiduciary law is laced with considerations of policies, different views of various disciplines, and social culture. What is the level of trust (or mistrust) acceptable in a society? Under what conditions do entrustors seek verification to support their trust in their fiduciaries, without which entrustors would refrain from interacting with fiduciaries? What are the costs of legal rules and their enforcement for the parties and the taxpayers? What is the effect of abuse of entrustment on society's systems such as the economy, finance, or public interest, such as health? What is the extent to which the law can and should support self-protection by entrustors on the one hand, and enhance moral behavior by fiduciaries on the other hand? Most arguments about fiduciary rules relate to these questions. And even though the arguments are not unique to fiduciary law, they are relatively more prominent in this area of the law.

2. Fiduciary Law and Other Disciplines

Like other laws, fiduciary law can be viewed through the prisms of different disciplines, such as logic, economics, behavioral economics, psychology, history, and philosophy, to name a few. Drawing on another discipline, however, may result in legal rules that are based on the values of that discipline. Economic fiduciary law may be governed by costs and benefits, efficiency, and market values. Every environment can be viewed as a market, every service as a commodity and every actor as a trader. These, however, are not necessarily the values that should govern the law.

When a lawyer defends an accused that is arguably insane, the lawyer's guiding value is to determine the extent to which the accused is responsible for his acts: does he distinguish between right and wrong? Did the accused act under an uncontrollable impulse? The psychiatrist-expert's guiding value is to heal the accused. The economist's values are based on how much such healing will cost, as compared to not healing the accused or alternative healing. The sociologist may focus on the effect of the accuser's illness on society. And the pharmacist would ask about the kind and number of pills the accused may need. Legal liability is the lawyer's concern, as well as rules that balance social safety with the

accused's human rights. However, the lawyer does resort to the expert physician, seeking information that would help determine the accused's legal liability. In addition, lawmakers might consider the social and cultural costs of the accused's illness. They will seek a rule to maximize social benefits and minimize the disadvantages.

A multi-disciplinary approach helps evaluate fiduciary rules from various points of view to reach more optimal solutions for society. However, rules cannot be established without guidelines on how to determine the priority of law's purposes and balancing various purposes. So let's face it! In most cases the best rules for individuals and society require an imprecise, balancing decision, rather than a straightforward, clear adherence to the norms of one discipline (e.g., economics, or logic), and one social value. I do not attempt to reach the unreachable certain and comprehensive guideline for fiduciary law, or any other law for that matter. The purpose of the following discussion is to raise awareness that fiduciary law, like most, if not all, law, is imperfect and imprecise. Nonetheless, like most, if not all, law, fiduciary law points to problems, as imprecise as they are. It points to goals, as unattainable as they are, and to the roads that lead to their achievement.

B. FUNDAMENTALS

1. When Do Fiduciary Duties Arise?

Most fiduciary relationships arise with the consent of both parties to enter into the relationship, coupled with entrustment. But some fiduciary duties can arise before or after the parties entered into a clear relationship. In these cases the triggering point is entrustment. For example, if the parties agree on a future money management relationship, so long as the money is not entrusted to the manager the fiduciary part of the relationship may not have arisen. However, fiduciary duties can arise even before the parties agreed to enter the main relationship. For example, if preliminary discussions with fiduciaries involve disclosure of confidential information, fiduciary duties will arise with respect to misuse of this information. That is why under the common law and rules of professional conduct lawyers owe fiduciary duties to potential clients.[1] Similarly, investment advisers owe fiduciary duties to potential clients under the common law[2] as well

1. *E.g.*, Maritrans GP Inc. v. Pepper, Hamilton & Scheetz, 602 A.2d 1277, 1283 (Pa. 1992) ("Our common law imposes on attorneys the status of fiduciaries *vis a vis* their clients. . . ."); Model Rules of Prof'l Conduct R. 1.6 (2007) (confidential client information); *id.* R. 1.7–8 (conflict of interest); R. 1.18 (2009) (prohibiting the use of confidential information that is offered to a lawyer by a prospective client, and. restricting the lawyer from representing another client in a related matter).

2. *See* SEC v. Bolla, 401 F. Supp. 2d. 43 (D.D.C. 2003).

as the Investment Advisers Act of 1940.[3] It should be noted that entrustment of confidential information by itself may not give rise to fiduciary relationships and consequent legal liability on misuse. However, in some cases, such as when lawyers interview would-be clients, lawyers may be fiduciaries with respect to the information that they received.[4]

2. Fiduciary Duties Carry with Them an Aura of Morality

As compared to breach of contract, a breach of fiduciary duties carries a moral stigma and stricter legal consequences. For example, in bankruptcy proceedings a bankrupt fiduciary will be relieved of paying his contract creditors but will not be relieved from paying the debts to his entrustors (e.g., investors, or partners who financed his venture).[5] That is because a breach of fiduciary duties carries with it the stigma accompanying misappropriating (stealing) of entrusted property and misuse of entrusted power. Similarly, the U.S. Sentencing Guidelines[6] authorize a court to enhance the sentences for egregious crimes. Sentencing enhancement was applied to a person who for a number of years defrauded investors by using their money to cover his personal expenses.[7]

3. Standards and Principles Versus Rules

Fiduciary duties, like other legal duties, can be designed and expressed by standards and principles, or by specific rules, or by both. In addition, the duties relate to the benefits from fiduciary relationships to society as well as to the parties.[8] Statutory duties can be interpreted literally, or against the background of public policy underlying the legislation. Both bright-line rules and more general principles can be justified and criticized.[9] Bright-line rules comply with the "rule of law." This principle requires that the law be known, not secret or surmised.[10] Yet, bright-line rules may entice and enable more circumvention. In addition, such rules can be costly to the regulated and to the enforcing regulators as they might become very bulky in spelling out prohibited activities.

Fuzzy rules, expressed as standards and principles, may raise issues concerning the "rule of law." They leave a gray area that presents a risk of violating the law,[11] and possible "secret law." Yet, when the wrongfulness of the actions is highlighted by clear social disapproval or harm, the substance of fuzzy rules may be sufficiently clear. For example, the Delaware Supreme Court affirmed the judgment of the trial court's conclusion that the power of attorney that the defendant guardian was granted did not expressly permit the guardian to make gratuitous transfers. But the Supreme Court rejected the trial court's use of the bright-line test in making its decision, and remanded the case to the trial court on that ground.[12]

In addition, the very risk that fuzzy rules pose for fiduciaries could act as a deterrent to violating the law. After all, more people might then avoid coming close to the absolute bright line if they do not know where it precisely is. When the costs of enforcement are high, as they often are in most cases of fiduciary relationships, fuzzy rules help reduce enforcement costs by creating stronger deterrents to misappropriating entrusted property and power. In such cases fiduciary law rules are not necessarily fuzzy, but as applied to the variety of fiduciaries, the rules may be. Yet applying fiduciary law to particular relationships is justified when violations are tainted with immorality and breach of socially acceptable standards, and when enforcement of the rules is costly.

Different approaches to interpretation may depend on the substance of the law. A narrower reading of criminal law and tax law may be justified because people are presumed innocent of crimes and the imposition of taxes must be clear. In both cases people face the mighty government power. This approach is far less justified in the case of fiduciary law. Fiduciaries are less presumed honest, and holding entrusted property or power they are less helpless against the entrustors. In fact, the reverse is more often true, as the entrustors are far more helpless against the fiduciaries.

An issue derived from the argument about specificity relates to the search and discovery of legal loopholes. The arguments reflect different attitudes about the interpretation of the law. One interpretation takes into consideration the law's underlying policies. These are derived from explicit authorities and from the problems that the law is designed to solve, the reasons for the rules, and the

3. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2006).

4. *See* SEC v. Lyon, 605 F. Supp. 2d 531 (S.D.N.Y. 2009) (holding that a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information).

5. Lewis v. Scott (*In re* Lewis), 97 F.3d 1182 (9th Cir. 1996).

6. U.S. Sentencing Guidelines Manual §§ 3A1.1, 3B1.3, 5K2.0 (2007).

7. United States v. Iannone, 184 F.3d 214 (3d Cir. 1999); U.S. Sentencing Guidelines Manual §§ 3A1.1, 3B1.3, 5K2.0 (2007).

8. Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795, 825–27 (1983); Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad 146–49 (2006).

9. *See generally* Hans-Bernd Schäfer, *Legal Rules and Standards*, German Working Papers In Law and Economics (2002), http://www.bepress.com/cgi/viewcontent.cgi?article=1029&context=gwp (last visited July 16, 2009).

10. There is an extensive literature on the design of law and the difference and balance between standards and rules. *See e.g.*, Isaak Ehrlich & Richard Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. Legal Stud. 257 (1974); Pierre J. Schlag, *Rules and Standards*, 33 UCLA L. Rev. 379 (1985); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 Duke L. J. 557 (1992); Louis Kaplow, *A Model of the Optimal Complexity of Legal Rules*, 11 J.L. Econ.& Org. 15 (1995).

11. *But see* Ehud Guttle & Alon Harel, *Uncertainty Revisited: Legal Prediction and Legal Postdiction*, 107 Mich. L. Rev. 467 (2008) (suggesting situations in which specific rules might provide a greater deterrent than specific ones).

12. Schock v. Nash, 732 A.2d 217 (Del. 1999).

guiding standards of behavior.[13] Another view focuses on the words of the rules. The inquiry is to find out the meaning within the dictionary definition. Policies and problem-solving are for the legislatures. No extension of the meaning is justified.[14] These conflicting approaches to the law have not been resolved.[15] A middle ground may be a guiding rule that that if a loophole clearly conflicts with the policy which the law is designed to establish, the loophole is not permissible, regardless of the text. Clarity per se should not close the door to a broader inquiry for interpretation.[16]

C. THE MAIN DUTIES OF FIDUCIARIES

1. Introduction: The Structure and Characteristics of Fiduciary Duties

Fiduciary duties are linked to the definition of fiduciary relationships. The duties aim at reducing entrustors' risks. The first risk is posed by the entrustment of property or power to fiduciaries, and the fiduciaries' possible temptation to abuse the entrustment. The second risk to entrustors stems from possible faulty performance of fiduciaries' services. Entrustment and expert services are precisely the ones that benefit society. These are the actions entrustors are encouraged to take. Because fiduciary duties are designed to reduce the entrustors' risks from these actions, the duties reflect the magnitude of the risks. To these considerations fiduciary duties are calibrated by assumptions about entrustors' own ability to protect themselves and by alternative protections that are available to entrustors.

The following discussion divides fiduciary duties as:

- The duty of loyalty, relating to entrusted property and power.
- The duty of care, relating to the quality and care of fiduciaries' performance of their services.

Based on the duty of loyalty are a number of additional duties:

- The duty to follow and abide by the directives of entrustment with respect to the entrusted power or property.[17]
- The duty to act in good faith in performing fiduciary services.[18]

13. *See generally* Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to Be Construed*, 3 VAND. L. REV., 395 (1949).

14. *Id.*

15. *See, e.g.*, John S. Dzienkowski, *Positional Conflicts of Interest*, 71 TEX. L. REV. 457, 460 (1993).

16. *See also* Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 506 (1989).

17. *Infra* Chapter 3 D 1.

18. *Infra* Chapter 3 D 2.

- The duty not to delegate the fiduciary services to others.[19]
- The duty to account and disclose relevant information to the entrustors.[20]
- The duty to treat entrustors fairly.[21]

In addition, there are situations in which the relationship between entrustors and fiduciaries involves the terms of the fiduciaries' services, including benefits. Because they might exercise influence and control over their obligations and entitlements, fiduciary law limits their freedom to benefit themselves even when they are entitled to the benefit. Fiduciaries' compensation is one of the main topics in which this issue arises as discussed at the end of this Chapter.

2. The Focus of Fiduciary Duties

Fiduciary duties aim at reducing entrustors' risks in two main areas. The first area relates to the risk from the fiduciaries' misappropriation of entrusted property or power. The second area relates to entrustors' loss from the faulty performance of the fiduciaries' services. These services are usually expert and often hard to evaluate by non-experts. Yet, this risk is precisely the one that entrustors are encouraged to take. Therefore, the third part of fiduciary duties focuses on the assumptions about entrustors' ability to protect themselves and alternative protections that entrustors can enjoy.

D. THE DUTY OF LOYALTY

1. What Does It Mean to Be Loyal?

Among the synonyms of the word "loyalty" are the words "trustworthiness" and "faithfulness."[22] Thus, loyalty can be defined as a state of mind and a manner of behavior in which one person identifies with the other persons' interests. The person to whom another is loyal can rely, trust, and believe that the loyal person's interests identify with his own.

Loyalty is not required in business relationships. No contract party is obligated to be loyal to the interests of the other party. A faithful servant who works under a contract can be cast out at the end of the contract term when his usefulness has been exploited and a better servant or a servant at reduced costs is available. Yet many employers do not behave this way. They reward loyalty with loyalty. The faithful servant may be relegated to a lower position or be paid a sufficient

19. Because fiduciary relationships are personal, the rule limits the extent to which fiduciaries may delegate their services to others, with the exception of non-discretionary or other necessary help to the fiduciaries.

20. *Infra* Chapter 3 D 3.

21. *Infra* Chapter 1B.5.d.

22. Loyalty is not necessarily obedience. Obedience can be an external sign of loyalty, but loyalty may require disobedience to protect the object of the loyalty.

amount to retire. In arms' length transactions the law does not require loyalty or reward it. But there is an exception to this legal "hands-off" attitude with respect to the fiduciaries' loyalty to entrustors. Not surprisingly, however, the exception applies mainly to entrusted property or power, as opposed to other kinds of entrustments.

2. The Two Aspects of the Duty of Loyalty

The duty of loyalty takes two aspects. One aspect is a requirement that fiduciaries act for the sole benefit of the entrustors. After all, if the entrusted property or power does not belong to the fiduciaries it follows that the fiduciaries may not benefit from it, except upon the consent of the true owner or the source of his authority or the law. The other aspect of the duty of loyalty is a prohibition on fiduciaries from acting in conflict of interest with the interests of the entrustors (always in relationship to the entrustor property or power). In certain cases, the prohibitions extend to fiduciaries that put themselves in conflict of interest situations where none existed before, such as lawyers who accept new clients, whose interests conflict with those of existing clients.[23]

3. Preventive Rules

The duty of loyalty supports the main purpose of fiduciary law: to prohibit fiduciaries from misappropriating or misusing entrusted property or power. Thus, the duty of loyalty is manifested by important preventive rules.[24] Such rules prohibit actions even though they are not necessarily injurious to entrustors. These preventive rules act to dampen the fiduciaries' temptations to misappropriate entrusted property or power, or to justify benefitting themselves, and establish a continuous reminder that entrusted property and power do not belong to the fiduciaries.

The duties of loyalty are "related to, but distinct from, the duties of performance that an agent also owes to a principal. An agent's duties of loyalty also operate with consequences not captured by contract law and tort law principles, consequences that both define and reinforce a principal's entitlement to faithful service from its agents."[25] An agent violates his duty of loyalty by receiving benefits from a third party even if he serves the interests of the principal. Further, an agent may not represent two contracting parties because their conflicts of interests cannot be reconciled.[26] For example, fiduciaries are prohibited from buying entrusted property for their own account even at market price or even at a price higher than the market price, and even if the purchase saves the entrustor

23. Model Rules of Prof'l Conduct R. 1.6 (2007).
24. Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795, 824–25 (1983).
25. Deborah A. DeMott, *Disloyal Agents*, 58 Ala. L. Rev. 1049, 1067 (2007).
26. *Id.* at 1049 (2007). *See generally* William A. Gregory, The Law of Agency and Partnership (3d ed. 2001).

a broker's commission.[27] The prohibition applies even to trustees who are also beneficiaries, but acted to acquire additional power by acquiring a majority control of a corporation.[28] The Tenth Circuit held the trustee had an individual interest to acquire a majority control of stock, which disadvantaged the beneficiaries. A disinterested fiduciary would have acted to protect the interests of the beneficiaries. Fiduciaries are held to high standards of conduct. Because only a full inquiry would have determined if the trustee violated his fiduciary duty or acted in good faith with wise discretion, dismissal was improper.[29]

Presumably, this transaction can be repeated to create a bad habit of considering one's own interests as well as the entrustors' interests in relationship to the entrusted property. Similarly, there are two interesting trust rules that demonstrate the preventive principle. One rule requires trustees to earmark entrusted property, including acquired securities. Another rule prohibits trustees from commingling trust assets. These rules protect entrusted property in a number of ways.

These rules protect the property from the claims of the trustee's creditors by notifying the trustees' creditors that the trustees do not own the property except as trustee. The rules prevent trustees from investing trust property and waiting to determine whether the investment is successful (in which case they might be tempted to credit it to themselves).[30] In addition, earmarking and segregation of trust assets have a psychological effect. They help remind trustees every time they look at trust properties that the properties do not belong to them.[31] If trustees are tempted to "borrow" trust assets ("just for a few days") the earmarked properties look back at them to say: "Don't even think of it!"

However, efficiency can play a role in relaxing the rules. Thus, lawyers who hold clients' assets, and banks acting as trustees, are allowed to commingle entrusted assets that belong to many entrustors.[32] But they may not commingle trust assets with their own.

4. Examples of Conflicts of Interest

a. Physicians[33] In *Moore v. Regents of University of California*[34] the Court held that a physician who recommended surgery to a patient and at the same time

27. Brophy v. Cities Serv. Co., 70 A.2d 5, 7 (Del. Ch. 1949).
28. Wotton v. Wotton, 151 F.2d 147 (10th Cir. 1945).
29. *Id.*
30. 2A Austin W. Scott & William F. Fratcher, The Law of Trusts 508 (4th ed. 1987).
31. *Id.* at 508–09.
32. *See* Delta Pride Catfish, Inc., v. Marine Midland Bus. Loans, 767 F. Supp 951 (E.D. Ark. 1991) (commingling of funds of several beneficiaries does not destroy trust character of funds).
33. *See generally* Marc A. Rodwin, Medicine, Money, and Morals: Physicians' Conflicts of Interest (2009).
34. Moore v. Regents of Univ. of Cal., 793 P.2d 479 (Cal. 1990) (some citations omitted).

planned to use the unique cells of a patient's body for research and potential profit acted in conflict of interest. The conflict of interest continued when the physician ordered the patient to return to the physician's clinic for examinations and further extraction of body fluids, and again used the examinations to commercially develop the cells without disclosing this fact to the patient.[35] A similar conflict arises when the physician fails to disclose to the patient mistakes or health dangers. Arguably, physicians should be liable for "failing to disclose medical errors and other emergent medical risks to patients who are unaware of these developments."[36]

The conflict poses a concern that the physician's desire for acquiring a sufficient number of these unique cells and his hope for financial benefits might overcome the physician's commitment to the patient's health and well-being. Therefore, he may not perform the operation unless the entrustor-patient or an authorized person on his behalf consents to the operation after receiving from the physician full information regarding the conflict.[37]

The court distinguished between the kinds and degrees of a physician's conflicts of interest. One serious kind is recommending surgery while planning to use the patient's body cells to conduct research with a view to financial benefits. Other, less serious types of conflicts include shortening the patient's healing process in order to gain favor with the insurance company that pays the bills, or conducting unnecessary examinations to learn more about a patient's disease. Similar conflicts arise when physicians receive substantial financial rewards from large pharmaceutical companies to recommend that patients use the drugs or other products of those companies.[38] "Thus, knowledge, money, and perhaps additional reputation weigh on the side of conflict with the patient's well being and perhaps discomfort."[39]

Do physicians violate their fiduciary duties when they engage in sexual relationships with patients or with the patients' spouses?[40] In such situations as well, entrustment is the underlying factor. In *Long v. Ostroff*[41] the court held that the

35. *Id.*

36. Thomas L. Hafemeister & Selina Spinos, *Lean on Me: A Physician's Fiduciary Duty to Disclose an Emergent Medical Risk to the Patient,* 86 WASH. U. L. REV. 1167 (2009).

37. *See* Chapter 4.B. It may well be that the reluctance of the physician to make the disclosure was the concern that the patient would require a share of the physician's potential profits.

38. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 144 (2006).

39. 793 P.2d at 480–86. *See also* MARC A. RODWIN, MEDICINE, MONEY, AND MORALS: PHYSICIANS' CONFLICTS OF INTEREST (1993).

40. Linda J. Demaine, *"Playing Doctor" with the Patient's Spouse: Alternative Conceptions of Health Professional Liability,* 14 VA. J. SOC. POL'Y & L. 308 (2007).

41. Long v. Ostroff, 63 Pa. D. & C. 4th 444, 446 (Ct. Com. Pl. 2003), *aff'd,* 854 A.2d 524 (Pa. Super. Ct. 2004), *appeal denied,* 871 A.2d 192 (Pa. 2005) (per curiam).

defendant physician had no duty to refrain from sexual relationship with the patient's spouse.[42] However, psychiatrists may not engage in such conduct.[43] In the psychiatrist's case the entrustment relates to the patient's psychological well-being, which is highly likely to be affected by conflicts in their marriage. But when the physician treats a patient for a broken bone the entrustment is not closely related to the patient's psychological well-being.

b. Lawyers and Accountants Lawyers face various conflict of interest situations in their practice. According to one study, they view such conflicts more seriously than other fiduciaries, such as accountants, psychotherapists, physicians, journalists, and academics.[44] "Virtually all" law firms will refuse to represent both opposing clients "in litigation against one another."[45] But in complex litigation or representation of large financial institutions it may be difficult to identify all the parties. The seriousness of the problem might depend on the degree to which the clients' interests conflict and whether the lawyers' representation precludes the clients from selecting other lawyers.

Lawyers' conflicts of interests increase with the rise in the number of their members and the global dispersion of their offices, even though in some of these cases the conflicts may be less serious.[46] Firms "devote substantial resources to identify, avoid, and deal with conflicts."[47] Conflicts also arise when lawyers

42. Long v. Ostroff, 854 A.2d 524 (Pa. Super. Ct. 2004), *appeal denied,* 871 A.2d 192 (Pa. 2005) (per curiam).

43. Linda J. Demaine, *"Playing Doctor" with the Patient's Spouse: Alternative Conceptions of Health Professional Liability,* 14 VA. J. SOC. POL'Y & L. 308 (2007).

44. Susan P. Shapiro, *Bushwhacking the Ethical High Road: Conflict of Interest in the Practice of Law and Real Life,* 28 LAW & SOC. INQUIRY 87 (2003) (she asked such questions as: (1) how conflict of interest regulation is accomplished; (2) where rules are most likely to be followed; (3) what the incentives for compliance are; and (4) what the costs and consequences of compliance are); MODEL RULES OF PROF'L CONDUCT R. 1.7 (2002) (Rule 1.7 of the Model Rules of Professional Conduct guides most of the issues concerning lawyers' conflicts of interest).

45. Susan P. Shapiro, *Bushwhacking the Ethical High Road: Conflict of Interest in the Practice of Law and Real Life,* 28 LAW & SOC. INQUIRY 87, 101 (2003).

46. *See* Edward S. Adams & John H. Matheson, *Law Firms on the Big Board?: A Proposal for Nonlawyer Investment in Law Firms,* 86 CALIF. L. REV. 1, 15 (1998); *see generally* Note, *Developments in the Law: Conflicts of Interest in the Legal Profession,* 45 HARV. L. REV. 1244 (1981) (discussing potential attorney conflicts of interest in various circumstances).

47. Susan P. Shapiro, *Bushwhacking the Ethical High Road: Conflict of Interest in the Practice of Law and Real Life,* 28 LAW & SOC. INQUIRY 87, 162 (2003) (in her 1999 study of lawyers of "elite" firms, Lisa Lerman researched cases involving frauds of "padding the bills and expenses." She found almost no prosecution of such cases before 1989 and 36 such cases during the following ten years. Of course, this increase could indicate either more incidents or more prosecution. The 16 cases that were studied in more detail involved persons who had privileged backgrounds, graduated from elite schools, and worked at a number of large law firms. They were accused of stealing over $100,000 over

occupy more than one role (e.g., acting as corporate directors and legal advisers), and potential conflicts appear when lawyers represent new clients, whose interests are likely to conflict with other clients.

Law firms' billings pose conflicts of interest issues.[48] During the years 2000 to 2006, competitive pressures brought increases in the associates' salaries, as well as pressures to increase the associates' billing hours,[49] notwithstanding the lawyers' Model Rules of Professional Conduct.[50] And even if lawyers did not "intentionally stall a case," they may have been tempted, or appeared, to "stretch" the billable hours. This possibility resulted in questioning the practice of hourly billing.[51]

The position of accountants and auditors is somewhat different from that of attorneys because accountant's services require independence from the clients and impartiality that may conflict with the clients' interests. In fact, accountants are not supposed to help the clients or serve their interests.[52] The main function of accountants and auditors is to ascertain the accuracy of their clients' accounts

an average of five years. Collectively they stole about $16 million from clients. These lawyers were at the height of their careers, serving as managing partners, members of the firms' executive committees, or "rainmakers." The researcher noted that in many cases "it is clear that their partners knew about and/or participated in the billing fraud.").

48. *Id.* at 162 ("Some lawyers defrauded their own clients by 'padding' their bills." Two lawyers were found guilty of mail fraud. One was disbarred, and one was suspended for three years for padding clients' bills. A lawyer was found to have breached his contract and committed fraud. Judgment against him amounted to $3,124,414.") Among the cases are United States v. Myerson, 18 F.3d 153 (2d Cir. 1994) (affirming the lower court's decision on mail fraud); *In re Duker*, 723 A.2d 410 (D.C. 1999) (William Duker disbarred after pleading guilty to mail fraud and related charges); Attorney Grievance Comm'n v. Hess, 722 A.2d 905 (Md. 1999) (Stanford Hess suspended 3 years for padding bills); Dresser Indus., Inc. v. Digges, No. JH-89-485, 1989 U.S. Dist. LEXIS 17396 (D. Md. Aug. 30, 1989) (awarding the plaintiff $3,124,414 in liquidated damages in case against former attorney, Edward S. Digges, Jr., for breach of contract and fraud). *See also* TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 23 (2006); John Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. REV. 301 (2004).

49. *See* Carol McHugh, *Firms Cease Raising Billable-Hours Goal; But Partners Work More*, CHI. DAILY L. BULL., Sept. 1, 1993 (associates' annual billing hours have increased from 1800 hours in the mid-1980s to over 2000 "toward the end of the '80s" to sometimes 2200–2400 in 1993).

50. MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (2003) ("time and labor required" is only one of several nonexclusive factors to be considered in determining reasonableness of fee); MODEL RULES OF PROF'L CONDUCT R. 1.7(a)(2) (2003) (defining conflict of interest when "there is a significant risk that the representation of one or more clients will be materially limited by . . . a personal interest of the lawyer.").

51. Scott Turow, *The Billable Hour Must Die*, ABA J., Aug. 2007, at 32, *excerpted from* Scott Turow, *Our Gilded Cage*, *in* RAISE THE BAR: REAL WORLD SOLUTIONS FOR A TROUBLED PROFESSION 3 (Lawrence J. Fox ed., 2007).

52. *In re* SmarTalk Teleservices, Inc. Secs. Litig., 487 F. Supp. 2d 928 (S.D. Ohio 2007).

and financial statements for the benefit of the public. Nonetheless, this gatekeeping function benefits the clients' legitimate interests. Auditing helps clients gain the public's trust in the clients' financial situation. Thus, auditors and accountants provide clients a valuable service. On the "fiduciary side" of the balance sheet clients must trust auditors and open their books and their documents to the accountants. Arguably, clients are entrusting accountants with power, but this entrustment is similar to the public's entrustment of power to the police. The power is to be used not only for the benefit of the entrustors but for the benefit of a far larger group. This is why accountants might be liable to their clients for performing their tasks negligently, but not for breaching a fiduciary duty, which might lead to a far stricter remedy.[53]

However, accountants and auditors might become their clients' fiduciaries by relinquishing their independence and offering fiduciary services to their clients, such as financial consulting and advisory services with respect to the clients' accounting treatment. In these cases accountants' and auditors' failure to provide reliable accounting might constitute a breach of fiduciary duty to the clients. In one case, for example, the court found "that Plaintiff has come forward with evidence sufficient to establish a genuine issue of material fact as to whether damages resulted from [the accountants'] alleged breach of duty in connection with acquisition accounting services."[54] Thus, "an independent auditor's obligation to investigate and disclose brings the accountant-client relationship within the ambit of fiduciary relationships."[55] Actions against accountants for breach of fiduciary duty are commonplace in New York courts.[56] They usually include allegations of malpractice.

c. Judges, the Courts, Government Officials, and Teachers When fiduciaries hold positions of power, such as judgeships or government offices, possible conflicts of interest may arise. In fact, social harm can be done even if the fiduciaries' behavior can raise the impression or suspicion of conflicts of interest. For example, a judge who dines with a lawyer who is currently appearing before him raises an impression of possible favoritism. A teacher who accepts significant gifts from students or their parents before the teacher has graded the students' performance may raise similar suspicions.

When the relationship is far-fetched, however, the problem of conflicts or seeming conflict is less serious. A judge who had invested in the securities of companies that have filed amicus curiae briefs in a case is not required to

53. *In re* SmarTalk Teleservices, Inc. Sec. Litig., 487 F. Supp. 2d 928 (S.D. Ohio 2007).

54. *In re* SmarTalk Teleservices, Inc. Sec. Litig., 487 F. Supp. 2d 928, 935 (S.D. Ohio 2007).

55. *In re* Investors Funding Corp. of New York Secs. Litig., 523 F. Supp. 533, 542 n.4 (S.D.N.Y. 1980).

56. Ross v. Patrusky, Mintz & Semel, No. 90 Civ. 1356 (SWK), 1997 U.S. Dist. LEXIS 5726 (S.D.N.Y. Apr. 28, 1997).

withdraw from sitting in judgment. The investments may have been made a long time ago, and the companies are interested in the issues as outsiders.[57] However, a judge who was a partner in a law firm that is involved in the case may have to withdraw from sitting in judgment.[58] That relationship is too close for comfort. A more difficult and intriguing issue relates to courts that are attuned to the interests of their state and to the political environment. In the area of corporate law the competition of the state's legislature and the courts to draw corporations to their jurisdiction has been examined[59] and debated for some time. The question of whether the courts should take the predominance of their State in the corporate area has not arisen. The issue resides in a gray area. After all, judges and the law should be responsive and sensitive to the society in which they function and its problems, However, it is unclear that courts' attitude may be guided or influenced by the state's political interests or the judges' political beliefs.[60]

d. **Bank Trust Departments** Trust and banking businesses pose for banks and their regulators an inherent conflict of interest. Legally, banks are debtors to their depositors (and creditors to their borrowers).[61] The main task of bank regulators is to ensure that banks remain "safe and sound," able to meet their obligations, especially their obligations to pay deposits on demand, and avoid "runs."[62] "Safety and soundness" are crucial to maintaining a strong banking and financial system. Therefore, the profits of banking belong to the banking institution. To reduce the risk of banking the government regulates and financially supports the banking system.

57. City of Hope Nat'l Med. Ctr. v. Genentech, 20 Cal. Rptr. 3d 234 (Ct. App. 2004), *modified, reh'g denied,* No. B161549, 2004 Cal. App. LEXIS 1962 (Ct. App. Nov. 22, 2004), *review granted, depublished,* 24 Cal. Rptr. 3d 178 (2005). *City of Hope* is an unpublished disposition issued before January 1, 2007, and as such may not be cited to Ninth Circuit courts except in certain limited circumstances. 9TH CIR. R. 36-3(C) (California Supreme Court held that the judges that had invested in these companies should not recuse themselves).

58. Corradino v. Corradino, 48 N.Y.2d 894, 895 (N.Y. 1979) (stating although there is "no canon of judicial ethics which specifically requires disqualification . . . it [is] the better practice for the court to have disqualified itself and thus maintain the appearance of impartiality").

59. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters,* 68 U. CIN. L. REV. 1061 (2000).

60. *See* Ward Farnsworth, *"To Do a Great Right, Do a Little Wrong": A User's Guide to Judicial Lawlessness,* 86 MINN. L. REV. 227 (2001).

61. *See* Washington Steel Corp. v. TW Corp., 602 F.2d 594, 601 (3d Cir. 1979) (holding that banks have no per se fiduciary duty to borrowers).

62. *See, e.g.,* Eugene F. Maloney, *Banks and the SEC: A Regulatory Mismatch?,* 25 ANN. REV. BANKING & FIN. L. 443, 454 (2006) ("Banking regulation emphasizes safety and soundness of both banks and the banking system as a whole, using a comprehensive supervisory process and periodic on-site examinations designed to resolve problems privately.").

With respect to entrusted property the division of benefits and risks is different. Banks should act in the sole benefit of the beneficiaries-entrustors. The banks are entitled to fees and no more. On the other side of the coin the investment benefits belong to the entrustors, and risks posed by the trustees' actions are borne by the entrustors. The main task of bank trust department regulators is to ensure that the banks comply with their fiduciary duties. Arguably, the banks' safety and soundness is irrelevant in this context.

The two views of bank regulation: ensuring their safety and soundness as well as the performing of their fiduciary duties as trustees coincide in some respects. When banks lose the trust of either their customers or their beneficiaries, the banks are ultimately in danger of "runs." Therefore, the rules impose on banks fiduciary duties (and limit their profits) and support bank "safety and soundness."[63] The danger of "runs" on banks and their exposure to "reputational risk" may be triggered by a public outcry.[64] And if banks abuse their trustees' duties, they might lose their trust business, or be fined heavily, and that might invite "runs." Thus, concern about the banks' safety and soundness induces regulators to ensure that banks behave as trusted trustees should. Yet, trust regulation, which aims at ensuring fair performance of the banks' fiduciary duties toward their beneficiaries, is secondary to the main objective of bank regulation to ensure the financial stability of the banks.

For the banks, the Comptroller of the Currency has relaxed some of the stricter rules in trust law.[65] While trust law requires trustees to segregate trust assets, banks may pool trust assets into "common trust funds." Pooling allows the banks to manage small trusts more efficiently.[66] Similarly, when banks hold trust funds in cash as demand or time deposits, banks face a conflict of interest. They can

63. 12 C.F.R. § 7.4002(b)(2) (2008) (requiring that a national bank establish and determine non-interest charges and fees "according to sound banking judgment and safe and sound banking principles"); *id.* § 7.4002(b)(2)(iv) (stating that such determination considers, among other factors, "[t]he maintenance of the safety and soundness of the institution"). For example, ATM fees charged to customers are subject to this standard. *See* Bank of Am. v. City & County of S.F., 309 F.3d 551, 562 n.6 (9th Cir. 2002) (noting that Office of the Comptroller of the Currency found that bank plaintiffs "had properly considered these factors in deciding to charge ATM fees to non-depositors").

64. Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, Bank Holding Company Supervision Manual § 2010.11.2.2, at 6 (2004) ("Reputational risk is the potential that negative publicity regarding an institution's business practices and clients, whether true or not, could cause a decline in the customer base, costly litigation, or revenue reductions."), http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc0604.pdf.

65. 28 Fed. Reg. 3309, 3311–13 (Apr. 5, 1963) (current version at 12 C.F.R. § 9.18 (2008)) (authorizing banks acting as fiduciaries to hold funds in common trust funds).

66. *See, e.g., In re Estate of Prankard,* 723 N.Y.S.2d 315, 326 (Sur. Ct. 2000) ("[I]n general, common trust funds provide the opportunity for greater diversification and growth, efficient management, and lower administrative costs, while providing increased

profit from lending "free cash," at the expense of profits to the trust beneficiaries. Therefore, when trust assets must be held in cash the Comptroller of the Currency allows the banks to hold trust funds in their deposit accounts for a limited period only, and requires the banks to pay acceptable market interest rate on trust assets' cash accounts.[67]

A fruitful area for conflicts of interest opened for banks in 1996, when Congress lifted a long-term prohibition in the Glass-Steagall Act of 1933,[68] and permitted banks to engage in securities activities, including the management of mutual funds and distribution of the funds' securities to public investors. Banks sought to convert "common trust funds" into mutual funds. The conversion gave banks a number of benefits.

First, conversion enabled banks to increase the assets under their management by drawing public investors interested in management. A larger asset pool raises bank fees and reduces cost by economies of scale.[69] Second, banks could use their controlled common trust funds to establish new mutual funds. New mutual funds are initially unprofitable to their promoters because the amount of assets under management is small and their costs are relatively high. Banks benefited from the ability to establish a new fund with an immediately large amount derived from the common trust funds' captive assets. This gave the banks a competitive advantage over mutual fund managers that do not have assets entirely under their control with which to start new funds.

Third, banks may invest trust assets in their own managed funds rather than funds managed by others. Trust beneficiaries cannot order the banks-trustees to invest their trust funds in other mutual funds nor withdraw their trust assets. Fourth, banks can collect management fees as managers of the funds and as trustees (subject to a discount). Thus, conversion of trust assets into mutual funds benefits the banks.[70] To be sure, conversion may benefit the beneficiaries as well, for example, by greater diversification of their trust assets and by more investment opportunities than were previously available.[71] And yet, permission to act as fiduciaries conflicted with the bank posture as a contract lender. The

profitability. . . ."); GEORGE GLEASON BOGERT ET AL., BOGERT'S TRUSTS AND TRUSTEES § 677 nn. 37–38 (2007) (Westlaw) (citing cases).

67. 12 C.F.R. § 9.10(b)(1) (2008) (allowing bank to deposit funds of fiduciary account awaiting investment or distribution in another bank department unless otherwise prohibited); *id.* § 9.10(a) (requiring that bank obtain "a rate of return that is consistent with applicable law").

68. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999) (repealing 12 U.S.C. §§ 78, 377).

69. John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 975 (2005).

70. *See id.* at 974 (noting that "the trustee derives fee income both from the mutual fund and the trust").

71. *Id.* at 975.

fiduciary duty to act in the sole benefit of the funds' investors conflicted with the bank personnel's mindset and the banks' culture as the guardians of the banks' financial safety and soundness. The bank's position as a contract party and its regulation to ensure its safety and soundness conflicted with the bank's position as a fiduciary and its regulation to care for the customers' entrustment and welfare. If these conflicts were not greatly significant before the revocation of the Glass-Steagall Act of 1933, they loomed far larger after the Act's revocation.

5. Fiduciaries' Self-Limiting Mechanisms

a. **Creating Walls** Both in the United States and in other countries such as Australia, large organizations that perform conflicting services under one roof have adopted a mechanism of preventing conflicts of interest. They have created a "wall" between the divisions that, if working together, would create conflicts of interest. Thus, the Federal Court of Australia dealt with the duties of Citigroup Global Markets Australia (Citigroup) holding that Citigroup was not acting as fiduciary but as an "independent contractor, based on the parties' agreement[,]"[72] the sophistication of the client, as well the establishment of "a wall" by Citigroup that prevented entrusted information to seep through and benefit other parts of the organization.

Similarly, investment banks face conflicts of interest when they serve as underwriters and as brokers. As underwriters the banks acquire insider information by virtue of their "due diligence" service. But the investment banks' other arm, the brokers, could use this insider information profitably in their trading and in advising their trading clients. Thus, the very functions of investment banks constituted a possible abuse of insider entrusted information. When courts held that under certain circumstances underwriters could be deemed fiduciaries, investment banks developed self-imposed structural prevention. They created what they hoped would prevent illegal transfer of insider information between the underwriting and brokerage arms. A wall prevents fiduciaries from acting in conflicts of interest. However, if the mechanism is unsuccessful, a violation of fiduciary duties may indeed occur.

b. **Using Independent Parties to Decide** Corporate directors that are also the managers and executives of the corporation can barely act as the supervisors of the managers—themselves. So long as the shareholders were involved in supervising the executives, the executives' conflict of interest could be contained.[73] But when the number of corporate shareholders grew and the shareholder population became dispersed, no one else took their place. The directors supervised

72. Australian Sec. & Inv. Comm'n v. Citigroup Global Markets Australia Pty. Ltd., [2007] FCA 963 (June 28, 2007) (some citations omitted).

73. Tamar Frankel, *Corporate Boards of Directors: Advisors or Supervisors*, 77 U. CIN. L. REV. 501 (2008).

themselves as executives. One solution was to appoint "independent directors," who were not executives of the corporation. This solution was not without flaws. First, the independent directors were chosen by the executives, and those executives were likely to choose friends rather than enemies. Second, directors ought to be well-versed in managing the corporate business, and yet, as such, they are usually executives of other corporations. As such, they identify with the views of corporate executives and their practices. Therefore, there are those who argued that the independence of the independent directors does not result in an objective, dependent supervision.[74] This view was especially strengthened with respect to executive compensation. Thus, in 2009 a rule of the Securities and Exchange Commission has provided enhanced power to shareholders both on the choice of directors and with respect to executive compensation.[75]

c. **Delegating to Independent Experts the Function to Recommend Decisions** When conflicts involved all or most of the directors, the practice evolved to seek the advice of independent outsiders, usually an expert. The experts, however, were not the ones to make the final decision. That decision could not be fully delegated to other than the directors. However, relying on that expert's decision was a sufficient barrier to the attack on the board decisions as tainted with conflict of interest.[76] In this case, as in others, the difficulty is to find the balance between the need to enable the expert fiduciaries freedom to do their job for the benefit of the entrustors, on the one hand, and avoid conflicts of interest that might undermine their focus on the sole benefits of the entrustors, on the other hand. Similarly, mutual funds and other managed large pools of investors' money hold shares. Because the funds are the shareholders, their managers vote these shares on behalf of the funds. The managers of such funds usually voted with the managements of the corporations whose shares the funds held.[77] However, since the year 2000 the pressure to vote these shares meaningfully and affect the corporations whose shares the funds held has resulted in the

74. Regina F. Burch, *The Myth of the Unbiased Director*, 41 AKRON L. REV. 509 (2008) (arguing that "non-management independent directors" are biased to favor the management).

75. *See* Shareholder Approval of Executive Compensation of TARP Recipients, Release No. 34-60218 (proposed July 1, 2009) *and* Facilitating Shareholder Director Nominations, Release No. 33-9046 (proposed June 10, 2009).

76. *See* DEL. CODE ANN. tit. 8, § 141(e) (2001) (protecting board in good faith reliance on opinions of experts); Brehm v. Eisner, 746 A.2d 244, 261–62 (Del. 2000).

77. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188 (Jan. 31, 2003), 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) ("Funds have often followed the so-called "Wall Street rule," according to which an investor should either vote as management recommends or, if dissatisfied with management, sell the stock. In recent years, however, some funds, along with other institutional investors, have become more assertive in exercising their proxy voting responsibilities.") (footnote omitted).

emergence of independent proxy voting consultants. Even though the managers do not follow the recommendations of the consultants blindly, these recommendations have a significant influence on the voting of corporate shares.[78]

d. **Disclosure** Most, but not all, fiduciaries' conflicts of interest are permitted if the entrustors consent to the transactions. The conditions for disclosure and consent are discussed in greater detail in Chapter 4.

6. Not-for-Profit and Charitable Organizations

In addition to the duties of care and loyalty,[79] directors of not-for-profit corporations have been held to a duty of obedience, i.e., "to be faithful to the purposes and goals of the organization."[80] This is not a new duty but has been emphasized in the case of not-for-profit organizations and has been adopted by a few states including California and New York.[81] It is analogous to the trust law duty to administer the trust in accordance with its terms.[82] A New York court explained the rationale for this duty by stating that "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the *raison d'être* of the organization."[83] Scholars in law disagree whether the duty of obedience exists separately or is subsumed under the other two duties.[84] However, regardless of the disagreement, the functions of managements of business and not-for-profit organizations are not so different. After all, many of these organizations are making money by raising donations, and this activity is not entirely different from making money in other business ways.

The main difference between managements of business organizations and those leading non-profit organizations is in the absence of shareholders or other parties that have a legal right to demand the managements' to account. The only

78. *See, e.g.*, *RiskMetrics Group*, http://www.riskmetrics.com (last accessed Dec. 11, 2009). When this group releases its policy update, the policy gets attention. *See* Paul Broude et al., *RiskMetrics Group Releases 2009 Proxy Voting Policies*, MONDAQ BUS. BRIEFING, Jan. 14, 2009, LEXIS, News Library, Curnws File ("Many institutional investors adhere to the RiskMetrics voting recommendations.").

79. *E.g.*, WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 242-368 (2d ed. 2007), *cited in* Note, *Reinvigorating Nonprofit Directors' Duty of Obedience*, 30 CARDOZO L. REV. 1677, 1687 (2009).

80. *E.g.*, Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 593 (Sup. Ct. 1999).

81. Nicole Huberfield, *Tackling the "Evils" of Interlocking Directorates in Healthcare Nonprofits*, 85 NEB. L. REV. 681, 703 & n.89 (2007) (citing cases).

82. RESTATEMENT (THIRD) OF TRUSTS § 76(1) (2007).

83. 715 N.Y.S.2d at 593 (quoting BJORKLUND, FISHMAN, & KURTZ, NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS § 11-4[a]. at 414).

84. *E.g.*, Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1406 n.30 (1998) (taking position that duty does not exist separately);

clear party that has the legal right and power to do so is the government, and following the managements of non-profit organizations is not highest on government's list of priorities.

"Currently, in most states, the only parties who have standing to sue for breaches of fiduciary duty by a nonprofit director are the attorney general or a director."[85]

This is similar to the trust law rule for enforcement of a charitable trust, providing that such a trust be enforced by the attorney general (or other public officer), a co-trustee, or a person with a "special interest" in its enforcement, but not a person with "no special interest" in its enforcement.[86]

However, some courts have applied the "special interest doctrine" of trust law to allow charitable beneficiaries with a "special" interest in a nonprofit corporation (as opposed to the public interest) to take action.[87] Whether beneficiaries can take action depends on (1) whether the attorney general has exclusive enforcement power and (2) facts and circumstances.[88] Most state statutes do not provide that the attorney general's enforcement power is exclusive.[89] If its power is not exclusive, courts may look to one or more of the following factors: (a) the extraordinary nature of the acts complained of and the remedy sought by the plaintiff; (b) the presence of fraud or misconduct on the part of the charity or its directors; (c) the state attorney general's availability or effectiveness; and (d) the nature of the benefited class and its relationship to the charity.[90]

85. Karen R. Vanderwarren, Student Note, *Financial Accountability in Charitable Organizations: Maintaining an Audit Committee Function*, 77 Chi.-Kent L. Rev. 963, 974 (2002); *see* Angela Gilmore, *Using the Private Attorney General Theory to Protect Florida Charitable Corporations*, 31 Nova L. Rev. 27, 28–29 (2006) (stating that state statutes generally restrict parties that can take action against nonprofit directors; generally such actions are limited to (1) an action by a "member" against corporation for an injunction, (2) an action by the corporation (direct or derivative) against a director, or (3) an action by the state attorney general); Ga. Code Ann. § 14-3-304 (Supp. 2009); Conn. Gen Stat. Ann. § 33-1038 (West 2005).

86. Restatement (Second) of Trusts § 391 (1959).

87. Sara R. Kusiak, Comment, *The Case for A.U. (Accountable Universities): Enforcing University Administrator Fiduciary Duties Through Student Derivative Suits*, 56 Am. U.L. Rev. 129, 146 (2006) (citing Lopez v. Medford Cmty. Ctr., Inc., 424 N.E.2d 229, 233 (Mass. 1981)).

88. *Id.* at 147.

89. *Id.* at 147 n.102 (citing cases).

90. Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. Rev. 37, 61 (1993); Sara R. Kusiak, Comment, *The Case for A.U. (Accountable Universities): Enforcing University Administrator Fiduciary Duties Through Student Derivative Suits*, 56 Am. U.L. Rev. 129, 147 (2006) (quoting Blasko); see Blasko, *supra*, at 61–78 (discussing cases).

Courts have also looked to "subjective and case-specific factual circumstances."[91] There are a number of internal mechanisms that sometimes help induce managements to account. One mechanism is when the donors sit on the managements' boards. They are concerned not only about how the money is spent but also in the level of spending. But in other situations managements might be honest but less careful about donated money. The Ponzi scheme of Bernard Madoff has absorbed millions of not-for-profit organizations' money, including educational organizations and charities.

The Revised Model Nonprofit Corporation Act and most States set the same standard for the fiduciary duty of care of directors of for-profit and non-profit corporations.[92] The Act imposes on these directors liability for gross negligence, in contrast to the negligence standard imposed on trustees under trust law.[93]

E. DUTIES IMPLEMENTING THE DUTY OF LOYALTY

Most, if not all, fiduciary duties cluster around entrustment. We noted that if the entrustment is not accompanied by directives, fiduciary relationships are not likely to arise. Thus, an important part of entrustment is the directives that accompany the entrustment. Therefore, the duty to comply with the directives is an ancillary part of the duty of loyalty.

1. Duty to Follow and Abide by the Directives of Entrustment with Respect to Entrusted Power or Property

The rule requiring the fiduciaries to comply with the entrustors' directives follows two situations. In one situation the entrustor writes the fiduciaries' "job description." In the other situation the fiduciaries write their "job description." In the first scenario, an agent receives specific authority from the principal. The agent may not exceed his authority to purchase an item or to pay for it more than the amount that the principal dictated.[94] Similarly, a trustee may not invest trust property in assets that the trust instrument excludes.[95] In the second scenario the fiduciaries describe their services. For example, the managers of mutual

91. Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. Rev. 37, 61–78 (1993); Kusiak, *supra*, at 147 (quoting Blasko) (discussing cases).

92. Michael W. Peregrine, *Revisiting the Duty of Care of the Nonprofit Director*, J. Health L., vol. 36, no. 2, Spring 2003, LEXIS, Lawrev Library, Allrev File (citing ABA, Revised Model Nonprofit Corp. Act § 8.30 & cmt. 1 (1987)).

93. *Id.* (citing ABA, Revised Model Nonprofit Corp. Act § 8.30 cmt. 1 (1987)).

94. *See* Restatement (Third) of Trusts § 2.01(1), at 89 (2006) (actual authority limited to principal's manifestations and objectives); *id.* cmt. f. at 99 (agent ordinarily lacks actual authority to exceed principal's instructions); *id.* cmt. f illustrations 20–21 at 99 (application of rule to purchase of land at higher price than allowed by instructions).

95. Restatement (Third) of Trusts § 91(b), at 388 (2003).

funds describe the investment policies which the funds will adopt. In this situation, when the fiduciaries' descriptions were too vague and too broad, legislation may interfere to impose limitations on the fiduciary's discretion or require detailed disclosure of the fiduciaries' authority.

Thus, the Investment Company Act of 1940 limits the managers of mutual funds' authority to the investment policies of the funds they manage.[96] If the registration statements of funds and their names indicate that the funds are investing in certain types of securities, such as "equities," the managers are bound to comply with the specifications.[97] Violations of these limits on the fiduciary's discretion are likely to result in prosecution by the Securities and Exchange Commission.[98]

The duty to follow and abide by the entrustors' directives has been singled out and named the "duty of obedience." Thus, in addition to the duties of care and loyalty,[99] directors of non-profit corporations have been held to a duty "to be faithful to the purposes and goals of the organization."[100] This duty has been explicitly adopted in a few states including California and New York[101] and is analogous to the trust law duty to administer the trust in accordance with its terms.[102] A New York court explained the rationale for this duty: "Unlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are [*sic*] central to the *raison d'être* of the organization."[103] Scholars in law disagree whether the duty of obedience exists separately or is subsumed under the other two duties.[104]

Difficult questions arise when the entrustors' directives are obsolete, such as when they remain fixed while the circumstances have changed. Should a will be

96. Investment Company Act of 1940, § 13(a)(3), 15 U.S.C. § 80a-13(a)(3) (2006).

97. *Id.* (prohibiting deviation from industry concentration stated in registration statement); *id.* § 35(d), 15 U.S.C. § 80a-34(d) (2000) (prohibiting deceptive or misleading investment company names).

98. *See* 4 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS ch. 33 (2001 & Supp. 2008) (SEC enforcement). Violations might also be subject to private rights of action by the shareholders, although this is less certain.

99. *E.g.*, WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 242–368 (2d ed. 2007), *cited in* Note, *Reinvigorating Nonprofit Directors' Duty of Obedience*, 30 CARDOZO L. REV. 1677, 1687 (2009).

100. *E.g.*, Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 593 (N.Y. 1999).

101. Nicole Huberfield, *Tackling the "Evils" of Interlocking Directorates in Healthcare Nonprofits*, 85 NEB. L. REV. 681, 703 & n.89 (2007) (citing cases).

102. RESTATEMENT (THIRD) OF TRUSTS § 76(1) (2007).

103. 715 N.Y.S.2d at 593 (quoting BJORKLUND, FISHMAN, & KURTZ, NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS § 11-4[a], at 414).

104. *E.g.*, Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1406 n.30 (1998) (taking position that duty does not exist separately).

reinterpreted in light of the new circumstances or be literally enforced?[105] In fact, a similar obsolescence can arise in interpreting the law. Should courts reinterpret the text by resorting to a different meaning of the existing text, or by putting the text in a different and current context?[106] However, while statutes can change the text, the testator, cannot. Gleaning the testator's intent from past actions is more problematic.

Some fiduciary duties can be waived by the entrustors.[107] But it is doubtful whether an entrustor can waive the trustees' duties to account and report to the beneficiaries (and thus keep the trust secret). Trust privacy can pose potential legal dangers to trustees that fail to report to the beneficiaries. It was suggested that "trustees ignore settler waivers of accounting and reporting requirements. Thus, for the conscientious trustee, trust privacy creates conflicts in fiduciary duties - conflicts in duties to settler and beneficiary and in duties to multiple beneficiaries."[108] Otherwise, the trustees may be held liable, especially if the trust assets experience losses or do not show sufficient profits.

Corporations have broad powers to engage in many activities. The traditional view, however, was that directors must exercise their power to maximize the shareholders' profits. Directors should not consider the welfare of the employees and the communities except to the extent that the decisions profit the corporations and their shareholders. Therefore, contributions to the First World War effort[109] and contributions to not-for-profit and educational organizations[110] are permissible provided they benefit the corporation's business and its shareholders (and management decisions do not involve conflicts of interest). However,

105. *See* Adam J. Hirsch, *Text and Time: A Theory of Testamentary Obsolescence*, 86 WASH. U. L. REV. 609 (2009) (recommending rules and offering an "error-minimizing default rule").

106. John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) ("The idea that courts will reinterpret statutory policies in light of new circumstances and frequently shrink the scope of 'obsolete' policies is not a new one.").

107. *See* Chapter 4.

108. Frances H. Foster, *Trust Privacy*, 93 CORNELL L. REV. 555 (2008).

109. *See* A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 586 (Del.) ("During the first world war corporations loaned their personnel and contributed substantial corporate funds in order to insure survival. . . ."), *appeal dismissed*, 346 U.S. 861 (1953); *cf. In re* Estate of London, 171 N.Y.S. 981, 983–84 (Sur. Ct. 1918) (overruling objection to trustees' investment of trust funds in First Liberty Loan bonds during wartime), *aff'd*, 175 N.Y.S. 910 (App. Div. 1919).

110. *See* A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 589–90 (Del.) (finding donation to university valid as advancing interests of corporation), *appeal dismissed*, 346 U.S. 861 (1953); FRANKLIN A. GEVURTZ, CORPORATION LAW § 3.1.4b, at 224 (2000) (stating that corporate charitable contributions may have business purpose "such as promoting goodwill" and "a rational relationship between the size of the contribution and the extent of corporate benefit").

the balance between the shareholders' interests and those of other constituencies is still subject to debate.[111] Because the use of corporate assets can be subverted by the management' personal preferences, some corporations allow the shareholders to note their preferred recipients of donation as well.[112]

"Corporate Social Responsibility." As corporations became larger and more powerful, and as their impact on society became significant, demands grew for corporate "social activism" and "social responsibility" to constrain wealth maximization or reduce it when it conflicts with social responsibility.[113] The use of corporate power beyond wealth maximizing can be couched in terms of freedom of private market activities and against government limitations.[114] Objections to "corporate responsibility" may be based on the argument that private trust law may not be compatible with public interest considerations. In addition, broadening management's power to a different objective may weaken management's accountability. It is more difficult to uncover conflict of interest in the case of social responsibility than in the case of accounting for specific actions.[115]

111. *See, e.g.*, Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1396 (2008).

112. *See* Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons for Corporate America Compiled and Introduced by Lawrence A. Cunningham*, 19 CARDOZO L. REV. 1, 10 (1997) (noting that "[a]t most major corporations management allocates a portion of corporate profit to charitable concerns" and "[t]he charities are chosen by management"; however, at Berkshire Hathaway, the donation is allocated by shareholder designation).

113. *See, e.g.*, David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1, 3 (1979) ("[T]he basic question of corporate social responsibility is . . . whether it is socially desirable for corporations organized for profit voluntarily to identify and pursue social ends where this pursuit conflicts with the presumptive shareholder desire to maximize profit.").

114. *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U.L. REV. 733, 803 (2005) (arguing that corporate managers have discretion to sacrifice corporate profits in the public interest; suggesting that "legal regulation is an important but insufficient means of policing behavior, be it the behavior of individuals, non-corporate businesses, or corporations").

115. In Brooks v. Wright, 971 P.2d 1025 (Alaska 1999), the Supreme Court of Alaska noted differences between private trusts and the state's natural resources trust. Thus, "private trusts generally require the trustee to maximize economic yield from the trust property" while the state constitution "requires that natural resources be managed for the benefit of all people." Further, under private trust law "the acts of a trustee should be reviewed for abuse of discretion" while "grants of exclusive rights to harvest natural resources listed in the common use clause are subject to close scrutiny." In addition, "[p]rivate trust law principles . . . provide no guidance as to when the public's right to common use of resources can be limited through means such as licensing requirements."Finally, "under private trust law a beneficiary may sometimes participate in management or act as trustee." The court noted that using private trust law in the public trust context may be harmful to the democratic process.

The business judgment rule limited the courts' interference in corporate managements' decisions and was based on rationales that the courts are not as expert in the corporations' business as management is, and that the shareholders—the entrustors—not the courts, chose the management and can remove it from office. The counterarguments are that courts have shown expertise in other cases, such as bankruptcy and securities regulation, and that they could use independent experts to enlighten them. As to the shareholders' power, so long as small shareholders can sell their shares, they would exit rather than express voice by trying to remove management (which can in most cases use corporate funds to hold on to their positions). In addition, the real claimants against corporate management are the lawyers who attempt to bring class actions, and gain large settlements of which they sometimes benefit handsomely.[116] Arguably, the shareholders pay these fees and gain little.

The doctrine of public trust. This issue has become far more serious when mammoth corporations' management could affect the well-being of the country's citizens and the integrity of its financial and economic system. The question is whether and how courts might interfere in the business judgment of managements when the business affects "social responsibility"? One basis for the courts' interference in corporate activities that abuse public assets may be the "doctrine of public trust." When corporate management ventures beyond corporate business into other social domains, management might be imposed with duties pursuant to the doctrine of public trust, as well as private fiduciary law. In both cases management is entrusted with power and in both cases it must use the power for the benefit of the entrustors and refrain from using it for any other purpose.[117]

The common law doctrine of public trust imposes on governing bodies fiduciary duties *toward the public*. The roots of the doctrine can be found in Roman property law and in America property law as well. The doctrine is based on the idea of property entrustment for the benefit of the public. Not surprisingly, those government entities entrusted with property are called fiduciaries.[118] Public trust duties can involve individual citizens[119] as well as public officials. The purpose of

116. Congress has restricted class action further in the Class Action Fairness Act of 2005, Pub. L. No. 109-2, 119 Stat. 4 (codified at 28 U.S.C. §§ 1, 1332, 1335, 1453, 1603, 1711–1715 (2006)).

117. Alethea O'Donnell, Comment, *Something Old, Something New: Applying the Public Trust Doctrine to Snowmaking*, 24 B.C. ENVTL. AFF. L. REV. 159 (1996).

118. Gail Osherenko, *New Discourses on Ocean Governance: Understanding Property Rights and the Public Trust*, 21 J. ENVTL. L. & LITIG. 317, 366–67 (2006) ("The relevant level of government acts in a fiduciary capacity as the trustee to protect the corpus (the productive capacity) of the trust resources for the beneficiaries who include both the current and future members of the community.").

119. *See, e.g.*, Nat'l Audubon Soc'y v. Superior Court, 658 P.2d 709, 721 (Cal. 1983) (stating that in public trust context "parties acquiring rights in trust property generally hold those rights subject to the trust").

public trust law is to protect the public against misuse of entrusted power by the government. The doctrine deals with the relationship between entrusted government, on the one hand, and the aggregate of unorganized individuals—society, on the other hand.

The doctrine of public trust has been applied in various situations. One example relates to sentencing for criminal offenses. Thus, a registered nurse owned and operated a private care nursing service for Medicaid patients. Seeking reimbursement from Medicaid, the nurse used fake documents to describe an imaginary nurse that that she employed as a supervising registered nurse (required by Medicaid) and gave 33 faked criminal background checks to government auditors. She testified at trial that she performed the supervisory visits herself, and denied the fake background checks. In sentencing the district court gave the accused a "two-level adjustment for abuse of a position of trust"[120] and denied a "downward variance sentence."[121]

In an entirely different context the Supreme Court cited the "background principles" of state property law as one of the two exceptions to the stringent rule concerning government taking.[122] Subsequent case law indicates that the public trust doctrine may qualify as a "background principle" exception.[123]

"Under the English common law, the king held shores, bays, rivers, arms of the sea, and the land under them as a public trust for the benefit of the whole community."[124] American courts followed the public trust doctrine. "[S]ubmerged lands, waters, and marine resources are not public property owned by the state," but the state is trustee for the people as beneficiaries.[125] "Public trust property is more properly categorized as common property, though in the U.S. legal system such property is frequently identified as a particular type of public property." Significantly, "public trust land is vested with two titles: the jus publicum, the public's right to use and enjoy trust lands and waters for commerce, navigation, fishing, bathing and other related public purposes, and the jus privatum, or the

120. The district court relied on United States v. Bolden, 325 F.3d 471, 504–05 (4th Cir. 2003) ("applying abuse of trust adjustment to nursing home operator who carried out scheme to defraud Medicaid").

121. United States v. Loving, 321 Fed. Appx. 246; 2008 U.S. App. LEXIS 25957 (4th Cir. 2008) (following the Second Circuit and rejecting the Eleventh Circuit view).

122. Lucas v. S.C. Coastal Council, 505 U.S. 100, 1029–31 (1992).

123. David L. Callies & J. David Breemer, *Background Principles, Custom and Public Trust "Exceptions" and the (Mis)use of Landowner's Investment Backed Expectations, in* Inverse Condemnation and Related Government Liability (ALI-ABA Course of Study Materials, Vol. May 1, 2001) (LEXIS) (analyzing cases).

124. Gail Osherenko, *New Discourses on Ocean Governance: Understanding Property Rights and the Public Trust,* 21 J. Envtl. L. & Litig. 317, 327–28 (2006).

125. *Id.* at 328.

private proprietary rights in the use and possession of trust lands."[126] This form reflects the bifurcated arrangement of a trust.[127]

The doctrine of public trust has been applied to problems similar to the managements' duty to follow corporate "social responsibility." For example, the Massachusetts Supreme Judicial Court prohibited the state Greylock Reservation Authority and a state authority from authorizing an arrangement including a ski resort and other commercial activities in a state reservation, finding no legislative authorization for such use of public lands for "a commercial venture for private profit."[128] The *Aspen* case,[129] however, "is the only example yet of an environmental group successfully blocking increased withdrawals of water from streams for snowmaking based on a public trust doctrine theory."[130]

The duty of corporate managers to their current shareholders may be expanded to future shareholders as well. "Furthermore, the modern public trust doctrine and several state laws recognize that states have a duty to protect natural resources for future generations."[131] "Because both federal and state law recognizes the important role of states in protecting natural resources for future generations, federal courts should apply a liberal approach to standing issues when states

126. *Id.* (quoting David C. Slade, Putting the Public Trust Doctrine to Work: The Application of the Public Trust Doctrine to the Management of Lands, Waters and Living Resources of the Coastal States 1 (1990)).

127. *See, e.g.,* Restatement (Third) of Trusts § 2 cmt. d, at 20 (2003) (stating that trust beneficiaries have "equitable title" to trust property; trustees generally have "legal title").

128. Gould v. Greylock Reservation Comm'n, 215 N.E.2d 114, 126 (Mass. 1966); *see* Alethea O'Donnell, Comment, *Something Old, Something New: Applying the Public Trust Doctrine to Snowmaking,* 24 B.C. Envtl. Aff. L. Rev. 159, 182 (1996) (stating that court was "implicitly relying upon the public trust doctrine").

129. Aspen Wilderness Workshop, Inc. v. Colo. Water Conservation Bd., 901 P.2d 1251 (Colo. 1995) (en banc).

130. Alethea O'Donnell, Comment, *Something Old, Something New: Applying the Public Trust Doctrine to Snowmaking,* 24 B.C. Envtl. Aff. L. Rev. 159, 186 (1996) (citing 901 P.2d at 1260–61). In *Aspen,* the Colorado Supreme Court reversed a ruling that the Colorado Water Conservation Board had the authority not to enforce a minimum water flow on Snowmass Creek set by the water court. The court found that the Board "has a unique statutory fiduciary duty to protect the public in the administration of its water rights decreed to preserve the natural environment." 901 P.2d at 1260–61. While the court did not use the phrase "public trust doctrine," one commentator said that "its language concerning "fiduciary duty" and its reasoning constituted a de facto use of the public trust doctrine." Alethea O'Donnell, Comment, *Something Old, Something New: Applying the Public Trust Doctrine to Snowmaking,* 24 B.C. Envtl. Aff. L. Rev. 159, 188 (1996)

131. Bradford C. Mank, *Standing and Future Generations: Does* Massachusetts v. EPA *Open Standing for Generations to Come?,* 34 Colum. J. Envtl. L. 1, 8 (2009) (citing cases, constitutions, and statutes).

bring parens patriae or public trust suits to protect those resources for the state's future citizens."[132]

In another case sport fishing organizations challenged a state board regulation allocating the number of Chinook salmon that can be harvested among several user groups, including sport and commercial fishing users. The organizations argued that (1) the regulation violates the policy of the "common use" and "no exclusive right to fishery" clauses of the state constitution; (2) "under the public trust doctrine the state has a fiduciary duty to manage the resources of Alaska for the benefit of all of the people"; and (3) "[g]iven these constitutional policies," the allocation of a quota to one group "creates an unconstitutional 'special privilege.'" The Alaska Supreme Court upheld the regulation, stating that the constitutional clauses apply only to limits on the admission of user groups, not on the allocation of resources among groups, and that the board had the authority to allocate among groups.[133] Such a balance of the interests between the business community and the larger community could be made by other courts as well. And this balance can be used to supervise "corporate responsibility" issues and yet maintain the managements' accountability for their actions. In the area of public trust the justifications of the business judgment rule are weaker.

Yet in another context a court affirmed the termination of a high ranking manager by a board of commissioners in a dispute "over how to respond to a freedom of information [FOIA] request submitted by a local newspaper." The manager refused to certify any documents except those that "she had assembled and presented." The [commission chair] charged the manager "with violating her fiduciary duty and wasting public funds in creating documents that [the chair] had specifically instructed [the manager] not to do." The Fourth Circuit held that her letter was "at most, crafted to protect her reputation or lessening her risk as a manager in the public sector," "not speaking as a citizen on a matter of public concern." The court quoted a Supreme Court case holding that speech must "'seek to bring to light actual or potential wrongdoing or breach of public trust' in the office" to meet the "public concern" test. "Because [the commission] reasonably believed that [the manager's] actions concerning the FOIA request permanently disrupted [the manager's working relationship with the Commission,] it was justified in terminating her employment as the highest ranking operations officer."[134] Courts have recognized a public trust concept in

132. *Id.* "There is a good argument that states have a quasi-sovereign interest in not just their current citizens but also their future citizens." *Id.*

133. Tongass Sport Fishing Ass'n v. State, 866 P.2d 1314, 1316–18 (Alaska 1994).

134. McVey v. Va. Highlands Airport Comm'n, No. 01-2466, 2002 U.S. App. LEXIS 16584 (4th Cir. Aug. 15, 2002) (quoting Connick v. Myers, 461 U.S. 138, 148 (1983)).

other contexts involving private actors, including a bank officer who conspired to defraud a bank[135] and an attorney for a class of plaintiffs in a class action suit.[136]

Thus, when corporate management exercises entrusted power that seriously affects the population of the financial system and the economy, the theory of public trust might offer a guiding principle to help balance the directives which corporate management should follow and the strong interests of society.

2. Duty to Act in Good Faith in Performing Fiduciary Services

By definition, fiduciaries have discretion on how to perform their services and how to use entrusted assets and power. Regardless of how detailed the directives to the fiduciaries are, the discretion remains. In fact, if service providers have little or no discretion they might not be considered fiduciaries. The fiduciary's discretion is linked to the use of entrustment and services. And these uses can be interpreted in many ways. Therefore the law imposes a general duty on fiduciaries to act in good faith. Fiduciaries should truly believe that they are doing the right thing. They should not seek "loopholes." There should be no evidence that they did not mean what they said.[137] In Delaware, corporate management that acted in good faith has received a high level of protection in connection with management's duty to prevent employees from violating the law.[138] One academic doubted that "good faith" has content apart from the duty of care or the duty of loyalty and wondered whether good faith in corporate law will create a new cause of action, or rather "provide the judiciary with maximum flexibility in its corporate law jurisprudence."[139] It seems that the latter will be the case.

135. United States v. Fredericks, 787 F. Supp. 79, 83 (D.N.J. 1992) (declining to reduce defendant's sentence because of his cooperation, balancing cooperation against the "enormity of the crime" and the "egregious breach of fiduciary duty and public trust," noting that his actions caused the "loss of confidence of an important institution").

136. Buford v. H&R Block, Inc., 168 F.R.D. 340, 351 (S.D. Ga. 1996) (in discussing adequacy of representation under Federal Rules of Civil Procedure, stating that "[t]he class attorney serves in 'something of a position of public trust'") (quoting Piambino v. Bailey, 757 F.2d 1112, 1144 (11th Cir. 1985)); *id.* at 351–52 (stating that class attorney "has a fiduciary duty to the court as well as to each member of the class") (citing *In re* "Agent Orange" Prod. Liab. Litig., 800 F.2d 14, 18 (2d Cir. 1986)).

137. *See generally* Hillary A. Sale, *Delaware's Good Faith*, 89 Cornell L. Rev. 456 (2004) (providing an overview of directors' fiduciary duties, as articulated in leading cases in Delaware, and discussing the evolving, independent fiduciary duty of directors to act in good faith).

138. Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559 (2008) (arguing that the Delaware corporate law has converged good faith with the duty of the directors to monitor employees' compliance with the law).

139. Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 Duke L.J. 1 (2005).

3. Duty to Account

It should be emphasized that accounting is not a mere duty to inform, but rather a duty to show responsibility and "accountability" for past activities relating to entrusted property or power. Accounting involves disclosure. But it involves more than disclosure. It is not enough for fiduciaries to send to entrustors the relevant information. If fiduciaries owe the entrustors money, then accounting should include the payment of the money due.[140] Thus, when an employee receives from the employer a sum of money to buy specific assets, such as diamonds, the employee should return with the diamonds, a receipt for the diamonds for which they paid and any change which they did not spend.

Fiduciaries, such as trustees, must account for the entrusted property consistently, not sporadically, and in full, not partially. Accounting must be systematic, periodic, and comprehensive, including accounting at the termination of the relationship. But accounting frequency must be reasonable. Trust reporting, for example, need not be daily, unless an unusual event occurred, in which case accounting must include the event reasonably promptly.

4. Duty Not to Delegate Fiduciary Duties

Because fiduciary relationships are personal, based on a high level of trust and often on a high level of expertise, fiduciaries have limited freedom to delegate to others the responsibility for, and performance of, their services. This does not mean that fiduciaries may not resort to the help of service-givers in the performance of their fiduciaries' duties. Secretarial, research, and similar services are permissible. A board of directors may delegate to the corporation's CEO significant powers to operate the company's business and determine its policies, provided the board reserves the right to overrule the CEO and to fire him (even though at a high cost of a significant pension).[141] A trustee that transferred all trust duties to an attorney and enabled the attorney to deal with trust property without checking the operations of the trust property would be liable if the attorney had

140. *See* Austin Wakeman Scott et al., Scott and Ascher on Trusts § 17.4, at 1188–92 (5th ed. 2007) (describing trustee's duty to render an accounting); *id.* at 1186 n.1 (stating that "duty to account" can mean "a duty to keep records"; "a duty to report to the beneficiaries or to a court concerning the administration of the trust," or "a duty to pay amounts that the trustee should pay to the beneficiaries" and "Ordinarily, a trustee has all three of these duties."); Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559 (2008) (arguing that the Delaware corporate law has converged good faith with the duty of the directors to monitor employees' compliance with the law).

141. *See* Rev. Model Bus. Corp. Act § 8.01 cmt. (1984) (stating that board may delegate appropriate powers and functions to officers) (citing Rev. Model Bus. Corp. Act § 8.01(b) (1984)).

misappropriated part of the property.[142] Delegation should never be complete. And if fiduciaries cannot perform the task, they should resign.[143]

F. THE FIDUCIARIES' SERVICE-CONTRACTS AND COMPENSATION

1. The Contract-Fiduciary Mix

Fiduciaries are entitled to compensation for their services. In principle, the payments are not entrusted; they are paid in exchange for service, and fiduciary law should not address them. Fiduciaries' terms of engagement pose a clear conflict between the interests of the fiduciaries and those of the entrustors. Fiduciaries are interested in reducing the burdens of their services and increasing their compensation and profits. Entrustors are interested in receiving the best services (whatever the burdens to the servicers) at the least costs to themselves.

This relationship follows a contract model. The model of contract law is a relationship negotiated at arm's length. Yet, an arm's length negotiation between entrustors and fiduciaries is often not possible. Fiduciary relationships can be long-term. After the relationship has been established the fiduciaries have the trust of their entrustors, and many fiduciaries hold the entrustors' money, from which fiduciaries can deduct their compensation and other amounts they believe are due to them. In addition, entrustors, such as individual investors, may not have the negotiation power with their money managers although some entrustors, such as large pension funds, may have. For small entrustors, exiting the relationships may be impossible (such as investors locked into a pension plan) or very costly in terms of tax payment and seeking advice. Similarly, corporate executives have strong influence and power over the board of directors and thereby affect the amount and nature of executive compensation.

Arguably, fiduciary compensation should involve fiduciary law principles, especially after the fiduciary relationship has been established and must be weighed against contract law.[144] And yet, a counter argument may be that even

142. *Cf.* Gaver v. Early, 215 P. 394 (Cal. 1923) (imposing the liability on a guardian and attorney and charging compound interest from the time of the misappropriation).

143. *See In re* Estate of Rothko, 379 N.Y.S.2d 923, 935 (Sur. Ct. 1975) ("[A fiduciary] cannot serve two masters, and if he has a conflict between his duty to his estate and his duty to his corporation, he must resign or seek the direction of the court in advance."), *modified*, 392 N.Y.S.2d 870 (App. Div.), *aff'd*, 372 N.E.2d 291 (1977).

144. *See* Eric Fryar, *Executive Compensation Decision—Carbona v. CH Medical, Inc.* Dec. 5, 2008, http:/blog.shareholderoppression.com/2008/12/texas-executive-compensation.html; *see, e.g.*, Investment Company Act of 1940, § 36(b), 15 U.S.C. § 80a-35(b) (2006) (imposing fiduciary law in relations to excessive payments charged mutual funds). *See also* Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.), *reh'g denied, reh'g en banc denied*, 537 F.3d 728 (7th Cir. 2008), *vacated, remanded*, No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010); Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 822–23 (8th Cir. 2009).

under these conditions the governing rules can fall within contract law rules of undue influence.

2. A Solution: Arm's-Length Negotiations by Entrustors' Representatives

The combination of contract and fiduciary law has led in many cases to a structure that replicates an arm's-length transaction and substitutes for the entrustors a stronger representative to negotiate the contract. Corporate directors are fiduciaries, empowered and required to represent the entrustors and authorized to negotiate executive compensation on behalf of the corporation and its shareholders. This function is entrusted to directors for the benefit of their entrustors (the corporation and its shareholders) and not for the benefit of anyone else (whether their own benefit of that of others). Therefore, fiduciary law imposes duties on the directors with respect to their award of compensation to corporate executives. In this case imposing fiduciary law applies to the directors but not to the executives.

However, if corporate executives exercise strong influence and power over the entrustors' representatives, as is the assumption in the case of mutual funds, the advisers may bear a fiduciary duty to avoid charging their funds "excessive fees and expenses." This duty does not relieve the directors of their fiduciary duty to negotiate with the advisers the terms of their contracts.[145]

During the past thirty years the CEO chose the directors rather than the reverse.[146] Corporate directors often identify with corporate executives. Many directors are current or retired CEOs.[147] Membership of CEOs on the boards is justified because they have the expertise in operating and supervising the operation of large organizations. Directors may be friends of the CEOs. After all, enemies cannot work well together. Yet, these directors are likely to determine that their chosen CEO's compensation is not excessive. They might sincerely believe that there should be no limit to a good executive's compensation. They might

145. *See* Eric Fryar, *Executive Compensation Decision—Carbona v. CH Medical, Inc.* Dec. 5, 2008 http:/blog.shareholderoppression.com/2008/12/texas-executive-compensation.html; *see, e.g.*, Investment Company Act of 1940, § 36(b), 15 U.S.C. § 80a-35(b) (2006) (imposing fiduciary law in relations to excessive payments charged mutual funds). *See also* Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.), *reh'g denied, reh'g en banc denied*, 537 F.3d 728 (7th Cir. 2008), *vacated, remanded*, No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010); Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 822–23 (8th Cir. 2009).

146. *See* Dr. Earl R. Smith II, *The CEO's Role in Board Member Selection*, Nov. 19, 2008, http://www.scribd.com/doc/8162988/The-CEOs-Role-in-Board-Member-Selection (last visited Oct. 21, 2009).

147. *See* Sharon Carty, *AT&T's Former CEO Ed Whitacre Joins GM as Chairman*, USA Today, June 10, 2009, http://www.usatoday.com/money/autos/2009-06-09-whitacre_N.htm (last visited Oct. 21, 2009); Press Release, VirtualScopics, Inc., VirtualScopics Adds New Board Members (Dec. 16, 2005), http://www.virtualscopics.com/pdf/PressRelease/add_board_members.pdf (last visited Oct. 21, 2009).

sincerely believe that corporate executives are motivated mostly by money, and the less money they gain the less effort they might invest in performing their services.

In January 2010, a Wall Street Journal study found that the top 38 financial firms were planning to award $145 billion for the year 2009 to their executives. This award is higher by 18 percent from the year before, and "slightly more" than the banner year of 2007.[148] The recipients are executives, traders, investment bankers, money managers. This is "despite fury over Wall Street's pay culture."[149] The bonuses came about one year after the government bailed out these banks and investment banks. These bonuses were paid with bank shares and have to be held for a period. Since the price of bank shares was low in 2010, the recipients of the bonuses might gain from the shares' appreciation. The representatives of the firms argued that they need "competitive pay packages" or else the companies might lose talented employees to non-U.S. enterprises, hedge funds, and private equity funds. Perhaps the directors might conclude that the lower the executives' compensation is, the lower their own prestige would be. These assumptions might be wrong, and may create a self-fulfilling culture that harms the corporations and their entrustors. Under these assumptions, the model of an arm's length negotiations between the board of directors and the executives is unrealistic.

For these reasons the "representative" model is subject currently to reconsideration and pressure to empower large investors to nominate directors and shareholders to have a say about executive compensation.[150]

3. Viewing Fiduciary Services as Businesses

a. From Professions to Businesses The trend in the past 25 years is toward recognizing fiduciary services as businesses. For example, in 1977 the Supreme Court struck down the prevalent governing provisions that imposed on lawyers fixed fee schedules and prohibited them from advertising.[151] This change tilted the focus from legal services to law firm profits and business competition.

Similarly, physicians have refocused on their practices as businesses.[152] Advisers to mutual funds have functioned under a similar model for many years,

148. Stephen Grocer, *Banks Set for Record Pay*, Wall St. J., Jan. 15, 2010, at A1, LEXIS, News Library, Wsj File.

149. *Id.*

150. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, § 7222, 111th Cong. (introduced Dec. 2, 2009) (providing SEC authority to require inclusion of shareholder director nominees in proxy solicitation); *id.* § 2002 (providing for shareholder vote on executive compensation).

151. *See* Bates v. State Bar of Arizona, 433 U.S. 350 (1977).

152. *See* Thomas S. Huddle, *Drug Reps and the Academic Medical Center: A Case for Management Rather than Prohibition*, 51 Perspectives in Biology & Medicine 251, 256–57 (2008).

and many have gone public.[153] Thus, fiduciaries increasingly operate and view themselves as businesses that offer fiduciary services. Joel C. Dobris has lamented the deterioration of the law of "trust and estates." It may be breaking down, he wrote, and is used to make money and abuse the form rather than to serve clients. "We seem to have decreasing faith in duty as a tool for regulating trustee conduct, insofar as the trustee has a duty to a non-beneficiary. Fewer lawyers and regulators believe that a trustee who is not watched will seek to fully discharge his fiduciary duties. Attention to duty seems quaint and the trustee as a creature of embraced duty is a relic."[154] Trust law is changing "as is commercial trustee conduct."[155]

b. The Issues: A view of professional services as businesses raises complicated questions The issues are not merely whether the fiduciaries' fees are paid in exchange for services (which they are), but whether a particular activity belongs to the fiduciary or the business status. Professionals, such as lawyers and physicians (and probably teachers and accountants), were defined with emphasis on public service.

Rafael Chodus has put it eloquently:[156]

> [L]itigation has changed from being a profession, to being a business, to being an industry.
>
> **A profession** is a career dedicated to helping others. It involves self-sacrifice because the interests of the client must always come ahead of the professional's own interests.
>
> **A business** is a means of generating wealth for the business owner. The business must of course provide something that is of use to others but this is only as a means towards generating wealth for the owner. It is different from a profession because, while businesses must stay within dictated legal and ethical boundaries, they are otherwise free to put their own interests first. . . .
>
> A profession is similar to a vocation or "calling" because it involves a similar kind of dedication to a higher purpose. But it has always been more secular than a calling, and has not traditionally involved the same kind of total abandonment of one's ego. . . . It is different also because a profession has always required special education and a highly developed and diligently maintained skill set—while a calling does not require these things. As for businesses, they benefit from skill sets but still do not generally require certification of them.
>
> There has always been an internal tension between the profession and the business. The lawyer needs to support himself. The client would prefer to have the lawyer work for free but the lawyer has to charge fees and this means that at least in this one regard he has to set his own interests ahead of his client's. In recognition of this tension, our law has always exempted fee negotiations from the strictures of the lawyer's fiduciary duties. . . .
>
> Tensions between the business and the industry have intensified over the years as the number of lawyers practicing in larger firms has increased relative to the number in solo or small-firm practice. . . .
>
> The law firm involves systematic delegation of duties—and it is not clear that professional duties can or ever should be delegated. The law firm—particularly the large law firm—involves a hierarchy. . . . This hierarchy interacts with the systematic delegation of duties to the point that there is a temptation to push the hard work down to the grunts at the bottom of the hierarchy in order to support the higher-ups. The law firm that wants to compete successfully on the industrial playing-field must adopt standards of "productivity" to justify the hierarchical structure: The partners who bring in the clients, for instance, are more valuable to the firm than the members who do the work. And in these ways, the law firm functions as a business does, measuring the contributions of its members to the firm before measuring their contributions to the clients. Those lower in the hierarchy focus their efforts on advancing within the firm: They curry favor with their employers and senior partners first, and seek the approval of their clients only to the extent that such approval enhances their upward mobility in the firm—or their lateral mobility if they can leave the firm and carry their clients with them.
>
> A deeper tension exists between the profession and the industry. The professional's client is someone who is vulnerable, and who seeks professional help to address his vulnerability. He has been sued; he has suffered an injury, or a calamity, so he goes to a lawyer. He is sick or wounded, so he seeks the aid of a doctor. This vulnerability is ultimately the source of the fiduciary duty and the professional must always be sensitive towards it. But once the profession becomes part of an industry, the sense of the client's vulnerability gets lost. The client becomes instead a customer and the object of a marketing effort in which he is encouraged to become a client.
>
> It is not my purpose here to make value judgments about law as an industry: I plan to do that elsewhere. . . . If law has in fact become an industry, can it also still really be a profession?[157]

A complex question arises, for example, when a dentist office writes to clients that are covered by dental insurance. It suggests that they use the rest of their coverage for various dental services before the end of the insurance term. After all, their payments will not be returned. Why not use the rest? There seems to be nothing in law that prohibits this message. There is, however, something terribly

153. Tamar Frankel, *How Did We Get Into This Mess?*, 1 J. Bus. & Tech. L. 133 (2006).

154. Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or We Don't Have to Think of England Anymore*, 62 Alb. L. Rev. 543 (1998).

155. *Id.*

156. Rafael Chodos, *Is the Law Still a Profession?*, Citations (Ventura County Bar Ass'n), Aug. 2009, at 14, http://www.vcba.org/citations/2009/citationsMag_aug09.pdf.

157. *Id.*

wrong with it. The message, if adopted by a sufficient number of dentists and their patients, destroys the insurance system or renders it more expensive. Insurance companies will either limit the dentists' treatment or the amounts of coverage, or increase the premium, or refuse insurance to those who use it to excess, or to some dentists. The cost of insurance will rise. Business people are not concerned with such considerations. The insurance companies should take care of their business. At some point lawmakers might interfere. Perhaps the dentists who wrote the letter thought they were very smart, and perhaps they considered the legality of the letter, but not its implication or their professional responsibilities to society and the insurance system. They should not fret when legislation will take on the free market to preserve a good and efficient insurance system.

I believe that the business of professionals, such as lawyers and physicians, is still weighted to reduce the weight of the business aspect of their relationships with entrustors. For example, law firms may not accept non-lawyers as partners or shareholders.[158] In contrast, other fiduciaries, such as investment advisers that establish mutual funds and manage the investors' money that is held in these funds, may raise capital from investors who are not managers.[159] In fact, most of these advisers-managers are publicly owned.[160]

The difference is understandable because these advisers invest and own the infrastructure necessary to manage large amounts of financial assets.[161]

158. Note that Australia has allowed for the first time a law firm to go public. *See* Bruce MacEwen et al., *Law Firms, Ethics, and Equity Capital*, 21 GEO. J. LEGAL ETHICS 61 (2008).

159. Rashid Bahar & Luc Thévenoz, *Conflicts of Interest: Disclosure, Incentives, and the Market*, *in* CONFLICTS OF INTEREST: CORPORATE GOVERNANCE & FINANCIAL MARKETS 1, 3–4 (Luc Thévenoz & Rashid Bahar eds., 2007); *accord*, 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 12.01, at 12-5 (2d ed. 2001) ("[A]dvisers for investment companies occupy a special position, in that they substitute for managing directors and paid officers of the investment company."); Tamar Frankel & Lawrence Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 ANN. REV. BANKING & FIN. L. 235 (2006).

160. Investment Adviser Association, *Evolution Revolution: A Profile of the Investment Advisory Profession* (2005), *available at* http://www.investmentadviser.org/public/evolution_revolution-2005.pdf (most of the 53 investment advisory firms managing over $100 billion in discretionary assets are wholly owned by publicly traded companies).

161. The infrastructure includes portfolio managers and analysts, legal and accounting staff, stock transfer agents, brokers and trading desks, and the investor contact personnel. The advisers invest their own resources or public funds in these services and receive from the mutual funds payment for some of their expenses as well as fees for their services. Advisers in this case are similar to a law firm that serves many clients and employs the staff to manage complex litigation and transactions. These independent advisers to mutual funds service millions of investors. *See* Tamar Frankel, *How Did We Get Into This Mess?*, 1 J. BUS. & TECH. L. 133 (2006).

The fiduciary-business mix, however, raises difficult issues. When advisers use their business clout to negotiate a 30 percent reduction of the cost of services to the funds they manage (e.g., statistical services), who is entitled to the benefit of the deduction? Is it the advisers' business or the investors' funds? May advisers pocket this deduction and charge the client funds the market price of the services? The answer may depend on the understanding or contract among the parties.[162] Unless specified, for example, as "out of pocket expenses," the answer may be drawn from a more general rule. Perhaps the default rule would be to charge investors "out of pocket expenses" unless the agreement with the investors specifies "market price," or a similar language.[163] Likewise, if an adviser to a mutual fund decides to reduce its service expenses[164] should the decision be publicized to future and current investors? As an increasing number of fiduciaries conduct large businesses, the need for specific distinction between their service, on the one hand, and their business benefits, on the other hand, becomes crucial.

These issues have expanded beyond financial services. Certain university professors have been found "liable for breaches of their fiduciary duty of loyalty based not on their status as professors but rather on their blatant pursuit of self interest at the great expense of trusting students."[165] Thus, unless the law or public pressure intervenes to reemphasize the public service aspect of professional fiduciaries, the business aspects of their services will trump their "professionalism." The traditional view is that professionals are fiduciaries who are empowered by the State to serve society. Lawyers are deemed "gatekeepers" to avoid violations of the law. Physicians are deemed healers of the sick.

Market pressures drive competing professionals to offer those who pay what they want. For example, the huge accounting firm of Arthur Andersen suffered a fatal defeat which started with allowing its client Enron Corporation, "aggressive accounting," in fact subverting the financial picture of the corporation.[166] Accounting firms profited from consulting services until they were forced to separate these two internally conflicting services.[167] Lawyers sell "legal

162. *See* Tamar Frankel, *The Seventh Circuit Decision in Wsol v. Fiduciary Management Associates and the Amendment to Rule 12b-1*, INV. LAW., Aug. 2004, at 8, 11.

163. The main rule is that the fiduciary may not interposition between itself and the client another entity in order to charge the entity's prices to clients while the fiduciary does not perform any services.

164. *See* Ross Kerber, *Fee Falling*, BOSTON GLOBE, July 2, 2006, at C1 (mutual fund companies, such as Fidelity, are embracing fee cuts).

165. *See* Chou v. Univ. of Chi., 254 F.3d 1347, 1362 (Fed. Cir. 2001); Johnson v. Schmitz, 119 F. Supp. 2d 90, 98 (D. Conn. 2000).

166. *E.g.*, Alan B. Krueger, *Accounting for Bad Apples; Investors in the Stock Market Render Their Verdicts*, N.Y. TIMES, July 25, 2002, at C2.

167. *E.g.*, Calmetta Coleman & Cassell Bryan-Low, *Audit Fees Rise, and Investors May Pay Price*, WALL ST. J., Aug. 12, 2002, at C2, LEXIS, News Library, Wsj File. The Sarbanes-

loopholes"[168] and physicians either increase treatment unnecessarily[169] or do not provide it when it is needed.[170] The main view of professional firms and other fiduciaries as conducting businesses is fairly prevalent.[171]

Competition among lawyers engaged in class action litigation brings temptations to pay potential plaintiffs for acting. The payment violates the rule against "champerty," which is designed to avoid litigation by plaintiffs who would otherwise not sue.[172]

> Similarly, lawyers, who compete for advisory business to public pension funds, have been driven to make contributions to the public officials who choose the advisory lawyers. This trend of "pay to play" has led to the American Bar Association Rule providing that: "A lawyer or law firm shall not accept a government legal engagement or an appointment by a judge if the lawyer or law firm makes a political contribution or solicits political contributions for the purpose of obtaining or being considered for that type of legal engagement or appointment."[173] The comment to the rule demonstrates the conflicting considerations involved.[174]

Oxley Act of 2002 prohibits an accounting firm from performing certain consulting services for an issuer for which it performs audit services, and allows other services for such issuer only if approved by the issuer's audit committee. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201(g), 116 Stat. 745, 771–72 (codified at 15 U.S.C. § 78j-1(g)-(h) (2006)).

168. TAMAR FRANKEL, TRUST AND HONESTY 140–43 (2006).

169. *Id.* at 11–12 (citing Steve Quinn, *Tenet Faces Tough Road to Recovery*, DALLAS MORNING NEWS, Jan. 2, 2005, 2d ed., at 1D, LEXIS, News Library, Arcnws File) (noting investigation of Tenet Corporation in connection with physicians conducting "procedures believed to have been unnecessary").

170. *Id.* at 74 (citing Dee McAree, *"Blacklisting" of Patients, Tenants Draws Ire: Is Use of Web Court Data an Unfair Black Mark or a Good Way to Reduce Risk?*, NAT'L L.J., Apr. 19, 2004, at 5 (noting that some physicians blacklist patients who have sued physicians for malpractice even though some blacklisted patients may have legitimate need for services in future).

171. *Id.* at 139.

172. *See* Gardner v. Surnamer, 608 F. Supp. 1385, 1391 (E.D. Pa. 1985) (stating that an agreement violates the public policy against champerty "if it provides for the institution of litigation by and at the expense of a person who, but for the agreement, has no interest in it, with the understanding that his or her reward is to be a share of whatever proceeds the litigation may yield"); Martin Zimmerman et al., *Lawyer Cuts Plea Deal in Kickback Case*, L.A. TIMES, Mar. 21, 2008, at C3 ("Melvyn Weiss was accused of paying class-action plaintiffs. He is expected to get 18 to 33 months.").

173. MODEL RULES OF PROF'L CONDUCT R. 7.6 (2001).

174. MODEL RULES OF PROF'L CONDUCT R. 7.6 cmt. (1) (2001) (noting balancing of lawyers' right to participate in political process against public concern that lawyers selected for engagement or appointment are selected on competence and merit); *id.* (5) (noting that purpose of contributions may be determined by circumstances; factors weighing

4. Market Competition Does Not Necessarily Regulate Management Compensation

In the United States there is a strong belief that the market should determine prices, salaries, or compensation. Legislators, regulators, and the courts should keep out of this area. And yet, market competition is ineffective to establish reasonable compensation for some services, such as the services of professionals, money managers, and corporate management. In fact, competition among CEOs produces not lower, but higher compensation. To bolster their positions and reputation corporate managers demand higher compensation than that paid to others.[175] A similar phenomenon has occurred in the area of legal and medical services. When higher compensation signals higher and more reliable performance, for example, in performing heart surgery, people will seek the highest paid surgeon, not the lowest paid one. To some people in business price is indeed an indicator of quality.

Highly paid executives may justify overpayment by offering pro bono services and contributions to charities, but not by reducing their compensation. Thus, competition can increase, rather than decrease, managements' compensation.[176] In addition, even if the compensation is linked to performance there are pressures to continue payment at a high level. When executives are used to receiving significant bonuses, the rationale of the bonuses as rewards for good performance is lost but the strong expectations of bonuses remains.[177] After all, there are many reasons other than performance for losses. And bonuses become compensation.

5. Theoretical Support for Identifying Executives with Corporations' Owners

During the past thirty years executive compensation has been fed by a theory based on the assumed incentives of executives; connecting executives' compensation with their corporation's performance. If their incentives match the benefits

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against prohibited purpose may include a lawyer's "political, social, or economic interest" or "existing personal, family, or professional relationship with a candidate").

175. *See* Slayton Search Partners, *Shift in Demand for Top Management Talent Puts Executives Atop Seller's Markets*, Sept. 2006, http://www.slaytonsearchpartners.com/docs/slaytonpovsept06_redirect.pdf.

176. *See Current Controversies in Executive Compensation: Issues of Justice and Fairness*, May 02, 2007, http://knowledge.wharton.upenn.edu/articlepdf/1727.pdf?cfid=5490206&cftolken=32430982&jsessionid=a830109b7c5bb77bfdabd54d3b340512484f.

177. *See, e.g.*, Susanne Craig & Deborah Solomon, *Bank Bonus Tab: $33 Billion*, WALL ST. J., July 31, 2009, at A1 (banks that received government support returned the money and were free to pay their employee-executives large bonuses. As these corporations repaid the government $50 million, they paid $32.6 billion to their managers. The question is whether they should have received the government's bounty even for a short while and whether their managers should be rewarded so richly. After all, they are the ones who enabled the banks to repay the money).

to the shareholders, so the theory runs, the executives' incentives will induce them to make their best efforts for the shareholders.[178] The theory is grounded on the fact that the executives' self-interest will be aligned with interests of the shareholders and the corporation, by standing in their entrustors' shoes.

This connection has proven not only ineffective, but also dangerous. First, executives are workers who serve the corporation; they are not the owners who put their dollars at risk. Our society has determined that the owners receive the residual benefits of the enterprises. Workers receive a fixed amount (plus incentive compensation at the discretion of the owners).[179] Similarly, the executives' risks are those of workers and not of capitalists. The risk and the benefits of the owners are more directly linked to the fortunes of the enterprise. Managers participate in the owners' benefit but have rejected full participation in the owners' risks.

Second, by equating themselves to the owners, executives may have begun to feel as owners and not as fiduciaries that hold entrusted assets and power. That was a dangerous shift to entitlement that invited many abuses of entrustment.[180] The "owners' mindset" can explain why executives and their supporters have been fighting congressional limits on the compensation of executives that operate corporations which received taxpayers' bounty.[181] Executives and supporters argue that American corporations will be drained of corporate *leadership and talent*, and that unless high payments are made, leadership and talent will follow foreign corporations abroad.[182] Yet, whether talent is equal to a dollar amount paid under these circumstances is open for debate; and the risk of losing talent that has taken enormous risks at the expense of the enterprise, shareholders, and employees may be a risk well taken.[183] Moreover, leadership that measures

178. *See* James Hamilton, *Executive Compensation*, Jan. 19, 2009, http://www.econbrowser.com/archives/2009/01/executive_compe.html; Uwe E. Reinhardt, *Whom Do Corporate Boards Represent?*, Feb. 20, 2009, http://www.law.harvard.edu/programs/olin_center/corporate_governance/MediaMentions/02-20-09_NYT.pdf.

179. *See* Lucian Bebchuk & Jesse Fried, Pay Without Performance 54–55 (2004) (arguing that equity-based compensation is inadequate to discourage higher executive compensation).

180. Center for Corporate Policy, *Corporate Crime and Abuse* (2004), http://www.corporatepolicy.org/issues/crimedata.htm.

181. Tomoeh Murakami Tse, *Lawmakers Goal to Cap Executive Pay Meets Resistance*, Wash. Post, Feb. 12, 2009, at D05.

182. *See* Stephen Grocer, Bank of America's Paying Bonuses to Keep Top Talent? Shocking!, WSJ.com, June 18, 2009, http://blogs.wsj.com/deals/?s=paying+bonuses+to+keep+top+talent.

183. *See* John Ydstie, *White House Takes Step To Rein In Executive Pay*, June 11, 2009, http://www.npr.org/templates/story/story.php?storyId=105241025 (last visited Oct. 21, 2009) ("[C]ompensation practices contributed to the current crisis by encouraging high risks.").

itself by the amount it is paid, and has no sense of pride or shame at the fortunes of the institution and the people that it led, may not fit America's expectations. And if the leadership is so bound to entrusted power for its own benefit, is that the leadership America needs and wants?

Third, unlike the contribution of sports and movie stars to revenues, it is harder to determine the contributions of the executives to the performance of their corporations. Performance may be due to many factors and to the large corporate workforce, or to the single employee's invention, in spite, and not because, of the CEO's and management's leadership.[184]

Not surprisingly, when market prices of corporate shares fell, management sought ways to retain the value of the stock options allotted to executives and valued employees. The justification for these ways, if not the legal justification, abandoned the theory of identity of interest with shareholders and the theory that the fortunes of the corporation were due to the efforts of the management and valued employees.[185] Ironically, the justification drew on the distinction between employees and owners: The employees need, and are entitled to, a salary. Implicitly, they should not take the market risks. But the threat that valued employees will leave the corporation is no justification. This threat is no different from the threat that the investors will leave and the share prices fall.[186]

The true justification for employees is that they should bear lower business risk as compared to the investors. And if that is the rationale, then employees should also reap lower business gains. When the levels of risks and gains are not balanced, there is a high probability that the party bearing the lower risk will seek to create higher risks in order to gain equally with, or even more than, the party that bears the higher risk. That is especially so when the controlling party is the party that bears the lower risk and seeks at least equal, if not more, benefits.

Fourth, the connection of executive compensation to the market price of the corporate shares can and did breed corporate management corruption. It has

184. Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad, 95 (2006) ("[T]he corporation's success is not directly linked to the CEO's efforts . . . [and] . . . [t]he corporation's success may have been achieved in spite of him or her"); Roderick Kramer, *Flawed Leaders: Their Rise and Fall*, Bus. Day (South Africa), Nov. 24, 2003, at 2 (discussing the many executives who have a highly exaggerated sense of entitlement).

185. *See* Lucian Bebchuk & Jesse Fried, Pay Without Performance 165–68 (2004) (noting justifications for "back-door repricing" of options when stock prices fall, including to "help retain and motivate executives" and to protect managers from a downturn outside their control).

186. Eric J. Wittenberg, *Underwater Stock Options: What's A Board of Directors To Do?* 38 Am. U.L. Rev. 75, 107 (1988).

incentivized a number of executives to manipulate the corporations' performance[187] or change the terms of their stock options.[188]

Fifth, the link of compensation to corporate profits and share prices does not translate to executives' quality performance. Short-term profits from cost-cutting, for example, can hurt corporate business long-term, can undermine the morale of the remaining workforce and empty the corporation of human and asset capital, bringing it to bankruptcy. Such cost-cutting, however, entitles executives to "performance fees."

The Sarbanes-Oxley Act connection. Section 304 of the Sarbanes-Oxley Act[189] authorizes the Securities and Exchange Commission to sue management members for repayment of their bonuses in the case of "a restatement due to the material noncompliance of the issuer." The SEC began to exercise this authority in 2006.[190]

Methods of avoiding conflicts concerning executive compensation. To protect themselves from shareholder claims against approval of high management compensation and their own conflicts of interest, boards usually engaged consultants or executive recruiters to advise them about the going market rate for a new CEO or, if the current CEO is negotiating a new contract, for their current CEO.[191]

187. Lucian Bebchuk & Jesse Fried, Pay Without Performance 165–68 (2004) (Robert A. G. Monks proposed eight steps to evaluate and control executive compensation: Do the homework: Research well the data comparing the executive compensation of comparable companies, starting with companies in the same industry. Evaluate the complexity of the job, and compensate accordingly. Link compensation to benchmarks of performance. Do not promise "golden parachutes" or pay without performance, and examine possible large amounts under other headings, such as pension plans. Seek others' opinions: Hire independent advisers that do not have financial ties to the company, review and negotiate the compensation with the CEO. Let shareholders vote on executive compensation, ask the money managers to vote on the compensation; they can be "[t]he biggest influence on executive compensation" but "frequently do not exercise an opposing vote.").

188. *See, e.g., Executives on Trial: Trial Opens in Brocade Backdating Case*, Wall St. J., June 19, 2007, at C2, LEXIS, News Library, Curnws File.

189. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (codified at 15 U.S.C. § 7243 (2006)).

190. SEC v. McGuire, No. 07-CV-4779-JMR/FLN, Litigation Release No. 20,387 (D. Minn. filed Dec. 6, 2007), http://www.sec.gov/litigation/litreleases/2007/lr20387.htm; SEC v. Shanahan, No. 4:07CV270 JCH, 2008 U.S. Dist. LEXIS 100640 (D. Mo. Dec. 12, 2008) (construing Section 304 to require issuer to actually file restatement even though SEC claimed restatement was required). *Cf.* SEC v. Gruttadauria, No. 1:02CV324, Litigation Release No. 17,369 (N.D. Ohio filed Feb. 21, 2002), http://www.sec.gov/litigation/litreleases/lr17369.htm (requiring disgorgement of monies broker misappropriated and compensation received as result of fraudulent activities).

191. *See* The Association of Executive Search Consultants, http://www.aesc.org (last visited Oct. 21, 2009).

These advisers, however, had conflicts of interest of their own. Because they represent executives as well as advise, the consultants benefit from higher executive compensations on which they expertly advise.[192] Thus, notwithstanding public criticisms, and lower shares' market prices, CEOs' compensation for the year 2006 continued to rise.[193] In fact, executive compensation reached a peak in 2007; shareholders' displeasure on this issue has not been effective,[194] and the courts refuse to determine how much executive compensation is too much.[195] Congress resorted to disclosure and tax provisions to resolve the issue,[196] although the public's persistence and pressure have increased.[197]

6. The Consequences of Curtailing Executive Compensation

A significant number of Chief Executive Officers (CEOs) left their posts in the years 2007 and 2008 (willingly or unwillingly).[198] Many received parting gifts of large amounts. In the past ten years there have been attempts to strengthen direct or indirect involvement of the shareholders on this question, but no judicial or legislative direct regulation is in the offing, except with respect to corporations that were rescued by the government.[199]

192. *See* D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 Tul. L. Rev. 829, 869–70 (2007) (stating that compensation experts are hired by management and therefore have incentive to look out for executives and not shareholders).

193. *See, e.g., Surveys Find CEO Pay Increases Moderate with More Emphasis on Performance*, Rep. on Salary Surveys, June 2008, LEXIS, News Library, Curnws File (noting that in the past year "executive pay still continued its upward climb" although "increases showed remarkable moderation"; some studies "found that there was greater attention paid to performance" although one report "found that 'true' links between pay and performance appeared nebulous").

194. Executive Compensation Disclosure, Securities Act Release No. 6962 (Oct. 16, 1992), 67 Fed. Reg. 48,126 (Oct. 21, 1992).

195. Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. Rev. 937, 398 (1993).

196. *Id.*

197. *See, e.g.,* Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 Cornell J.L. & Pub. Pol'y 383, 389 (2008) ("Shareholders at many corporations appear to be frustrated by the levels of executive compensation and many are pushing for a change.").

198. *See, e.g.,* Press Release, Weber Shadwick, Global CEO Turnover Rises 10 Percent in Past 12 Months According to New Weber Shadwick Study, http:://www.webershandwick.com/Default.aspx/AboutUs/PressReleases/2008/GlobalCEOTurnoverRises10PercentInPast12MonthsAccordingToNewWeberShandwickStudy (last visited Oct. 21, 2009); *North American CEO Departures Dominate Fourth Quarter 2007*, PR Newswire, Mar. 3, 2008, LEXIS, News Library, Curnws File.

199. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111, 2008 U.S.C.C.A.N. (122 Stat.) 3765, 3776–77 (to be codified as amended at 12 U.S.C. § 5221))

In 2008 Congress bailed out a number of mammoth financial and industrial corporations. The fierce arguments about executive compensation and public outrage led first to a vague provision requiring limits on management compensation.[200] But continued public outcry rose to new heights when the former CEO of Merrill Lynch & Co. arranged for management bonuses while negotiating a "fire sale" of the company with the government support.[201] Then and only then was the compensation of executives that have presided over corporations that receive a significant handout of taxpayers' money capped at $500,000.[202] Shareholders' suits attacking compensation of executives that presided over bankrupt corporations have opened the door to demands for retroactive repayments.[203]

When the market price of corporate stock fell, stock options became worthless. Corporate directors attempted to reduce the options' exercise price, or issue new options exercisable below the market price. But then directors could be vulnerable to shareholder derivative suits for "corporate waste, for breach of fiduciary duty, for violations of Rule 14a-9, for violations of the proscriptions on fraud contained in the federal securities laws, and for violations of section 12(2) of the Securities Act and section 18(a) of the Exchange Act. Costly litigation is certain to follow if an interested director acts to issue new options if old options go underwater."[204] The shareholders' ratification, however, could protect the directors, as any consent by the entrustors would. Directors built into the stock options a language which attempted to "allow directors to act in the face of underwater options" with certain exceptions. It is unclear, however, to what extent such shareholders' consent is binding. "The October 1987 stock market crash has provided fertile ground for a new round of shareholder derivative suits arising out of directors' actions to deal with underwater options."[205]

Corporate management has not given up. Management has been organizing to influence Congress. Bank of America had difficulties in recruiting a new CEO

(authorizing Secretary of the Treasury to require financial institutions receiving assistance under Troubled Assets Relief Program to meet executive compensation standards).

200. *See* Deborah Solomon & Mark Maremont,, *Bankers Face Strict New Pay Cap,* WALL ST. J., Feb. 14, 2009, at A1, LEXIS, News Library, Curnws File, http://online.wsj.com/article/SB123457165806186405.html (last visited Aug. 25, 2009).

201. Dan Fitzpatrick et al., *Thain Ousted in Clash at Bank of America,* WALL. ST. J., Jan. 23, 2009, at A1, LEXIS, News Library, Curnws File.

202. *See* Suzanne Malveaux, *Obama Sets Executive Pay Limits,* CNN, Feb 4, 2009, http://www.cnn.com/2009/POLITICS/02/04/obama.executive.pay/index.html.

203. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).

204. Eric J. Wittenberg, *Underwater Stock Options: What's a Board of Directors to Do?,* 38 AM. U.L. REV. 75, 106 (1988).

205. *Id.* at 107.

because of disagreements about proposed compensation.[206] In sum, at the end of the year 2008 it seemed that the market and public opinion rather than the law were likely to affect, if not resolve, this issue. In March 4, 2009, the *Wall Street Journal* front page showed the pictures of three of the ten earners in Merrill Lynch, who received together $209 million in bonuses, "as the First Foundered."[207] At the beginning of 2009, it seems that Congress, the regulators[208] and perhaps the courts might respond to the issue as well.

If the executives' compensation is fully or mostly linked to the corporate profits, executives must share the full downside in corporate profits as well. If they accept a fixed amount, they should be sheltered from corporate losses, but not from being terminated. What is less acceptable and hard to understand is a system that attributes the upside to the efforts of power holders and rewards them accordingly, yet shelters their pay and reputation from the downside. As of the year 2009 this issue has not yet been resolved.

7. Compensation of Mutual Funds' Managers

A problem similar to the issue of executive compensation has risen in the context of the fees to advisers who manage mutual funds. Section 36(b) of the Investment Company Act of 1940[209] imposes a fiduciary duty on advisers (promoters and managers) of investment companies with respect to fees and expenses charged to their investment companies. What does fiduciary duty mean in this context? While some courts listed the factors that board of directors of investment companies should consider when they approve the advisory contract or the payments, a recent decision imposed a simpler test: disclosure. So long as information about the fees and expenses is publicly disclosed, the shareholders—the markets—should determine the level of the fees. Market prices are the fiduciary prices.[210] The Supreme Court rejected this view and adopted the

206. *Bank of America to Repay US $45b,* BOSTON GLOBE, Dec. 3, 2009, at 6, LEXIS, News Library, Curnws File (stating that repayment of bailout funds would end compensation restrictions; compensation restrictions had been "a problem" in CEO search).

207. Susanne Craig, *Merrill's $10 Million Men,* WALL ST. J. Mar. 4, 2009, at A1, LEXIS, News Library, Wsj File.

208. *See* list of bank regulators, http://www.sec.gov/answers/bankreg.htm. *See* Serena Ng et al., *In Battle With U.S. over Pay, AIG Chief Meets His Match,* WALL ST. J. Dec. 24, 2009, LEXIS, News Library, Wsj File.

209. Mutual fund advisers and managers may not charge "excessive fees" to mutual funds. Investment Company Act of 1940, § 36(b), 15 U.S.C. § 80a-35(b) (2006).

210. Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.) (stating that the markets should determine the fees and shareholders should vote with their dollars), *reh'g denied, reh'g en banc denied,* 537 F.3d 728 (7th Cir. 2008), *vacated, remanded,* No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010) (rejecting Seventh Circuit view).

view that the courts guide the funds' directors in their negotiations with the adviser.[211]

In theory the issue has remained the same: To what extent is the power to decide the executives' compensation separate from the power that the same executives exercise? Presumably, the less power executives exercise with respect to their compensation, the less fiduciary law should apply. The more power they exercise—the higher the fiduciary law intrusion should be. Lower fiduciary duties involve a lower prohibition on conflicts; greater power comes with stricter prohibitions.

8. The Courts' and Legislatures' Approaches

The courts and legislatures have taken different approaches to the fiduciaries' compensation and expenses issue. The Court of Appeals of the Seventh Circuit interpreted the Investment Company Act of 1940 that explicitly imposed fiduciary duties in determining investment managers' excessive fees, against the backdrop of the market. That court expressed its strong belief that fiduciary duty is limited to public disclosure; with appropriate information, the investors and the financial markets are effective in setting the fees and expenses of financial managers' services.[212] Other courts have introduced explicit and detailed guidelines for the directors to determine excessive fees and expenses.[213] The Supreme Court resolved the disagreement, following the view of the Second Circuit, recognizing specific guiding factors for board of directors.[214]

The story of executive and fiduciaries' compensation is not yet complete, but the signals at the end of the year 2009 are that public opinion, the government, and a number of congressional leaders, on the one hand, and the corporate management on the other hand, are ready for the conflict.

G. THE DEBATES

The duty of loyalty and especially the prohibition on conflicts of interest and the extent of this prohibition have been subject to extensive criticisms and debates. These debates cover disagreement on the measure of the entrustors' risks, the

211. Jones v. Harris Assocs. L.P., No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).

212. Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.) (stating the markets should determine the fees and shareholders should vote with their dollars), *reh'g denied, reh'g en banc denied,* 537 F.3d 728 (7th Cir. 2008), *vacated, remanded,* No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010) (rejecting Seventh Circuit view).

213. Gartenberg v. Merrill Lynch Asset Mgmt, Inc., 740 F.2d 190 (1984).

214. Jones v. Harris Assocs. L.P., No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).

strictness of the prohibition on conflicts, as well as proposals for its elimination. One academic noted that corporate directors' fiduciary duties no longer exist.[215] Another doubted whether conflicts of interest are more "costly" than the violation of the duty of care.[216]

The proposed solution for this failure of fiduciary law to regulate corporate management is to avoid fiduciary law altogether, and seek contract and legislation to stem the tide of violations. Other solutions for the same problem resort to fiduciary law. Recent clashes concerning management's bonuses demonstrate management's self-perception and entitlement as owners rather than holders of entrusted assets and money. Managements' compensation and its insistence on bonuses, even when the corporations which they led needed a government handout, and the return of these supports to free management from constraints on its bonuses, show an entrenched attitude of entitlement.[217] The result, however, may not be a contract approach but rather legislation and judicial tightening of management's freedom. Shareholders might acquire greater influence regarding management's compensation. In the year 2009 there seems to be a rise of government, investors, and citizens' counter-power facilitated by proxy rules, and the establishment of a "compensation czar."[218] Private power is desirable as a balance for public, government power. But private power without a balance of counter-power is just as dangerous as all unaccountable power is.

1. Should Conflict of Interest Be Prohibited Unconditionally?

The debates concerning preventive rules in fiduciary law focus on the degree to which the rules should prohibit fiduciaries from engaging in activities that do not harm the entrustors, but may raise greater temptation to abuse entrustment.

215. Kelli A. Alces, *Debunking the Corporate Fiduciary Myth,* 101 MICH. L. REV. 2037 (2003).

216. Jonathan Macey, *Robert Clark's Corporate Law: Twenty Years of Change: The Nature of Conflicts of Interest Within the Firm,* 31 IOWA J. CORP. L. 613 (2006) ("it is not clear that violations of the duty of loyalty and transactions that involve conflicts of interest, involve conduct that is worse, from a moral point of view, than conduct that is "merely" negligent;" "It is clearly not the case that the costs of identifying wrongdoing are lower in duty of loyalty/conflicts cases than in duty of care/negligence cases. Basic analytic distinction between negligence and loyalty is not as clear as is generally presumed").

217. *E.g.,* Susanne Craig, *Merrill's $10 Million Men,* WALL ST. J., Mar. 4, 2009, A1, A11; Dan Fitzpatrick, Suzanne Craig & Carrick Mollenkamp. *Thain Ousted in Clash at Bank of America,* WALL. ST. J., Jan. 23, 2009 at A1.

218. Louise Story & Stephen Labaton, *Overseer of Big Pay is Seasoned Arbitrator,* N.Y. TIMES, June 11, 2009, at B1, LEXIS, News Library, Curnws File (noting appointment of "compensation czar" as "compensation official for companies on federal assistance"); Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, §§ 2001–2004, 111th Cong. (introduced Dec. 2, 2009) (providing for shareholder vote on executive compensation, compensation committee independence, and enhanced compensation reporting).

The proponents of limiting such preventive rules argue that the rules are costly for fiduciaries and reduce their profits while they offer unnecessary protection to the entrustors.[219] Why prohibit transactions that benefit the fiduciaries and the economy and harm no one?

A number of modern commentators, who object to unconditional prohibitions on conflicts of interest, suggest that an automatic "finding of impropriety should be replaced by a rebuttable presumption."[220] This means that conflicts of interest are fine, if they do not harm entrustors. The decision on that score, however, is made by the courts or regulators and not by the entrustors. While entrustors may simply refuse to agree to a conflict of interest transaction, even if it benefitted them, a decision by third parties would be based on benefits to the entrustors and thus be more limited, rational and not arbitrary.

In part, the reason for this relaxation is that "modern law and accounting is more apt to deal with fiduciary power; [and] partly out of unease at the penal or deterrent application of private law remedies to pursue public policy goals."[221] In the years 2007 and 2008 these arguments are less persuasive in light of fraudulent accounting, the discoveries of enormous Ponzi schemes,[222] and a garden variety of frauds following the crash of the previous bubble years.[223] These schemes have proliferated, notwithstanding modern accounting and

219. *In re* Martin, 817 F.2d 175, 181 (1st Cir. 1987) (in bankruptcy proceedings, always precluding counsel because of a conflict of interest is too costly because the conflict of interest may have no effect on the outcome and finding counsel who does not have a conflict of interest may prove to be more expensive. The "conflict of interest" may just mean that counsel will have a financial stake in the matter and that does not harm the entrustors); *see* T. Leigh Anenson, *Creating Conflicts of Interest: Litigation as Interference With the Attorney-Client Relationship,* 43 AM. BUS. L.J. 173, 200-201 (2006) (Conflicts of interest are created or exposed to put the attorney with the "conflict of interest" at a disadvantage, when it would not have affected the attorney's fiduciary duties to the client.).

220. *See In re American Printers & Lithographers, Inc.*, 148 B.R. 862, 866 (Bankr. N.D. Ill. 1992) (adopting this presumptive rule).

221. *Id.* (footnote omitted) (citing S. CRETNEY, THE RATIONALE OF KEECH V. SANDFORD (1969) 161–63, 78; P. D. FINN, FIDUCIARY OBLIGATIONS 246–51, 259–65 (Law Book Co. Sydney 1977); L. SMITH, THE MOTIVE, NOT THE DEED, *reprinted in* J. GETZLER (ED) RATIONALIZING PROPERTY, EQUITY AND TRUSTS 57–64, 73–80 (LexisNexis/Butterworths London 2003)); *see* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?* 114 YALE L.J. 929 (2005) (suggesting that the "sole interest" rule prohibiting conflicts of interest in trust law be replaced by a more lenient "best interest" rule).

222. *See* Robert Frank, Amir Efrati, Aaron Lucchetti, & Chad Bray, *Madoff Jailed After Admitting Epic Scam,* WALL ST. J., Mar. 12, 2009, at A1, LEXIS. News Library, Wsj File.

223. *See generally* Steven Huddart & Henock Louis, *Managerial Stock Sales and Earnings Management During the 1990s Stock Market Bubble* (2005) (discussing the pressure to meet goals, either legitimately or through fraud). http://w4.stern.nyu.edu/accounting/docs/speaker_papers/fall2005/Huddart_1990s_stock_market_bubble.pdf (last visited July 14, 2009).

investor education. They did not produce the promised self-protection. In fact, conflicts of interest and disclaimers of fiduciary responsibilities based on the modernity and complexity of the financial system have adversely affected the financial markets after the 2008 crash. Many entrustors-investors have concluded that the law does not protect them from frauds, or perhaps from temptations that they cannot withstand. Consequently, rationally or not, these investors have escaped *en masse* with whatever money they could take with them, leaving the financial system in shambles.[224]

As mentioned, a contrary calculation may demonstrate that the cost of monitoring and controlling the fiduciaries may be lower than the cost of future losses to the aggregate of entrustors. Much depends on habits. It is important for fiduciaries, regardless of their initial tendencies, to be conditioned to avoid first-step actions that can lead to temptation.[225]

To determine the cost and benefit of regulation one can itemize the following. As to the costs of regulation we can count: (1) lost profits of private sector fiduciaries, (2) lost innovations by fiduciaries, presumably, beneficial to the society, and (3) the government's cost of regulation. On the benefit side are (1) the saving to entrustors and the system from possible misappropriation by fiduciaries of their entrustments, (2) the possible decay of the financial system, and (3) conditioning of fiduciaries to avoid misappropriations. These possibilities are not quantifiable and do not occur at the same time. Nonetheless, looking back at past periods, it might be more efficient to strictly regulate fiduciaries.[226]

2. From "Sole Interest" to "Best Interest"

One proposal to relax the strict prohibition of fiduciary law was to allow banks to act not in the "sole interest" of the beneficiaries but in the "best interest" of the beneficiaries.[227] Under the traditional trust rule, if trustees do not act in the "sole interest" of the entrustors-beneficiaries, the trustees' actions are voidable at the election of the entrustors-beneficiaries. The entrustors may choose to adopt the conflict-of-interest transactions and keep their benefits. They may reject the transactions even if they are in their best interest. For example, the entrustors may decide that even though the transactions benefit them, the benefits are too low as compared to the trustees' benefits, and may, for reasons of envy, or anger,

224. Dan Jamieson, *Financial Markets Face a Lost Generation of Investors,* INVESTMENT NEWS, Apr. 19, 2009, http://www.investmentnews.com/article/20090419/REG/304199990.

225. *See* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?* 114 YALE L.J. 929, 957–58 (2005) (discussing monitoring).

226. *Id.* at 952 (discussing the auction rule, while designed to prevent self dealing, often causes results in lost profits).

227. John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?* 114 YALE L.J. 929 (2005) (abridged and footnotes omitted).

avoid the transactions.[228] If the trustees did not act in the sole interest of the entrustors, the entrustor may sue the trustees for violation of their fiduciary duties. All the entrustors must show is that the fiduciaries-trustees did not act in the sole interest of the entrustors.

The proposal to change the "sole interest" test to the "best interest" test is based on a number of reasons.[229] For beneficiaries, transactions based on the "best interest" test serve "the purpose of the duty of loyalty." After all, what harm is there to the beneficiaries if the trustees benefit as well? Therefore, instead of the beneficiaries' freedom to avoid transactions in conflict of interest the trustees should be permitted to prove the transactions' prudence and merit. "In such a case, inquiry into the merits is better than 'no further inquiry.'"[230]

Further, the "best interest" measure would modernize the rule. The current fact-finding procedures are more effective than in the past, and the chances of concealment by the trustee are lower than before.[231] In addition, bank trustees have been "professionalized," presumably rendering today's trustees more reliable and trustworthy than in the past. And the proposed change in the rule against conflicts of interest would impose on the trustees the burden of proving "best interest." In light of the great success of institutional trustees, conflicted institutional and corporate trustees should be permitted to defend their actions by showing good and prudent actions even if they benefit from these actions.[232]

In fact, courts did not strictly adhere to the "sole benefit" rule; they allowed trustees to seek judicial approval of transactions in conflicts of interest.[233] In those situations the courts look to the "best interests" of the entrustors. Even the rules of the Comptroller of the Currency that regulate bank trust departments allow banks to engage in some conflict of interest under certain circumstances.[234] Therefore, the "best interest" proposition will amend trust law and make it similar to corporate law, which has evolved far more lenient rules with respect to fiduciary conflict of interest. The new rules should allow "overlapping interests."[235]

And yet, there are a number of differences between trust beneficiaries and corporate shareholders. First, most corporate shareholders can escape their fiduciaries; trust beneficiaries cannot escape, except under a few extreme situations. Second, in contrast to shareholders, not all beneficiaries can be identified, because beneficiaries can include unborn children, who are unable to give their consent directly. Presumably under the proposal, the beneficiaries' consent would "sanitize" these transactions. But if the number of beneficiaries is large or if they themselves are conflicted, then someone else, or the majority of a group of beneficiaries, will have to consent for or against the minority. Besides, if shareholders are the model, we know that few shareholders vote. Consequently, the trustees will determine their own as well as the "best interests" of the beneficiaries.[236]

Most importantly, corporate laws did not relax the prohibition on conflicts of interest. No corporate law—not even one—has introduced the "best interest" concept. Corporate fiduciaries, who plan conflict of interest transactions, may disclose their conflicts to the boards of directors or shareholders, and then, after receiving full information about the proposed transaction, a majority of the disinterested directors or the shareholders (sometimes including interested shareholders) may approve and "sanitize" the conflict of interest transaction.[237] A conflict is abhorrent to fiduciaries of both kinds and has remained so.

Hidden behind the "best interests" proposal are far-reaching legal implications. On its face, the proposal serves to change a prohibition to a default rule. But in addition it opens a back door to a new substantive change. "Best interest" becomes the measure of misappropriation. Using entrusted asset or property becomes legal and legitimate (under certain conditions). From this innocuous

228. George Gleason Bogert et al., Bogert's Trusts and Trustees § 543 (2007) (Westlaw) ("If the dealing presented conflict of interest and consequent temptation to the trustee, it will be voided at the option of the beneficiary, regardless of gain or loss to the trustee. . . . It is also immaterial whether the beneficiaries of the trust were financially damaged or not."; also noting that courts have generally not allowed "a defense that the trustee acted in good faith, or that fair value was paid, or that the trust incurred no loss (or that actual benefit accrued to the trust).")

229. John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?* 114 Yale L.J. 929 (2005) (abridged and footnotes omitted).

230. *Id.* at 932.

231. *Id.*

232. *Id.* at 990.

233. *Id.* at 933.

234. 12 C.F.R. § 9.10(b)(1) (2008).

235. John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 Yale L.J. 929, 982 (2005) (under the proposed rule: "(1) The trustee is under a duty to administer the trust in the best interest of the beneficiaries. (2) A trustee who does not administer the trust in the sole interest of the beneficiaries is presumed not to have administered it in their best interest. The trustee may rebut the presumption by showing that a transaction not in the sole interest of the beneficiaries was prudently undertaken in the best interest of the beneficiaries. . . . The trustee asserting a best interest defense would bear the burden of proving it, echoing practice under the advance-approval doctrine and under those versions of the corporate rule that assign the burden of justifying fairness to the conflicted director who failed to seek and obtain advance approval.")

236. For a response to Langbein's article, *see* Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 Wm. & Mary L. Rev. 541 (2005). Another issue is how should the interests of the entrustor and fiduciary be balanced? How should the law avoid subverting their incentives to interact in the long term? This has not yet been worked out.

237. *See, e.g.*, Del. Code Ann. tit. 8, § 144 (2001).

change, the habit of thinking about "the fiduciary's best interest" could take hold. This is an effective unobserved way of changing substantive law, or muddying the waters and altering perception and focus: "Banks may benefit from entrusted power so long as they can show benefit to the entrustors as well." It provides a theoretical justification for bank trustees' conflicts of interest and renders trust beneficiaries even less protected than they are under the current rule.[238] Finally, courts are unlikely to engage in evaluating the "best interest of the beneficiaries" or in determining bank charges or the value of financial transactions.[239]

3. Should Entrustors Be Required to Exercise Greater Self-Protection Against Abuse of Entrustment?

A related debate regarding fiduciary duties involves the extent to which the entrustors should and can protect themselves from fiduciaries' abuse without the protection of fiduciary law. Are contract law or market pressure sufficient protections? How costly would self-protection for entrustors be, as compared to the costs of their fiduciaries in complying with the rules, and perhaps the costs of government in enforcing the rules?[240] The proponents of reducing substantive fiduciary legal rules argue for educating the investing public to protect itself against trusted service providers. The proponents of government intervention argue for constraining trusted service providers by fiduciaries rules and their enforcement.[241] In fact, even those who believe in market regulation rather than government regulation concede that some constraints by law may be desirable. The real bone of contention is where the line should be drawn.

To be sure, if the legal prohibitions relate to other than entrusted property or power, the entrustors might be educated with respect to these aspects of the

238. If a bank can show that diversification is greater in mutual funds than in trust funds—trust beneficiaries have received investments in their "best interest." The fact that the bank has benefited from the conversion is then less serious. The burden is shifted to the beneficiaries to show that mutual funds are not the best investments for them.

239. To be sure, trustees will provide beneficiaries information before the beneficiaries give their consent. But it is easier to justify a violation of a watered-down default rule than to justify a violation of a strict prohibition. Disclosure is flexible and can be accompanied by noise, implications, inferences, and veiled threats. When such "information" is sent by the big bank that holds the beneficiaries' money, and when a trust officer is far too busy to meet with a beneficiary of a small trust, the beneficiary is helpless. It is not generally difficult for a trustee to gain the consent of beneficiaries who have no choice but to have their money managed and controlled by this trustee.

240. *See* Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad 52–58 (2006) (discussing costs of trust and verification).

241. *See* Hodgkinson v. Simms, 117 D.L.R. 4th 161 (1994) ("The law's intervention by means of its jurisdiction over fiduciary duties fosters the fair and proper functioning of the investment market. . . .").

relationships, and taught to protect themselves against profit-seeking fiduciaries, if they can do so without incurring unreasonable costs.

In addition, we should recognize that the existence of legal prohibitions does not necessarily support entrustors' trust. Arguably, legal prohibitions and punishments of fiduciaries can undermine entrustors' trust. Law signals that the fiduciaries—trusted persons—are trustworthy for fear of punishment, rather than that they are trustworthy voluntarily, by controlling their temptations. Advocating self-protection by entrustors results in advocating a higher level of mistrust, as in contract relationships. The law that governs contract relationships assumes the mode of "verify"—caveat emptor—rather than "trust." "Suspect"—rather than "rely."

Yet, in many cases, especially in the case of entrustment, "trust" can be far more efficient and less costly to society than "verify." That is why even contract parties trust each other to some extent, and often more than the assumptions on which contract law is based. Thus, the correct solution to optimal relationships is not either trust or verify, or either fiduciary or contract relationship, but perhaps something in between. The issue is: how should the demarcation line or the slippery slope from non-trust to maximizing trust be determined?[242]

4. Are the Markets Efficient or Desirable Protectors Against Abuse of Entrustment?

A third associated debate regarding fiduciary duties involves the evaluation of market effectiveness as enforcer of fiduciaries' honesty. After all, restrictive fiduciary rules should not apply if the markets are likely to protect entrustors against the fiduciaries' abuse of trust.[243] In this debate the question is whether law should retreat to make more space for the markets. There are studies that demonstrate the great weight of market protection.[244]

The counter-argument is that people in general, and investors in particular, trust fiduciaries and non-fiduciaries alike. They trust regardless of whether they should. But when they discover that they have been abused they wake up and exit the relationship *en masse*. This observation is demonstrated by market bubbles and crashes.[245] Crashes can destroy the financial system and sometimes the

242. Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad 114 (2006) (discussing costs of trust and verification).

243. *See infra* Ch 1 B ("there is a likelihood that . . . the markets may fail to protect entrustors from such risks").

244. See Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1254 (1995) ("[W]hen 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.").

245. *See* Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad 168–69 (2006) (investors who suspect fraud "cash out and run" and a "run"

economy. Therefore, waiting until investors or entrustors in general discover that they are harmed by their counterparties or service-givers or fiduciaries may prove to be a dangerous wait, not merely for the individuals but for the financial system and economy as a whole.[246] The law should interfere before such reactions reach their peaks, and not after.[247]

Yet, regulators and lawmakers, so the counter-argument runs, have no crystal ball through which they see the future. Their interference may be worse than the woes produced by the markets. That is especially the case if regulators do not wait for the market to respond to excesses and abuse of entrustment, and may create additional and different problems.[248] Regulators would do better to wait until it is quite clear that their help is needed; and not a minute before that![249]

Indeed, this country has moved toward verification and away from trusting based on fiduciaries' self-limitation or on regulation. For example, today's patients attempt to protect themselves against surgeons' conflicts of interest or lack of care and expertise by seeking second opinions. Patients do not study medicine, although the literature designed to educating people on self-healing has grown as well.[250] In serious cases, however, people seek the opinion of more experts—a more costly approach. Recent court decisions have tended to favor the market approach, especially when the fiduciaries engage in the business of fiduciary services.[251] The guiding principle seems to be: "Let investors receive the information they need to make their own decisions but otherwise they should beware of the dangers of dealing with fiduciaries or anyone else." This approach contrasts with the approach of: "Let intermediaries limit their temptations by themselves or with the help or pressure of the law." These arguments are played out in the laws and their interpretations, which follow.

Conflicts of interest can be hard to identify in the web of private, social, and governmental structures. One example is the suspicion and sometimes proof of "pay to play." To encourage large investors, such as pension funds, to sue issuers and money managers for violations of their duties, Congress passed the Private Securities Litigation Reform Act of 2005.[252] Most large potential litigants are fiduciaries, such as pension fiduciaries. These fiduciaries rarely sued on behalf of their entrustors. Managers of large mutual funds do not sue because they are short-term investors. But even long-term investors refrained from suing. Their intentions may have been honorable (to avoid costs for low returns) or may have involved conflict of interest (to avoid displeasing managements of large corporations that may be clients for other services). The Act authorized institutional investors to obtain lead-plaintiff appointments in securities class litigation,[253] entitling the lead plaintiffs to pick the lead counsel, manage the litigation, and pay the counsel higher fees. It was assumed that the lead plaintiff rather than the lawyers would drive the litigation.[254] However, pension fiduciaries may wish to please potential defendants, or litigation lawyers who might be

develops); *id.* at 98–99 (discussing "bubbles").

246. Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393 (2006) (the sharp drops in the stock prices and investor confidence (after a bubble) can have dire spillover effects for the economy as a whole, and even infect the international economy).

247. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 168–69 (2006); *id.* at 161 (noting that early discoveries may prevent abuses).

248. *See id.* at 155–58 (discussing balance between law and market regulation).

249. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002). ("Markets are capable of responding more quickly and precisely than regulation to corporate fraud, as long as regulation does not impede or mislead them.").

250. *See, e.g.*, MAOSHING NI, SECRETS OF SELF-HEALING (2007); MEIR SCHNEIDER, MOVEMENT FOR SELF-HEALING (2004); LINDA PAGE, HEALTHY HEALING (12th ed. 2004).

251. Nelson v. Hodowal, 512 F.3d 347 (7th Cir. 2008) (investors in a pension plan sued the fiduciaries who controlled the plan. The court sided with the fiduciaries because the investors made their own investment decisions and their employer had hired professional investment counselors to assist them in making those decisions; therefore, they should have been aware of the dangers of dealing with these fiduciaries); Green v. Nuveen Advisory Corp., 295 F.3d 738, 743–45 (7th Cir. 2002) (shareholders sued their fund manager because they lost money when their common shares decreased in value while the manager's compensation increased. There was no evidence that the fund manager abused his fiduciary duties and had a conflict of interest, and the authority to increase or decrease leverage in the funds belonged to the shareholders' board of directors, making them the ones in the position to invest properly).

252. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

253. *Id.* sec. 101(a), § 27(a)(3), 109 Stat. at 738–40 (codified at 15 U.S.C. § 77z-1(a)(3) (2006)) (Securities Act provision); *id.* sec. 101(b), § 21D(a)(3), 109 Stat. at 743–45 (codified at 15 U.S.C. § 78u-4(a)(3) (2006)) (Securities Exchange Act provision); *e.g.*, Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U.L. REV. 91, 104 n.68 (2007) (noting that goal of "lead plaintiff provision" "was to elevate institutional investors over other private actors to curb abuses of the securities litigation system").

254. S. Rep. No. 104-98 at 10–11 (1995). *See* David H. Webber, *Is "Pay to Play" Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study* (2010), http/ssrn.com/abstract=1432497. However, some argue that some lawyers have begun to pay lead plaintiffs for the position. The suspicion started with government officials responsible for the city or state employees' pension funds, who were lead plaintiffs and lawyers, who seem to be the contributors to the official's election war chest. *In re* Cendant Corp. Litig., 182 F.R.D. 144, 147–49 (1998), *rev'd on other grounds*, 264 F.3d 201 (3d Cir. 2001) (argument that at least one of the institutional lead plaintiffs received contributions from the counsel that it chose). Speculation abounds, but has not been proven. However, David H. Webber's study suggests that politicians have significant control over large pension funds. But it is not clear that they receive pay from lawyers to sue or from corporations not to sue.

large contributors. The jury is out on whether pension boards are influenced by private or political power holders.

State pension funds are increasingly acting as lead plaintiffs. They hire private law firms on a contingent fee basis. In a case which

> ultimately resulted in the largest class action settlement on record ($3.1 billion), one contender for the position of lead counsel charged that two of the lead plaintiffs (the New York State and New York City pension funds) had chosen as their co-lead counsel two law firms that had been major campaign donors to the elected official who had sole discretion over each fund.[255] . . . While it may be risky to attribute this increase to the lead plaintiff provision, it is noteworthy that the class action that received the greatest press attention for its "pay-to-play" practices . . . also resulted in the largest class settlement in history. . . . Although there is little evidence as to how they do in these separate suits, a number of empirical studies suggest that the class in a securities class action typically receives only between 5% and 10% of their estimated damages in a settlement.[256]

The issue of "pay to play" demonstrates the potential political and competitive pressures exerted on fiduciaries of large pools of investors' money and the legal difficulties of insulating the fiduciaries from such pressures.

H. WHEN SHOULD FIDUCIARIES CONSIDER PUBLIC INTEREST?

1. The Case of Hospitals

Private monopolistic organizations that offer public service such as health care may have fiduciary duties to the public. For example, in *Greisman v. Newcomb Hospital*[257] a qualified physician sought user-privileges at a Newcomb Hospital. The Hospital was the only one near the physician's home and practice. The Hospital denied the privilege on the sole ground that the applicant physician graduated from a school that was not approved by the American Medical Association, and that he was not a member of the County Medical Society. Many other professional medical associations, however, accepted physicians with similar backgrounds, and the Hospital had no specialized practices to justify the exclusion. "The lower court determined that the by-laws of the Newcomb Hospital conflicted with the public policy of the State." And although Newcomb Hospital was a private hospital that could operate at its discretion, its position as the only

255. John C. Coffee, Jr., *"When Smoke Gets in Your Eyes": Myth and Reality About the Synthesis of Private Counsel and Public Client,* 51 DePaul L. Rev. 241, 244 (2001).

256. *Id.* at 247–48.

257. Greisman v. Newcomb Hosp., 192 A.2d 817 (N.J. 1963) (abridged and citations omitted).

hospital within one hundred miles of the plaintiff's home and practice area, "and its special services concerning people's health imposed upon it certain duties."[258] A hospital's power of exclusion was to "be viewed judicially as a fiduciary power to be exercised in reasonable and lawful manner for the advancement of the interests of the medical profession and the public generally," regardless of the fact that the hospital was a private organization.[259]

The court distinguished their intervention in a physician's membership in a hospital from memberships in social, religious, and fraternal organizations. In these cases "the policies against judicial intervention were strong and there were no significant countervailing policies." Courts interfere with "trade and professional associations exercising virtually monopolistic control." Here,

> sufficiently compelling factual and policy considerations, [were involved, and] judicial relief will be available to compel admission to membership. . . .
>
> . . . [H]ospitals are operated not for private ends but for the benefit of the public, and that their existence is for the purpose of faithfully furnishing facilities to the members of the medical profession in aid of their service to the public. They must recognize that their powers, particularly those relating to the selection of staff members, are powers in trust which are always to be dealt with as such. While reasonable and constructive exercises of judgment should be honored, courts would indeed be remiss if they declined to intervene where, as here, the powers were invoked at the threshold to preclude an application for staff membership, not because of any lack of individual merit, but for a reason unrelated to sound hospital standards and not in furtherance of the common good.[260]

Courts deal differently with corporate directors' consideration of community needs. The far stronger principle is that directors must consider the financial well-being of the corporation.[261] However, consideration of the community needs

258. *Id.*

259. *Id.* at 823 (citing Falcone v. Middlesex County Med. Soc'y, 34 N.J. 582, 597 (1961) (holding that "the Medical Society's authority to pass on membership applications by licensed physicians is a power which is fiduciary in nature, to be exercised accordingly. . . . [The physician applicant] was entitled to admission despite the Society's requirement of four years' study at a school approved by the American Medical Association. . . . [In this case, as in a precedent case,] similar policy considerations apply with equal strength and call for, a declaration that the hospital's power to pass on staff membership applications is a fiduciary power, and a holding that Dr. Greisman is entitled to have his application evaluated on its own individual merits without regard to the bylaw requirement rejected by the Law Division.")).

260. *Id. See also* Pinsker v. Pac. Coast Soc'y of Orthodontists, 526 P.2d 253 (Cal. 1974).

261. Dodge v. Ford Motor Co., 170 N.W. 668 (Mi. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.").

is sometimes permitted, but not required, to overcome the business considerations and interests of the shareholders. But when permitted, the consideration of communities' financial and economic welfare should be linked to the main objective of the corporation: to serve the business interests of the shareholders and the corporate enterprise. Similarly, the shareholders' policy directives that are unrelated to the corporation's business enterprise are not always binding on the corporate board of directors and its officers.[262] The argument for requiring directors to base their decisions and guidelines on the financial well-being of the corporation stems not only from the very purpose of corporations but also from the concern that broad authority to consider other than business issues would weaken the accountability of corporate management.[263]

A number of jurisdictions have allowed corporate directors to consider the interests of the communities in their decisions about the future of the corporations (and takeover proposals), such as denial or decision to fight against proposed takeovers that might have benefited the shareholders but harmed, at least in the short-term, the communities around which the corporate enterprises were located.[264] The fact that the directors may have had identity of interest with the community would not in this case cast the shadow of conflicts of interest on their decision. However, some critics question the economic wisdom of this policy. In addition, they are concerned that a permission to consider the interests of the communities, rather than solely the interests of the corporation, would undermine the accountability of the directors to the shareholders.[265] The issue is far from clear and the debate continues.

In another case the hospital's business was weighed against the patients' health care. A court held that a director of a not-for-profit hospital is entitled to examine the corporate books and records in order to uncover suspected violations of the staff's fiduciary duties to patients.[266] The Court of Appeals reinstated the trial court's holding that the director was entitled to examine the corporate books and records "involving cancer experiments on patients," who consented to

262. Eric Engle, *What You Don't Know Can Hurt You: Human Rights, Shareholder Activism and SEC Reporting Requirements*, 57 Syracuse L. Rev. 63 (2006) ("A shareholder resolution is a non-binding suggestion to the board of directors . . .").

263. Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 Notre Dame L. Rev. 1431 (2006) (a cost of legally compelling socially-responsible governance is reduced managerial accountability to shareholders).

264. Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 Tex. L. Rev. 579 (1992).

265. Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 Notre Dame L. Rev. 1434 (2006).

266. *Id.* at 308–09 (citing Hyman v. Jewish Chronic Disease Hosp., 206 N.E.2d 338 (N.Y. 1965)).

injections, but had not been "told that the injection was of cancer cells because the doctors did not wish to stir up any unnecessary anxieties in the patients."[267]

2. When Society's Interests Conflict with Those of Individuals

A surgeon's research can present a conflict between the needs of the patient and the benefits to society from the research. On that score one court held that one patient should not bear the cost of the benefits to other patients from a possible future patent.[268] Another court reached the same conclusion when the risk of non-therapeutic experiments on children was imposed in order to discover a less expensive method of removing lead paint. Even though the child's mother signed off on the experiment, she did not receive full disclosure when the child showed symptoms of being affected by the lead paint exposure. The researchers and research institution justified their actions for the good of society. The court's majority rejected this justification.[269]

In other conflict-of-interest situations, such as in the case of financial situations, the courts are less likely to elevate the public's interest over that of the individual. However, when the financial system is threatened, the duties of the fiduciaries may rise at the expense of the individuals.[270]

As to corporations, the traditional view was that directors must exercise their power to maximize the shareholders' profits. The employees' and communities' welfare should not be considered except to the extent that they profit the corporations. Similarly, contributions to the First World War effort[271] and contributions to not-for-profit organizations[272] are permissible to the extent that they benefit

267. *Id.* at 308–09 (footnotes omitted) (citing Hyman v. Jewish Chronic Disease Hosp., 206 N.E.2d 338 (N.Y. 1965)).

268. Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad 144 (2006).

269. Grimes v. Kennedy Krieger Inst., 782 A.2d 807, 823–37, 848 (Md. 2001); *id.* at 860 (Raker, J., dissenting). *See also* Mark Fagan & Tamar Frankel, Trust and Honesty in the Real World, Module 6 (2006).

270. Jo Ann J. Brighton, *Deepening Insolvency: Secured Lenders and Bankruptcy Professionals Beware: It's Not Just for Officers and Directors Anymore*, 23-3 Am. Bankr. Inst. J. 34, 34 (2004) (a director's fiduciary duties increase when his corporation goes bankrupt because his actions now have greater effects, oftentimes deepening the insolvency).

271. *See* A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 586 (Del.) ("During the first world war corporations loaned their personnel and contributed substantial corporate funds in order to insure survival. . . ."), *appeal dismissed*, 346 U.S. 861 (1953); *cf. In re* Estate of London, 171 N.Y.S. 981, 983–84 (Sur. Ct. 1918) (overruling objection to trustees' investment of trust funds in First Liberty Loan bonds during wartime), *aff'd*, 175 N.Y.S. 910 (App. Div. 1919).

272. *See* A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 589–90 (Del.) (finding donation to university valid as advancing interests of corporation), *appeal dismissed*, 346 U.S. 861 (1953); Franklin A. Gevurtz, Corporation Law § 3.1.4b, at 224 (2000) (stating that corporate charitable contributions may have business purpose "such as promoting

the corporate business and its shareholders (and management decisions do not involve conflicts of interest). However, the balance between the shareholders' interests and those of other constituencies has changed throughout the years and is still subject to debate. Because the use of corporate assets can be subverted by management' conflicts of interest and personal preferences, some corporations allow the shareholders to express their preferred recipients of donation as well.[273]

3. Duties of Professional Fiduciaries to Prevent Harm by Colleagues

a. Physicians' Duties When Colleagues Act Incompetently or Unethically With very few exceptions, people are not required to prevent others from negligently causing harm. To be sure, a bartender may not continue to serve liquor to a drunken customer who is reaching for his car keys with the obvious intent to drive. But even in this example, the bartender reduces possible drunken driving by NOT serving liquor rather than by preventing the customer from driving.

Fiduciaries, however, may be subject to stricter duties. Arguably, physicians may have a responsibility to expose unethical or incompetent colleagues.[274] A physician should assess a colleague's performance by quality of performance and morality. On the quality side, there are a number of degrees.

Physicians are not responsible for entirely unanticipated accidents, such as a sudden electric power failure. An accident may be due to a reasonable decision that was very unlikely to turn out badly, but did, such as administering a medicine to a patient with no history of allergic reaction to the drug. In that case, however, the physician could have tested the patient's propensity to the allergy. But, a physician need not have done so without reasons.

Further, there are cases in which the balance between benefits and risks of treatment are unclear, and subject to disagreement among competent physicians. In such cases, the physician may have acted correctly and with care, even if the results were negative. If a physician made a poor but not horribly bad judgment or exercised lower skill, such as not recognizing something obvious on an X-ray, the behavior shows questionable skills, and the failure of care is more serious.

A most serious case is an outrageous violation of required care, such as operating on the wrong leg. Finally there is a fundamental distinction that should be made between accidents due to ignorance or even insensitivity, and deliberate and morally wrongful actions. A physician should consider the extent to which a colleague's conduct violated accepted ethical standards of medicine and the medical community. These violations may be intrinsically wrong, regardless of the likelihood of harm, such as misuse of placebos or lying to a patient. But in less egregious situations, the harm must be weighed as well.

In reacting to a colleague's behavior a physician should determine the nature of the problem. If the problem is ignorance, the response may be education. If the problem is misguided ethics, the response may be moral education. If the problem is morally wrong conduct, the response may be punishment. If a physician is unsure of another physician's competence, the physician should discuss the matter with other trusted colleagues, without violating the physician's anonymity, and apprise colleagues of the situation. But in no case may a physician ignore the problem, or pass the problem on by recommending the colleague to another employer.

Initially it may be best for the physician to act alone. But sometimes it may be appropriate to seek help from a colleague. Some situations may require a formal group action. In the latter case, the physician must consider which group to address (e.g., a hospital committee). More serious misconduct should be reported to medical boards and/or legal authorities. In general, the author suggests that the profession should move from a "punitive approach" to a "continuous improvement" approach, except for very incompetent or unethical physicians.[275]

b. Lawyers' Duties to Prevent Legal Violations by Clients Who Are Fiduciaries The position as gatekeepers–officers of the court and guardians of the law, on the one hand, and trusted advisers to clients, on the other hand–has long presented a difficult issue for attorneys. This issue became prominent in the 1990s scandals, in which lawyers gave weak comfort letters to clients who in fact, had violated their fiduciary duties to client-entrustors. The letters indicated that the clients' activities were "not illegal" and contained unclear reservations and generalities.

Opinions about the legitimacy of these opinion letters differ. One opinion is that, based on a cost and benefit analysis, lawyers should not police the clients' legal activities but, after the appearance of clear red flags signaling illegal

goodwill" and "a rational relationship between the size of the contribution and the extent of corporate benefit").

273. *See* Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons for Corporate America Compiled and Introduced by Lawrence A. Cunningham*, 19 CARDOZO L. REV. 1, 10 (1997) (noting that "[a]t most major corporations management allocates a portion of corporate profit to charitable concerns" and "[t]he charities are chosen by management"; however, at Berkshire Hathaway, the donation is allocated by shareholder designation).

274. E. Haavi Morreim, *Am I My Brother's Warden? Responding to the Unethical or Incompetent Colleague*, HASTINGS CENTER REP., May 1993, at 19, LEXIS, News Library, Arcnews File. For the question of whether one physician owes a duty to act in light of the incompetence of another, *see* Frances H. Miller, *Doctors in the Executive Suite: Should the U.S. and U.K. Be Putting M.D. Licensure at Risk for Shortfalls in Institutional Quality of Care?* 31 J. HEALTH L. 217 (1998) (a story of an incompetent surgeon who had a horrendous history of death during surgery yet was not removed for many years, and the issue of the duties of his superiors who managed the hospital).

275. E. Haavi Morreim, *Am I My Brother's Warden? Responding to the Unethical or Incompetent Colleague*, HASTINGS CENTER REP., May 1993, at 19, LEXIS, News Library, Arcnews File.

activities, should enforce the law.[276] Another view is that lawyers' duties depend on the degree to which other parties protect society and third parties. Thus, in court, lawyers represent the opponents. An independent judge, and sometimes a jury, determine the outcome. In such cases, the lawyer's duty to the client can be far higher than the duty to society and third parties. The lawyer may not facilitate perjury and has the duty to prevent perjury, but has no duty to protect the other party in the proceedings. In negotiations among parties that are presented by lawyers, the duty to protect the other party to the negotiation is also very limited. But if, as in the case of preparing a prospectus for public distribution of securities, the lawyer represents the corporation (issuer) and the investors are not represented (although the government is), the lawyer's duties may be higher. And if the lawyer advises a client corporation and recognizes clear signs of misrepresentation or other violations of law, then the lawyer's duty to attempt actively to prevent the wrongdoing or to even to resign is much higher.

Another opinion is that a "[G]atekeeper . . . provides verification or certification services or . . . engages in monitoring activities to cabin illegal or inappropriate conduct in the capital markets."[277] Therefore, there is a distinction between independent gatekeepers, such as auditors, and dependent gatekeepers, such as lawyers. Both types have access to insider information and both function as gatekeepers, but they differ in the degree of their independence, including independence from the clients. Dependence tilts the scales and the weight of the duty to prevent the client's forbidden actions.[278]

How should lawyers act when, in their discussions with corporate management, the lawyers begin to suspect that the corporate books are manipulated, but have no evidence to support the suspicion? Should the lawyers do nothing? Or should they speak to the Chief Financial Officer or Chief Executive Officer or approach the compliance officer or the general counsel, or the members of the board? As a last resort, facing blank stares and a growing conviction that something really very wrong is going on, but no proof, conservative lawyers might resign. Knocking on the door of the Securities and Exchange Commission should depend on the strength of the evidence and the severity of the violation. Since 2002 the Securities and Exchange Commission is required to

> issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing

276. Steven L. Schwarcz, *Financial Information Failure and Lawyer Responsibility*, 31 Iowa J. Corp. L. 1097 (2006).

277. Arthur B. Laby, *Differentiating Gatekeepers*, 1 Brook. J. Corp, Fin & Com. L. 119, 123 (2006).

278. *Id.* at 124–125. *See generally* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. Rev. 301 (2004). *See generally* John C. Coffee Jr., Gatekeepers: The Professions and Corporate Governance (2006).

> and practicing before the Commission in any way in the representation of issuers, including a rule—
>
> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
>
> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[279]

Yet, lawyers are rarely, if ever, responsible as aiders and abettors for violations of the securities acts in actions by private parties.[280]

Should lawyers who are not involved in wrongdoing of their partners be responsible for their partners' liabilities? Under what conditions should lawyers be liable for the misdeeds of their colleagues in the law firms? Under what conditions should the law firm as an entity be liable? How can both lawyers and their law firms protect themselves from liability in such cases?[281] One suggestion is a peer review.[282] While the Model Code of Professional Responsibility does not require peer review of performance, the Model Rules of Professional Conduct state that partners should make reasonable efforts to be certain that all lawyers conform to the rules of professional conduct.[283] In addition, Rule 5.1 acknowledges that partners have indirect responsibility for all work being done by the firm.[284]

Another view renders law firm partners responsible for their partners' misdeeds. "If the partnership were found liable, the partners would be liable for

279. 15 U.S.C. § 7245 (2006).

280. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 768–69 (2008) (holding that liability under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2000), does not apply to aiders and abettors). However, the Securities and Exchange Commission may prosecute aiders and abettors under section 20(e) of the Act, 15 U.S.C. § 78t(e) (2006).

281. *See, e.g.*, Susan Saab Fortney, *Am I My Partner's Keeper? Peer Review in Law Firms*, 66 U. Colo. L. Rev. 329, 329–36, 348–61 (1995) (discussing liability of attorneys for acts of partners, and actions firms have taken to reduce liability exposure); *id.* 363–70 (discussing peer review initiatives in this regard).

282. *Id.*

283. Model Rules of Prof'l Conduct R. 5.1(a) (2002).

284. Model Rules of Prof'l Conduct R. 5.1(c) (2002).

their partner's derelictions."[285] Once a client retains a firm, the firm's members owe fiduciary obligations to the client. A California court has held that partners acting as co-fiduciaries who do not supervise other partners are liable for "negligent inattention."[286] Presumably, partners can uncover the wrongs performed by the partnerships, on the one hand, and might have an interest in allowing such wrongful acts to continue because the partners benefit from the wrongs.

There are many situations, however, in which partnerships are very large and spread all over the world. Nonetheless, it seems that the rule is applied, perhaps because of the temptation to expect the profits and avoid accountability. In the last analysis, "the actions of a partner you don't even know, working in an office on the other side of the country, could cost you your house and force your kids to go to public school."[287] Partners would usually be liable for misdeeds of their partners to third parties. "Tortious acts done in connection with, or in the process of, the business of the partnership will subject the general partners to liability to creditors. However, the fact that a misdeed will subject all partners to liability to a creditor does not necessarily mean the misdeed causes equal liability to a losing limited partner."[288]

4. Trustees' Liability for the Actions of Co-Trustees

"While a trustee is not strictly liable for the wrongful acts of a cotrustee, a trustee is responsible for the wrongful acts of a cotrustee to which he consented, or which, by his negligence he enabled the cotrustee to commit."[289] Presumably, trustees do not conduct business together, and are more akin to directors. Neither do trustees usually share benefits from their position as trustees. Most trustees are not bound to join a professional organization of trustees or obligate themselves to follow the organizations' rules. In addition, the variety of trustee practice is enormous. Some trustees are family members, some are money managers, some are law firms, and some are banks and other financial institutions. Thus, their liability is linked to their fiduciary duties as trustees rather than their duty to prevent wrongful action by the co-trustee generally. Similarly, two fiduciaries

285. Buran Equip. Co. v. Superior Court, 190 Cal. App. 3d 1662, 1666 (Cal. App. 6th Dist. 1987).

286. *See* Blackmon v. Hale, 463 P.2d 418 (Cal. 1970) (the nonparticipating partner must exercise reasonable supervision over the other partners' conduct in relation to trust property and negligent inattention to his duties rendered the partner liable, notwithstanding the fact that he did not actually participate in the misapplication of client funds).

287. Michael Orey, *The Lessons of Kaye, Scholer: Am I My Partner's Keeper?*, AM. LAW., May 1992, at 3, 81, *cited in* Susan Saab Fortney, *Am I My Partner's Keeper? Peer Review in Law Firms*, 66 U. COLO. L. REV. 329 (1995).

288. Kazanjian v. Rancho Estates, 235 Cal. App. 3d 1621, 1625 (Cal. App. 1991); *see also* Buran Equip. Co. v. Superior Court, 190 Cal. App. 3d 1662, 1666 (Cal. App. 1987) ("If the partnership were found liable, the partners would be liable for their partner's derelictions.").

289. Middlesex Ins. Co. v. Mann, 124 Cal. App. 3d 558, 573 (Cal. App. 1981).

related by contract are not fiduciaries of each other. Thus, when an insurance company refused to pay an employee long-term disability payments because the employer did not pay its premiums to the insurance company, the court held that the insurance company was not a fiduciary of the employer, even though both were fiduciaries in connection with the pension plan.[290]

5. Employee Whistle-Blowers and Their Fiduciary Duties

Employees who uncover, or are aware of, violations of the law in their organizations are not required to "blow the whistle" and report to the authorities unless they are coerced into taking part in the illegal activities. But employees perform a public service if they inform the authorities of such illegal activities. After all, employees are more likely to have the relevant information and the evidence, or know where they can be found. This knowledge is very valuable, especially in large corporations. "The usefulness of private arrangements and legal rules for the maintenance and promotion of social and economic relationships depends, in great part, on their effective enforcement. Enforcement, however, is not possible unless violations are first detected. It therefore seems critical to consider the ability and motivation of legal actors to monitor each other's behavior."[291]

However, whistle-blowing is not necessarily without problems. First, an employee that holds or has access to insider information is in almost all cases a fiduciary to whom the information is entrusted by the employer. Knowing about illegal activities, the employee faces conflicting duties. One is to the employer; the other is to society. The law has strengthened the employee's position by protecting the employee from the employers' punitive reactions.[292] However, an employee who "blows the whistle" on his employer cannot continue to work for the same employer. Suspicion, anger, and ill feelings make that impossible.[293] Moreover, an employee who blew the whistle may find it difficult to obtain a position anywhere, regardless of qualifications. Such an employee, especially the one whose revelations became well known, has to resort to other means of employment. Sherron Watkins, who was not even a "whistle blower" in the normal

290. Sharp Electronics Corp. v. Metropolitan Life Ins. Co., 578 F.3d 505 (7th Cir. 2009) (the court noted that connection between the two parties did not relate closely to the Pension Plans).

291. Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L. J. 49, 49 (1982).

292. Julie C. Suk, *Discrimination at Will: Job Security Protections and Equal Employment Opportunity in Conflict*, 60 STAN. L. REV. 73, 79 (2007). ("For example, New York has a whistleblower statute, N.Y. LAB. Law § 740 (McKinney 2007), and New Jersey has a Conscientious Employee Protection Act that protects employees who engage in whistle-blowing activities, N.J. STAT. ANN.§§34:19-1 to 19-8 (West 2007)."). *Id.* at n. 30.

293. *See* Harper Collins, *The Victim's Fortune: Inside the Epic Battle over the Debts of the Holocaust.* 41 COLUM. J. TRANSNAT'L L. 489 490–91 (2003) ("threatened with prosecution in Switzerland, and was, as the authors note, "viewed as a traitor" there. . . . he moved to the United States, and was essentially supported by plaintiffs' lawyers").

sense, and who was forced to testify against the management of Enron Corporation after she sent an anonymous letter to her supervisor expressing her concerns, seems to have resorted to the writing of a book and speaking engagements.[294] Thus, in some cases, service to the public may raise the employers' deep mistrust and result in terminating relationships with employers for a long time, if not forever. That is a high price for employees to pay, and may deter the whistle-blowing unless the employees are ready to retire.[295]

6. Balancing Fiduciary Duties with Voter Sentiments and Public Interests

Fiduciary duties are anchored in the interests of the parties to the relationship rather than the public's interests. For example, when the school trustees are engaged in selling a public school's building, the trustees must sell the building to the highest bidder, even though the "voters who attended a public meeting preferred to sell [the building] to the church [presumably at a lower price]."[296] The interests of the public school trust trumped the interests of the resident voters.[297]

When regulation supporting public needs conflict with corporate business purposes, some courts have "opposed using concepts of fiduciary duty to attain desired public policies, even when the policies had been enacted legislatively."[298] In one case, the court protected corporate directors who decided to authorize the violation of antitrust laws.[299] In the period of 2000 to 2008, the courts' tendency was to allow fiduciaries to "opt against regulatory compliance if prospective profits seemed sufficiently high."[300] The "Court[s] refused to place the law of fiduciary duty in service of the regulatory state" at the expense of private trust arrangements. "[T]he law, at bottom, remained committed to insuring that private managers of private investments acted honestly and with due diligence."[301]

294. *See* Mimi Swartz & Sherron Watkins, Power Failure: The Inside Story of the Collapse of Enron (2004).

295. *See* Lynn M. LoPucki, *A Theory of Legal Strategy*, 49 Duke L.J. 1405, 1433 (2000). "The written law may applaud and protect the whistleblower at the same time that social norms render him or her unemployable." *Id.*

296. William E. Nelson, *The Law of Fiduciary Duty in New York, 1920–1980*, 53 SMU L. Rev. 285, 307 (2000) (citing Ross v. Wilson, 127 N.E.2d 697 (N.Y. 1955)).

297. There were other cases that involves issues of public interest as compared with breaches of fiduciary duties. *Id.* at 308 (footnotes omitted) (citing cases).

298. *Id.* at 308–09.

299. *Id.* at 310 (citing Simon v. Socony-Vacuum Oil Co., 38 N.Y.S.2d 270 (Sup. Ct. 1942)).

300. *Id.* at 310–11.

301. *Id.* at 312 ("As a result, the law of fiduciary duty in 1980 did not differ greatly from what it had been in 1920. Courts had applied it to occasional cases involving international and other public policy issues and thereby somewhat expanded its scope. They also had subtly changed the law's application so as to make it more pragmatic and sensitive to the business and financial needs of both fiduciaries and beneficiaries and more tolerant of entrepreneurial activities designed to increase income or grow principal.").

Enforcing duties toward the individual entrustors trumped enforcement of more general laws.

Bribing foreign officials took another turn, perhaps because it has such pernicious effects on American companies as well as on the bribed foreign governments. Generally, bribery raises the costs for the entrustors. For example, a bribe to a fiduciary by a service giver who seeks the job raises the expense for the entrustors because the servicer is willing to provide the services for less; that is the amount it is paid by the entrustors minus the bribe it pays to get the job. If the bribed person is a foreign government official, the payment may adversely affect American foreign relationships with the country, and support corruption in that country.

A serious effect on the bribing parties and their entrustors is the pressures to manipulate the bribing parties' financial statements. To hide the bribe, a bribing institution must fabricate the items in its accounting statements (e.g., provide untrue description and "proof" to justify the entries in its books), or create "slush funds," which are not accounted for.[302] Habits are powerful. Small amounts of bribes are likely to become larger and more frequent. There is no accountability for these amounts, and there are strong justifications for hiding them (e.g., for the good of the business, the country). A habit of bribing can spread to the home country, and may evolve from being asked to bribe to offering a bribe. Therefore, bribing, especially with other people's money, and accepting bribes by misusing entrusted power undermines the accounting system, which is one of the most important protective mechanisms for entrustors. It tempts violations of fiduciary duties and reduces their deterrence and enforcement.

Government officials empowered to impose and enforce laws may be prone to bribery.[303] To be sure, similar results could apply to any entrusted power,

302. *See, e.g.*, Siri Schubert & T. Christian Miller, *Where Bribery Was Just a Line Item*, N.Y. Times, Dec. 21, 2008, Business Section, at 1, LEXIS, News Library, Curnws File.

303. President Richard Nixon used his presidential power to direct harassment of his political opponents. *E.g.*, Drake Bennett. *The "I" Word: Why a Growing Grassroots Movement on the Left Wants to Impeach the President—and why Democrats in Washington Don't Even Want to Talk About It*, Boston Globe, June 24, 2007, at E1, LEXIS, News Library, Curnws File. In the farther lands of Africa Presidents use their power more blatantly to hold on to public assets. *See, e.g.*, Nigeria; Obasanjo–the Probe Before the Probe, Africa News, Mar. 16, 2008, LEXIS, News Library, Curnws File (noting revelations that former president of Nigeria sold public assets to political allies at low prices). A study in 2008 noted that most people around the world view political parties and politicians as the most corrupt, and expect corruption to rise. *See, e.g.*, Richard M. Ebeling, Global Corruption and the Role of Government, Research Reports (Am. Inst. for Econ. Research), LXXV, No. 10, June 2, 2008, at 59–60, *available at* http://www.nassauinstitute.org/articles/article736.php (in Europe at least 5% of the people paid bribes to officials during the past 12 months. Most corrupt in the EU are Eastern European countries (13–71 percent paid to someone). Corruption is worse in Africa (42 percent; 79 percent in Cameroon), Asia (22 percent;

whether backed by police or by wealth and market influence. After all, political and government power, as well as power over other people's money, are entrusted powers. If these powers are not sufficiently constrained they can be easily abused. Therefore, fiduciary law can apply to both government power holders, and private entrusted power. Both must be restricted to the purposes for which the entrustment was made.

It is tempting to try to bribe foreign government officials in order to gain a profitable business, especially if these officials insist on payment, and "everyone does it and knows about it." Nonetheless, these foreign officials may demand evidence of legitimate payment—a subterfuge such as contract fees for services, or insurance premiums. Thus, American companies face a problem. Their management drives for "performance," but are prohibited from bribing and inserting untrue information in their financial statements.

The Foreign Corrupt Practices Act (FCPA) reduces the problem for American corporations. The Act prohibits American companies from bribing foreign officials.[304] There is an exception for gifts up to $10,000 and for higher amounts, approved by the Department of Justice upon application and justification. Arguably, the FCPA makes it more difficult for American companies to compete with foreign firms that are allowed to bribe foreign officials, and can even deduct the amounts of the bribes from their income taxes.[305] One academic suggested "two obvious" steps to equalize the treatment of competitors globally. Either "convincing the rest of the world to ban extraterritorial payment of bribes, or repealing the FCPA" and allowing American companies to pay bribes.[306] Otherwise, "indeterminacy under the FCPA is a chilling effect on U.S. business activity abroad."[307]

It is doubtful whether all or most foreign nations will adopt the Foreign Corrupt Practices Act.[308] A report of the U.S. intelligence agencies predicts that U.S. businesses will be seriously disadvantaged in bidding for $1 trillion in

72 percent in Cambodia), and Latin America (13 percent). Around the world most bribes are paid to the police, and next to the judicial system, and then to access to education and medical care).

304. Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1 et seq. (2000).

305. Melissa Hurst, *Eliminating Bribery in Business Transactions*, 6 J. INT'L. L. & PRAC. 111 (1997).

306. Steven Salbu, *Bribery in the Global Market: A Critical Analysis of the Foreign Corrupt Practices Act*, 54 WASH. & LEE L. REV. 229 (1997).

307. *Id.* at 270.

308. Beverley Earle, *The United States' Foreign Corrupt Practices Act and the OECD Anti-Bribery Recommendation: When Moral Suasion Won't Work, Try the Money Argument*, 14 DICK. J. INT'L L. 207, 209 (1996) (proponents of FCPA-approach are sometimes characterized as excessively idealistic and unrealistic, "the equivalent of Don Quixote tilting at windmills"); Stephen Muffler, *Proposing a Treaty on the Prevention of International Corrupt Payments: Cloning the Foreign Corrupt Practices Act Is Not the Answer*, 1 ILSA J. INT'L & COMP. L. 3, 15 (1995) (current attempts to develop multilateral agreement on FCPA-style legislation are likely to fail).

international capital projects against foreign companies that pay bribes.[309] Yet notwithstanding the Foreign Corrupt Practices Act, bribery in international business continues to flourish.[310]

Perhaps American companies are violating the Act. A more plausible explanation is that the Justice Department is generous in granting American companies permission to bribe. The latter possibility removes much of the problems of corporate corruption. After all, it requires American companies to disclose their intention to bribe. The disclosure is made to American government officials and the payment is approved by the officials. In addition, foreign corrupt governments found that in order to attract American companies they had to "legalize" their officials' demands for bribes. They converted the bribes into tax-deductible expenses.[311] Thus, it may well be that the Act has led to less corruption in international trade, and reduced the competitive pressures on American companies. In the United States, Erie County, a trial court required a director and manager of a business "to reimburse the business for $800 in bribes paid to local officials to overlook violations of the Sunday closing laws."[312] In this case the interests of the public trumped the interests of the business.

I. THE DUTY OF CARE

1. The Principles Underlying the Duty of Care

The duty of care requires fiduciaries to execute their services, and execute them well. They should perform their services with prudence, attention, and proficiency. The duty of care relates to the quality of the services that fiduciaries offer and perform, focusing on the area that is left to the fiduciaries' discretion in reliance on their expertise. One can consider this duty to be weaker than the duty of loyalty. In contrast to the duty of loyalty, which is linked to misappropriation of entrustment, a violation of the duty of care is linked to lack of expertise, inattention, and negligence.[313] Intentional avoidance of knowledge may amount

309. Robert S. Greenberger, *Foreigners Use Bribes to Beat U.S. Rivals in Many Deals, New Report Concludes*, WALL ST. J., Oct. 12, 1995, at A3; *see* KPMG, INTERNATIONAL FRAUD REPORT 3–4 (1996) (noting that losses from international fraud are over $1 billion).

310. *See generally* Stewart Toy et al., *From Corner Office to Corner Cell*, BUS. WK. INT'L ED., July 22, 1996, at 20.

311. *See, e.g.*, Martine Milliet-Einbinder, *Writing Off Tax Deductibility*, OECD OBS., May 2000, http://www.oecdobserver.org/news/fullstory.php/aid/295/Writing_off_tax_deductibility.html (last visited Aug. 31, 2009).

312. *Id.* at 311 (citing Kalmanash v. Smith, 51 N.E.2d 681, 688 (N.Y. 1943)).

313. Just as a violation of the duty of loyalty can amount to larceny, depending on the other elements of criminal law, the violation of the duty of care can amount to breach of

to a violation of the duty of care as well. In a recent case against Bernard Madoff's brother, Peter, based on Rule 10b-5 of the Securities Exchange Act of 1934 the New Jersey District court found that

> the Complaint pleads sufficient facts giving rise to a "strong inference" that Peter Madoff knew that BMIS [Madoff's organization] was engaged in a massive fraudulent scheme, that is, to put it mildly, not honoring its fiduciary responsibility to investors such as Plaintiffs. In its analyses of the scienter element of the Rule 10b-5(b) claim and again in its discussion of a control person's culpable participation in the securities fraud, this Court has amply discussed the detailed allegations of the Complaint concerning Defendant's job responsibilities at BMIS and facts indicating fraud. Together, these allegations, taken as true, have the effect of establishing that Defendant was at the very least willfully blind of BMIS's wrongdoing for failure to investigate those facts and confirm what the indicia of fraud would suggest to him.[314]

Nonetheless, the approach to the duty of care is less strict than the approach to the duty of loyalty.

We recognize that people, even experts, can, and do, make mistakes or fail to pay as much attention to their decisions as they should have. In hindsight, we are much more able to recognize and point out mistakes. In addition, entrustors may not complain about their fiduciaries' lack of expertise if the entrustors chose their fiduciaries and failed to do their homework. At least formally, shareholders chose the directors. Patients chose their physicians and clients chose their lawyers. The students (or their parents) chose their children's schools and teachers. And perhaps it may be easier for entrustors to seek information about a fiduciary's expertise than a fiduciary's honesty, although reputation may point to (or away from) both.[315] Thus, "[a] trustee is not a guarantor of, but trustee must

contract as well as a tort, depending on the other elements of breach of contract and tort. In *The Nature and Function of Fiduciary Loyalty*, 121 L.Q.R. 452 (2005), Matthew Conaglen argued that the duty of loyalty is designed to facilitate proper performance of the duty of care and performance. I reject this approach. Although violation of a promise not to steal without the consent of the true owner (perhaps not to kill the owner) may be a violation of "proper performance" the gravity of misappropriation far exceeds the neutral description of "proper performance."

314. Lautenberg Foundation v. Madoff, No. 09-816 (SRC), 2009 U.S. Dist. LEXIS 82084 (D.N.J. Sept. 9, 2009).

315. *See* Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad 52–58 (2006) (discussing costs of trust and verification). *See* Jonathan Macey, *Robert Clark's Corporate Law: Twenty Years of Change: The Nature of Conflicts of Interest Within the Firm*, 31 Iowa J. Corp. L. 613 (2006) ("it is not clear that violations of the duty of loyalty and transactions that involve conflicts of interest, involve conduct that is worse, from a moral point of view, than conduct that is "'merely' negligent;" "It is clearly not the case that the costs of identifying wrongdoing are lower in duty of loyalty/conflicts cases

observe" a degree of care or be held "personally responsible for any neglect in that regard."[316] Thus, the duty of care is not as weighty and prohibitory as the duty of loyalty.

Measuring, let alone controlling, the quality of expert performance is difficult. It contradicts the very reason for entrusting fiduciaries with discretionary power. Their decisions cannot be dictated in advance because they require a high level expertise and often unpredictable environments. Therefore, the directives to fiduciaries on their use of discretion must be general. And yet, our society is averse to unlimited and unaccountable power, even of experts. The duty of care can be viewed as encircling the fiduciaries' services while recognizing their discretion and expertise.

2. The Standards of Care

The standards of care follow a number of principles outlined blow.

a. Fiduciaries Should Possess and Use the Expert Skills They Purport to Possess[317] An agent's skills are considered in determining his duty of care.[318] Generally, a fiduciaries' quality of services can be evaluated by examining the results of the services, and comparing the results to analogous market and other professional practices. Performance can be evaluated by other experts. Thus, physicians' recommendations can be evaluated by a second opinion, before and after the administration of the remedies.[319]

b. Fiduciaries' Performance is Evaluated by the Process that the Fiduciaries Have Adopted in Performing Their Services Fiduciaries must pay attention to the tasks at hand, devote a reasonable amount of time to their services, and exercise their expertise the best they can. Many variables affect the depth of an investment adviser's duty of care, including the duty to investigate particular issues. For example, an adviser that provides advice to the public by newsletter must investigate the recommended investments by approaches, risk, return, and unusual aspects.[320] If the adviser is advising a class of persons, the duty to investigate includes the investment's suitability to this class.[321] The extent of the fiduciary's investigation is affected by the client's sophistication, the length and

than in duty of care/negligence cases. Basic analytic distinction between negligence and loyalty is not as clear as is generally presumed"); Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 Am. U.L. Rev. 75 (2004).

316. *In re* Estate of Cook, 20 Del. Ch. 123, 171 A. 730 (1934).

317. *See* Restatement (Second) of Agency § 379 cmt. c (1958) ("The paid agent is subject to a duty to exercise at least the skills which he represents himself as having.").

318. Restatement (Third) of Agency § 8.08 (2006).

319. For guidelines on trustees and guardians duty of care see Del. Code Ann. tit. 12, § 3302 (2007).

320. Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers: Mutual Funds and Advisers § 16.03(A)(1) (2001).

321. *Id.*

nature of the adviser-client relationship, the general access and ease of access of the fiduciary to relevant information, and the generality or specificity of the information provided.[322] In addition, there are non-legal guides that point to an acceptable duty of care, such as market practices. These may be used as guides but are not necessarily decisive.

Care may depend on the kind of "red flags" that the fiduciaries should, but failed to, notice. It might mean diligence related to the importance of a situation or transaction (e.g., sales of the corporation) and reasonable expectations of the parties.[323] Similarly, a physician may interrupt a casual conversation with a patient on receiving a "margin call" from his broker, may ask to be excused, in order to go to the bank and deposit more money lest the securities shares will be sold at a loss. But a physician who receives a margin call during surgery may not leave the operating room and rush to the bank to make the deposit. A physician who acted this way had his license revoked for life (even though the patient survived).[324] In general, the courts tend to limit their interference in the exercise of the fiduciaries' discretion, so long as their decisions are not tainted by conflict of interest.

e. The Duty of Care May Be Affected by **the Legal Risk Imposed on the Fiduciaries** Thus, corporate directors' duty of care is measured by "gross negligence"[325] rather than by a higher standard of "negligence." There are a number of reasons for this level of duty of care. Most of the results of the directors' decisions are hard to predict. Moreover, a stricter duty can result in significant financial personal liabilities, which can be ruinous. The concern that knowledgeable persons will decline to sit on boards may have induced courts and legislators to impose a lighter duty of care level (and accept the insurance of directors, under certain conditions).[326]

Thus, even though the duty of care regulates the fiduciaries' performance of their service, the courts are inclined to limit their interference in the exercise of the fiduciaries' discretion. As long as their decisions are not tainted by conflict of interest, and so long as the fiduciaries paid attention to performing their

322. *Id.; see generally* Banca Cremi S.A. v. Alex, Brown & Sons, Inc., 132 F.3d 1017, 1028 (4th Cir. 1997); Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1032 (2d Cir. 1993); *In re* Prudential Ins. Co. of Am. Sales Practices Litig., 975 F. Supp. 584, 611–12 & n.28 (D.N.J. 1997).

323. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

324. Anne Barnard, *Board Says Surgery Halted for Bank Trip: Doctor Suspended for Leaving Patient*, BOSTON GLOBE, Aug. 8, 2002, at A1, LEXIS, News Library, Arcnws File.

325. *E.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (quoting *Aronson*); FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.1.2 d., at 284 (2000) (noting that standard has been adopted "well beyond the Delaware courts").

326. FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.1.3 a.–d., at 288–96 (2000) (discussing justifications for rule).

services, fiduciaries are likely to be protected from legal liability, even if their decisions were mistaken and the results hurt the entrustors.

d. The Evaluation of the Fiduciaries' Performance is Affected by the Reasonable Expectations of the Parties and the Constraints on the Fiduciaries' Discretion The standard of care is affected by the reasonable expectations of the parties, as reflected in their agreements. Thus, the fees that fiduciaries obtain and the amount of assets managed by the fiduciary affect the level of their duty of care. A $50 fee commands a lower level of service than a $50,000 fee. Nonetheless, regardless of pay, fiduciaries must perform with the reasonable level of care and skill.[327]

The duty of care is also affected by the constraints on the fiduciaries' discretion. These constraints include the degree of control that fiduciaries usually exercise in general and in the particular case, the specificity by which the quality of the service can be described, and the time period in which the quality of the service can be evaluated and its flaws can be discovered.[328] In addition, standard of care is affected by the accessibility of relevant information to the fiduciary. For example if an adviser knew of material facts concerning the affairs of the entrustors, or if the adviser could easily have discovered material facts but paid no attention, the adviser may have violated the duty of care. In contrast, if a great deal of effort is required to discover the facts, the duty of care may not have been violated.[329]

e. The Duty of Care May Vary Depending on Different Applicable Laws Different laws can apply to the fiduciaries' duty of care. These include trust law;[330] corporate law;[331] agency law;[332] contract law, securities law;[333] the Investment

327. There is extensive literature on the meaning of "care." *See, e.g.*, William A. Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 AKRON L. REV. 181 (2005); Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U.L. REV. 75, 109–25 (2004). For other references to "fiduciary duty of care" see D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1409 n.39 (2002).

328. *E.g.*, a lawyer's preparation of a will can be faulty, but the deficiency can be discovered only after the testator dies. On the other hand, the physician's treatment may be excellent but the patient might die.

329. TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 16.03(A)(1) (2001).

330. RESTATEMENT (THIRD) OF TRUSTS § 77(2) (2003) (trustee's duty of prudence requires exercise of reasonable care); *id.* § 90(a) (duty of prudent investment requires exercise of reasonable care).

331. FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.1 (2000) (discussing duty of care of corporate directors and officers).

332. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006) (agent owes duty of care to principal).

333. Securities Act of 1933, 15 U.S.C. §§ 77a-aa (2006); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-nn (2006).

Company Act of 1940;[334] the Investment Advisers Act of 1940;[335] the Employee Retirement Income Security Act of 1974;[336] federal regulations such as those of the Office of the Comptroller of the Currency;[337] state statutes governing trusts[338] and state pension funds; principles of common law; the securities acts imposing a duty of care;[339] or an implied promise of due care arising from a contractual relationship.[340] It should be noted that when the duty of care is imposed by statute, a court might reject an expanded duty outside the express language of the statute.[341]

f. Courts' Evaluation of the Fiduciaries' Expertise Courts evaluate the performance of highly expert fiduciaries with the aid of other experts in the fiduciaries' area. When the experts disagree, especially when each party to the litigation brings its own expert, a judge may seek a third expert to determine which of the parties' experts is more credible.[342]

3. Examples of the Duty of Care and Its Violations

a. **Corporate Directors' Duty of Care: The Identity of the Entrustors** Directors must pay attention to the risks inherent in the corporation's business. A factory manufacturing explosives must be appropriately ensured against explosions and employees' protective processes must be installed. The managers of a bank must

334. 15 U.S.C. §§ 80a-1 to -64 (2006).

335. 15 U.S.C. §§ 80b-1 to -21 (2006).

336. 29 U.S.C. §§ 1001-461 (2006).

337. 12 C.F.R. § 9.18 (2008).

338. *See, e.g.*, Barker v. First Nat'l Bank, 20 F. Supp. 185, 188–89 (N.D. Ala. 1937) (sale of mortgage participations by originating bank to trusts for which it acted as trustee). *See generally* 2A Austin Wakeman Scott & William Franklin Fratcher, The Law of Trusts § 179.4 at 512, 516-19 (4th ed. 1987).

339. 15 U.S.C. § 77k(b)(3) (2006) (exempting party from liability on account of false registration statement if it conducted due diligence).

340. *E.g.*, Santulli v. Englert, Reilly & McHugh, P.C., 586 N.E.2d 1014, 1016 (N.Y. 1992).

341. Smith v. Richard, 205 Cal. App. 3d 1354; 254 Cal. Rptr. 633; 1988 Cal. App. LEXIS 1070 (1988) (defendants were real estate brokers. Plaintiff argued that Cal. Civ. Code § 2079 imposed on real estate brokers a duty to inspect the property subject to the sale and to disclose to the buyer any material defects affecting the value or desirability of the property. The question was whether this duty applied only to residential property or also to property for agricultural and commercial property. The court noted the "rule of statutory construction was that the expression of one excluded the other" and that "the court was without power to supply an omission. Additionally, the court noted that the presence of a residence on commercial property did not transform the property into residential property." Therefore, the brokers "had no duty to inspect the portion of the property at issue in order to disclose to plaintiff facts that would affect the value or desirability of the property.").

342. *See* Fed. R. Evid. 702 (authorizing testimony by expert witnesses); *id.* 706(a) (authorizing court to select and appoint expert witnesses).

focus on the honesty of the employees and the security of the bank's safe.[343] Further, directors may not ignore specific signals of problems in their corporation. For example, a government negative report and fines on particular patterns of employees' behavior, such as payment of bribes, must alert directors to a problem and trigger steps to prevent transgressions, even if the activities produce significant profits.[344] Thus, there are situations in which the directors should be proactive.

However, in large corporations with a decentralized structure, directors are not likely to be informed about everything that is happening in the entire organization. Directors need not ferret out problems in the corporate organization. Nor may directors be able to establish in such a decentralized structure sufficient controls over disparate and dispersed employee population. These circumstances are taken into consideration when determining the directors' personal liabilities. But the Delaware court, among others, has shown no interest in judging issues of corporate structure or information flow to the board of directors.[345] "In general, courts do not second-guess business decisions made in good faith."[346]

To what extent are corporate directors liable for legal wrongs committed by the corporations under their stewardship? Put differently, to what extent does the duty of care require directors to enforce the law of the land and prevent the commitment of legal violations by the corporation on whose board they sit? The

343. *See* Rev. Model Bus. Corp. Act § 8.01 cmt. (1984) (scope of directors' oversight depends on nature of business).

344. *See* Colleen Taylor, *Siemens Faces $538M in Taxes, Fines for "Black Money" Scandal*, Electronic News, Oct. 2, 2007, at NO, LEXIS, News Library, Curnws File (noting that German firm was ordered to pay fines following reports that firm "had for years used a network of 'black accounts' for bribery around the world"; company "ha[d] taken aggressive steps . . . to clean up its sullied image" including hiring new president and CEO and stating that it was strengthening its compliance measures and internal controls); David Crawford & Mike Esterl, *Siemens Settlement Sets Off Criticism of German Inquiries*, Wall St. J., Oct. 8, 2007, at A12, LEXIS, Busfin Library, Wsj File (noting that fine "isn't much of a deterrent for companies . . . with deep pocketbooks").

345. *See In re* Caremark Int'l, Inc. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996) ("[T]he duty to act in good faith to be informed cannot be thought to require directors to possess detailed information about all aspects of the operation of the enterprise. Such a requirement would simple be inconsistent with the scale and scope of efficient organization size in this technological age. . . . Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, . . . in my opinion only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits [sic]—will establish the lack of good faith that is a necessary condition to liability."); Stone v. Ritter, 911 A.2d 362, 364–65 (Del. 2006) (following *Caremark*).

346. Lange v. Schropp (*In re* Brook Valley VII), 496 F.3d 892 (8th Cir. 2007).

answer is: legally, the duty is quite light. In the court of public opinion, however, the duty might be far stricter.[347]

In the case of *In re Caremark International Inc. Derivative Litigation*,[348] the Delaware court offered guidelines on directors' liability for legal enforcement. The corporation's structure was highly decentralized, and left to the sales persons and their supervisors freedom to conduct their business in a profitable but illegal way. The corporation received government citations on legal violations, and each time the board imposed added limitations on the particular wrongful sales practice or particular subject of the practice. Only after the corporation was fined a significant amount, the corporate structure and the internal rules were changed sufficiently to prevent future transgressions.

The shareholders sued the directors for a breach of the duty of care by dragging their feet in curtaining the sales practices. The shareholders did not charge the directors with violating their duty of loyalty, such as self-dealing, or the desire to entrench themselves. The court divided the directors' duty into negligent actions—the board's decision, and negligent inaction—failure to act. The court emphasized that its supervision of the board (and any fiduciary in fact) does not include the substitution of the board's decision for that of the court:

> [C]ompliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. . . . Indeed, one wonders on what moral basis might shareholders attack a good faith business decision of a director as "unreasonable" or "irrational." Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention. If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors.

Negligence manifested by inaction covers a fairly limited area of activities. The courts do not expect the board to operate the company's business. The board is "required only to authorize the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, appointment and compensation of the CEO, etc." but not "ordinary business decisions that are made by officers and employees deeper in the interior of the organization."[349] Thus, the range of the board's duty of care is fairly narrow.

347. See Tamar Frankel, *Court of Law and Court of Public Opinion: Symbiotic Regulation of the Corporate Management Duty of Care*, 3 NYU J.L. & Bus. 353 (2007).

348. *In re* Caremark Int'l, Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996) (footnotes and citations omitted).

349. *Id.*

In *Stone ex rel. AmSouth Bancorporation v. Ritter*,[350] bank directors were sued for failing to prevent the use of the bank's account for money laundering. The court reconsidered *Caremark* and noted that "[m]ost of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention." Consequently, a claim that directors should be personally liable for the corporate employee's failures is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." For the plaintiff's derivative complaint to withstand a motion to dismiss, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." Bad outcome is not bad faith.[351]

The board's lack of control may be due to the structure of the corporation and absence of centralized guidance. Yet, it is unlikely that the Delaware courts will interfere and impose standards on corporate structure. The Sarbanes-Oxley Act does not go that far, although there are not yet court cases to determine the limits of the Act.[352] Whether courts will impose on directors heavier duties under federal law remains to be seen.

b. Duty of Care of Debtors in Possession of the Bankrupt Estate "Debtors in possession and those who control them owe fiduciary duties to the bankruptcy estate."[353] They are no longer the equity holders but fiduciaries for the benefit of the creditors. "Thus, the partners in a bankrupt partnership, acting as a debtor in possession, must run the business as agents of the bankruptcy estate, and not for their own personal gain. The fiduciary obligation consists of two duties: the duty of care and the duty of loyalty. . . . The duty of care requires the fiduciary to make good-faith decisions that can be attributed to a rational business purpose."[354]

J. SERVING ENTRUSTORS WHOSE INTERESTS CONFLICT

1. Introduction

Fiduciaries may be placed in a position of arbitrators among entrustors with conflicting interests. Sometimes the fiduciaries' posture involves a hint of their own conflicting interests. The conflicts need not necessarily be financial. They

350. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).

351. *Id.*

352. *See In re* Caremark Int'l, Inc. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (stating that directors generally are liable for knowledge of "liability creating activities" within organization only when there is a "a sustained or systematic failure of the board to exercise oversight"); Stone v. Ritter, 911 A.2d 362, 364–65 (Del. 2006) (following *Caremark*).

353. Lange v. Schropp (*In re* Brook Valley VII), 496 F.3d 892 (8th Cir. 2007).

354. *Id.*

may involve personal relationships with one of the entrustors. They may involve the fiduciaries' desires to protect themselves from liability. Even so, the arbitrator's posture poses a difficult dilemma for fiduciaries. How should they mediate among conflicting claims of entrustors to whom the fiduciaries owe duties of loyalty and care? How can they reach a decision without violating their legal duties and rules of ethics?[355]

A first step that fiduciaries in this situation may follow is to clarify the rights of the conflicted entrustors. A careful examination of the rights of the contending parties can help deal with the demands of each entrustor. A second step for fiduciaries in the arbitrators' mode is to understand their own role. A third, and less comforting, position is a situation in which the fiduciaries face a clear conflict between two entrustors with no guidelines in the entrustment directives. In such a case fiduciaries may attempt to envision what the parties would have agreed upon had they been asked. The fiduciaries might resort to general principles of law and precedent, such as maximizing the fairness to each party, and the impact of the fiduciaries' decisions on the parties, as well as the general legal or financial implications.[356] A fourth step is for fiduciaries to resort to the decision of third parties such as the courts or regulators. And, of course, they might, in most serious cases,[357] resign.

2. Clarifying the Entrustors' Seemingly Conflicting Rights and Understanding the Fiduciaries' Own Role

In *Zahn v. Transamerica Corporation*[358] the corporate articles required the directors to determine and execute actions under certain conditions. The directors of the company, Axton-Fisher, were nominees (appointees) of the majority shareholder—Transamerica Corporation. The financial structure of Axton-Fisher consisted of (1) preferred stock, which entitled the holders to a fixed amount plus a fixed interest rate, and to priority in the event of the corporation's bankruptcy; (2) Class A shares, which had priority over Class B as follows. Class A shares entitled the holders to a fixed dividend, and an equal share as Class B of any additional dividend. Upon liquidation of the corporation Class A shares were entitled to receive "twice as much per share" of the value of the remaining assets as compared to Class B shares; (3) Class B shares, which entitled the holders to vote for the board of directors, unless the dividends, to which Class A was entitled, were in arrears. In that case Class A and Class B shares had equal voting rights.

In addition, the terms of Class A shares provided that the directors had the power to "call" Class A shares, and pay them the face amount of the shares, plus dividends due. Within 60 days from the date of the "call" Class A shareholders had a choice. They could accept the money payment. Or they could convert each of their Class A shares into one Class B share at a fixed price (which is the face amount of the shares).

What was the purpose of these provisions? Class A shares had significant rights as compared to Class B Shares, and could be considered "expensive" capital for the corporation and to Class B shareholders. Presumably, the directors were expected to exercise their power to "call" Class A shares when the company was successful and could raise money on less onerous terms. It could sell Class B shares in the market to pay off Class A, or borrow at lower cost than the cost of these shares. The directors' duty was to "call" Class A shares if less expensive capital was available to the corporation. However, at the same time the directors' duty was to notify Class A shareholders of their right to convert their shares to Class B shares, presumably at a price that was lower than the market price.

But then an unexpected event arose. While the company was losing money, and owed Class A shares about $80 per share in face amount and arrears in dividend payments, the value of the corporation's assets increased dramatically. The corporation's main asset was tobacco, whose value rocketed during the Second World War. That presented a temptation for the majority shareholder—Transamerica Corporation. So long as Axton-Fisher was not liquidated the company was sitting on a pot of gold that none of the shareholders could reach. But whether the corporation sold the tobacco, or not, it would be awash with cash, and upon its dissolution it would distribute its assets to the shareholders at a 2/3 ratio, that is for every $2 paid to class B, class A would receive $3. Another possibility was for the directors to "call" Class A shareholders and offer them $80, but not notify them about the imminent dissolution of the company. Had Class A shareholders known about the imminent dissolution they would have waited for the dissolution and collected twice the amount paid to Class B shareholders. If they were "called," and knew about the impending dissolution, they could convert their shares and receive not the $80 due but more—an equal share with the controlling majority of class B shareholders.

Most of the directors were employees of Transamerica Corporation that owned most of Class B's shares (as well as Class A shares). The directors followed

355. For an in-depth analysis in connection with the duties of trustees in bankruptcy *see* Steven L. Schwarcz, Fiduciary Conflicts (July 29, 2009) (draft with the author).

356. *See. e.g.*, Bevel v. Higginbottom, No. CIV-98-474-X, 2001 U.S. Dist. LEXIS 17977 (E.D. Okla. Oct. 4, 2001) ("A fiduciary . . . must serve both masters (or at least the plan) with the utmost care and fairness. But in the instant case, Defendants consulted with independent advisers. . . .").

357. *See* William L. Medford, *Preparing for Bankruptcy: Director Liability in the Zone of Insolvency*, 20-3 Am. Bankruptcy Inst. J. 30 (2001) ("[I]f a director's resignation would cause or allow harm to the corporation or leave the interests of the corporation unprotected, the director is not free to resign. Resignation at such an inopportune time may therefore result in a breach of fiduciary duty. Regardless of timing, liability may accrue after resignation."). *See also* Ariz. Rev. Stat. Ann. § 14-5210 (2005) ("[A] fiduciary acting as a guardian may not resign or terminate their responsibility or authority to the ward until the court approves the termination of guardianship.").

358. Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947).

Transamerica's interests. They called Class A shares and offered to pay the face amount and arrears (approximately $80). The directors knew that the corporation held valuable tobacco that the controlling shareholder planned to sell and dissolve the company, but failed to disclose the facts to the Class A shareholders. These facts were not public knowledge. Most Class A shareholders were happy to receive the $80 and did not convert into Class B shares, which would have netted them more.

The court held that the directors breached their fiduciary duties to the Class A shareholders. The court did not award Class A shareholders double the amount of Class B shareholders. After all, the majority shareholder had no duty to dissolve the company on these conditions. The directors could indeed "call" Class A. In this case the Class A shareholders would choose to convert to Class B shares. Therefore, Class A shareholders were awarded an equal amount to the amount collected by Class B shareholders (not double the amount), based on the assumption that had the Class A shareholders known of the plan to liquidate the company and the value of the tobacco, and had they known that the directors would not dissolve the corporation and allow them to collect double the Class B shareholders, they would have converted their shares to Class B shares.

3. Clear Conflict among Entrustors with Little Guidance from Entrustment Directives

A conflict among entrustors can arise, for example, when a trust has two types of beneficiaries: income beneficiaries and remaindermen. The income beneficiaries are entitled to income from trust investments. The remaindermen are entitled to the capital, once the income beneficiary dies. Usually income beneficiaries are the wives of the trustors and remaindermen can be the children or charitable institutions. If the trust investments are more risky, the wife may receive higher benefits while risking the payment to the remaindermen. Conversely, more conservative investments will produce lower returns for the wife and the children may be assured of more. What should guide the trustee in making investments? Barring guides in the trust document the trustee draws on facts signifying the trustor's intent. It might matter that the husband and wife during his lifetime lived in luxury or in modest conditions. It might matter that the couple was separated. It might matter that the children are of age and can earn a living.[359]

359. RESTATEMENT (THIRD) OF TRUSTS § 79(2) (2007) (providing that in this situation trustee has duty to invest so "that the trust estate will produce income that is reasonably appropriate to the purposes of the trust and to the diverse present and future interests of its beneficiaries"); *id.* cmt. g (providing that balance between income and principal elements must "reflect[] the trust's purposes, terms, and obligations, in light of the circumstances of the trust and usually the circumstances of its beneficiaries, including the needs of an income beneficiary so far as these needs are relevant to the purposes of the trust").

Conflicts among entrustors can arise for other reasons. In *Rippey v. Denver United States National Bank*,[360] the daughter of the trustor fought for the controlling shares of a newspaper while the other beneficiaries fought to realize the highest price for the shares. The bank trustee sided with the daughter of the trustor against an "outsider" who was ready to pay a far higher price for the shares than she could. The Court wrote:

> The first duty of a fiduciary is to protect the interests of its beneficiaries. In selling an asset of the trust he must make every reasonable effort to sell at the best price obtainable. It is a violation of the fiduciary duty to sell at a private sale to one purchaser to the exclusion of another known interested purchaser who would foreseeably pay more. The Bank's failure to make any effort to contact [the outside bidder for control of the newspaper] and its determined effort to sell to . . . [the daughter of the deceased] without regard to consequences, which determination is evidenced by the exclusive shareholders' agreement together with its other actions which were designed to complete the sale without either contacting [the outside bidder] or affording opportunity for [the outside bidder] to make an offer, constituted a breach of trust.

Under the circumstances the remedy was surcharge, rather than rescission. Surcharge was calculated as "the difference between the sale price and the price which would have been obtained if the Bank had conducted a non-restricted sale," that is damages, evaluating the possible price from the outside bidder and comparing it with the price paid by one of the favored entrustors.[361] This was not a self-dealing case but the trustee's failure "to exercise good judgment in conducting the sale and from its failure to act fairly and to follow accepted trust practices in seeking a sale which would yield the maximum price." The trustee does not have "unlimited or absolute discretion in making a sale of trust property." He may not "operate beyond the bounds of prudent judgment" or act unreasonably, even if he was given "absolute and uncontrolled discretion." Here the bank failed "to test the market or to make a move toward [the potential interested party]." The bank created a high probability of harm to the beneficiaries. It was also biased toward the daughter of the newspaper founder. The court concluded: "The law is clear that the Trustee's duty of loyalty and of reasonable care dictate that he must seek to collect the best price obtainable for the property which he is selling."[362]

4. Where Fiduciary Duties End

Fiduciary duties toward entrustors do not include a duty to commit illegal acts. Thus, brokers may not disclose to clients insider information, prohibited by law,

360. Rippey v. Denver United States Nat'l Bank, 273 F. Supp. 718, 723 (D. Colo. 1967).
361. *Id.* at 734–35.
362. *Id.* at 735–42 (footnotes and citations omitted).

or in conflict with the brokers' fiduciary duties to another party.[363] The fact that the entrustor trusted the fiduciary broker or adviser to serve the entrustor's interest does not include violations of the fiduciary's duties to others or violations of the law.[364] Fiduciary relationships are not as protected as the relationships between husband and wife, which protect spouses from testifying against each other.[365] And unlike marriage, or even contract to a limited extent, fiduciaries can terminate the relationships more easily. Courts have long held that parties to fiduciary relationship may sever the relationship, in recognition of the foundation of trust on which the relationship is grounded.[366]

K. FIDUCIARIES' RIGHTS AND PROTECTIONS FROM THE ENTRUSTORS' CLAIMS

Fiduciary services are not risk-free. Fiduciaries are not guarantors. They are expected to do their best but not necessarily to produce specific results. No lawyer is expected to guarantee that the client's case will be won. No doctor can ensure the patient's good health. And no director and officer are required to produce specific profits for the shareholders. Yet, the line between a duty of care or the duty to follow the entrusting directives, on the one hand, and the results of the fiduciaries' services, on the other hand, is somewhat murky.

Fiduciaries may promise or imply to produce results that they cannot, and did not, deliver. Disappointed shareholders or clients may sue on the implied promises or on expectations that did not materialize, or on unrealistic hopes that are unjustified. Such suits may involve millions of dollars in judgments, lawyers' fees, and court expenses, and can ruin directors and officers.

Therefore, anticipating possible suits, corporate directors and officers, lawyers, and physicians, seek protection by insurance policies[367] and obligations of corporate employers[368] to indemnify them against the costs of litigation, under certain conditions.[369] And because it is against public policy to indemnify and insure against illegal behavior, most litigation against fiduciaries is settled, so that the insurance companies and the indemnifying corporation can pay without delay and problems.[370] The right to indemnification has been strengthened when a court rejected the government's pressure to withdraw the right as a condition to settlement.[371] Most cases against corporate fiduciaries are settled. Fiduciaries settle because they will not be protected if they are found liable, and the plaintiffs settle because they are not sure of winning their cases.[372] Yet, to trigger the higher returns for the litigating lawyers and the lowest cost for the fiduciaries, litigation must start, and its costs must be borne.[373]

L. FIDUCIARY DUTIES IN LEGISLATION

Legislation that defines fiduciary relationships and imposes fiduciary duties has risen in the past fifty years. Like all legislation, it has raised questions of interpretation as well as the issue of relationship between the common law fiduciary law and the legislative provisions. While the common law is a more open-ended area of the law, allowing not only the acceptance of new fiduciaries into the fold, but also different interpretations of fact situations and contexts, legislation is more specific, relates usually to particular fiduciary functions, sometimes expanding and sometimes limiting fiduciary duties. Legislation, such as the Employee

363. Cotton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 699 F. Supp. 251 (N.D. Okla. 1988) (some citations omitted) (The action was based on the Securities Exchange Act of 1934, 15 U.S.C. § 78j, and Rule 10b-5, 17 C.F.R. § 240.10b-5).

364. 699 F. Supp. at 256 ("[B]rokers have a primary obligation not to reveal inside information to clients for the clients' benefit in trading securities.") (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961) ("[E]ven if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. . . . Clients may not expect of a broker the benefits of his inside information at the expense of the public generally.")).

365. *See* Robert Kardell, *Spousal Privileges in the Federal Law,* FBI L. ENFORCEMENT BULL., Aug. 2003, http://www.fbi.gov/publications/leb/2003/august2003/aug03leb.htm#page_27 . *See also* Wolfle v. United States, 291 U.S. 7, 14 (1934). (The U.S. Supreme Court stated the marital privilege was "regarded as so essential to the preservation of the marriage relationship as to outweigh the disadvantages to the administration of justice").

366. *See In re* Cooperman, 83 N.Y.2d 465 (1994); *id.* at 472–73 ("[P]ublic policy recognizes a client's right to terminate the attorney-client relationship *at any time with or without cause.* This principle was effectively enunciated in *Martin v. Camp:* 'The contract under which an attorney is employed by a client has peculiar and distinctive features . . . [thus] [n]otwithstanding the fact that the employment of an attorney by a client is governed by the contract which the parties make. . . . the client with or without cause may terminate the contract at any time'") (citations omitted) (quoting Martin v. Camp. 219 N.Y. 170, 172–74 (1916)).

367. Vickie Bajtelsmit & Paul D. Thistle, *The Reasonable Person Negligence Standard and Liability Insurance,* J. RISK & INS., June 2007, http://www.allbusiness.com/insurance/liability-insurance-general-liability/11708916-1.html.

368. Stockman v. Heartland Indus. Partners, L.P., Civ. Nos. 4227-VCS, 4427-VCS, 2009 WL 2096213 (Del. Ch. July 14, 2009) (directors of a failed portfolio company of a private equity fund could not be deprived of indemnification even in light of an ambiguous provision in the partnership agreement); *see also* Mark W. Pierce, *Indemnification of Directors and Officers: Delaware and Tennessee,* 6 TRANSACTIONS 395 (2005).

369. Stockman v. Heartland Indus., *supra.*

370. *See* SAMUEL WILLISTON, 7 A TREATISE ON THE LAW OF CONTRACTS § 901, at 60 (Walter H.E. Jaeger ed., 3d ed. 1963) (stating criminal liability insurance has been deemed illegal for public policy reasons).

371. United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

372. *See, e.g.,* Serv. Corp. Int'l v. H.M. Patterson & Son, 263 Ga. 412 (1993).

373. *See* Chapter 6.

Retirement Income Security Act, specifically establishes a relationship between its provisions and state trust law.[374] In contrast, the courts started by imposing fiduciary common law rules as well as the provisions of the Investment Company Act of 1940 on investment advisers to mutual funds, only to retreat entirely from this position, and impose only the provisions of the Investment Company Act of 1940. The Supreme Court's decision in the 1960s that imposed fiduciary duties on investment advisers under the common law as well as under the Advisers Act of 1940 has remained intact, however.

When legislation has authorized regulators to exempt from the provisions of the acts this authority has created a "common law of legislation" by exemptions and rules. These are sufficiently broad yet more focused. Thus, throughout the years we have developed two modes of establishing fiduciary relationships: the courts' common law mode, which focuses on the facts and draws on precedents; and the legislative mode, which defines fiduciaries by selecting various features and functions as well as the rules that apply to it, and sometimes determines whether both or only one of these sources and approaches will apply.

1. The Employee Retirement Income Security Act (ERISA)

a. Background The Employee Retirement Income Security Act of 1974 (ERISA) required employers, who promise their employees pensions upon retirement, to fund the promises rather than "pay as you go." The establishment of pension funds raised issues concerning the fiduciary duties of the employers and the pension managers. The Act imposed strict fiduciary duties on the managers. The Act relieved these duties for pension funds managed by advisers registered as advisers under the Investment Advisers Act of 1940,[375] and partially preempted state laws so that its provisions govern exclusively.[376]

b. Prohibited Conflict of Interest Section 1104 of the Act provides that "(a) (1) . . . a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—(A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan;. . . ."[377]

374. 29 U.S.C. § 1144(a) (2006) (providing that Act generally supersedes state law relating to covered employee benefit plan).

375. Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (2006)).

376. 29 U.S.C. § 1144 (2006) (preempts all state laws).

377. 29 U.S.C. § 1104(a)(1) (2006). Section 1104(a)(1) follows the other duties of a "plan fiduciary" relating to the duty of care and the duty to follow the directives of the entrustment: requiring the fiduciary to "discharge his duties" "(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter."

Not surprisingly, the exception to the conflict-of-interest duties is linked to the control of the investment in the entrusted assets. If the employees-pensioners control the investors, the managing fiduciaries are not responsible. Section 1104(c) provides:

> (1) (A) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account . . .—
>
> (i). such participant shall not be deemed to be a fiduciary by reason of such exercise, and
>
> (ii). no person who is otherwise a fiduciary shall be liable . . . under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control, except that this clause shall not apply in connection with such participant or beneficiary for any blackout period during which the ability of such participant or beneficiary to direct the investment of the assets in his or her account is suspended by a plan sponsor or fiduciary.
>
> . . .
>
> (2) In the case of a simple retirement account established pursuant to a qualified salary reduction arrangement . . ., a participant or beneficiary shall, for purposes of paragraph (1), be treated as exercising control over the assets in the account upon the earliest of—
>
> (A). an affirmative election among investment options with respect to the initial investment of any contribution,
>
> (B). a rollover to any other simple retirement account or individual retirement plan, or
>
> (C). one year after the simple retirement account is established.
>
> No reports, other than those required under section 1021(g) of this title, shall be required with respect to a simple retirement account established pursuant to such a qualified salary reduction arrangement.[378]

378. Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1104(c) (2006). "In the case of a pension plan which makes a transfer to an individual retirement account or annuity of a designated trustee or issuer under section 401(a)(31)(B) of title 26, the participant or beneficiary shall, for purposes of paragraph (1), be treated as exercising control over the assets in the account or annuity upon—(A) the earlier of—(i) a rollover of all or a portion of the amount to another individual retirement account or annuity; or (ii) one year after the transfer is made; or (B) a transfer that is made in a manner consistent with guidance provided by the Secretary." 29 U.S.C. § 1104(c)(3) (2006).

In sum, entrustment of the power determines the responsibility for the exercise of the power. And if a manager controls the possession of the assets but not the investments, the manager will not be responsible for the decisions regarding the investments.

2. Exemption from the Prohibition on Conflict of Interest

In 2006, Congress passed a number of exemptions from the provisions of ERISA. The exemptions apply to "parties in interest" who were prohibited from interacting with the pension plans in conflict of interest. Congress granted a blanket exemption from these restrictions to persons who are "parties in interest solely by reason of providing services to a plan" (or by reason of a relationship to such a service provider). The exemption is subject to the condition that the amount paid by the plan to the fiduciaries will be equal or lower than the market value, and the amount received by the plan is equal or higher than fair market value.[379] The difficulty with such a condition is always who will determine the market price, and what guidelines will be established for such a determination.

In addition, Congress provided: (1) An exemption permitting investment managers to engage in discretionary cross-trading of publicly traded securities, provided certain requirements are met; (2) An exemption making it clear that fiduciaries do not engage in prohibited transactions by using electronic trading networks; (3) An exemption facilitating foreign exchange transactions; (4) An exemption permitting block trades involving the assets of certain employee benefit plans; (5) A provision permitting the correction of inadvertent prohibited transactions involving securities within 14 days after the transaction occurs, and abatement of the prohibited transaction excise tax when such a correction occurs. The new rules regarding corrections of prohibited transactions would apply to any transaction the non-plan party involved discovers, or should have been discovered, after the date of enactment.[380] (6) A new exemption from the Act's bonding requirements for registered broker-dealers (and an increase from a maximum of $500,000 to a maximum of $1,000,000 per plan in the amount of bond required if the plans hold employer securities).

According to one commentator, the purpose of these new exemptions was "to allow plans to complete many transactions more freely, while still providing protection for plans and their participants and beneficiaries."[381] Like the general

379. Pension Protection Act of 2006, Pub. L. No. 109-280, § 611(d), 2006 U.S.C.C.A.N. (120 Stat.) 780, 969–71 (2006) (codified at 26 U.S.C. § 4975(d)(20), (f)(10), 29 U.S.C. § 1108(b)(17) (2006)).

380. Pension Protection Act of 2006, Pub. L. No. 109-280, § 611(a)–(c), (e)–(g), 2006 U.S.C.C.A.N. (120 Stat.) 780, 967–69, 971–75 (2006) (codified at 26 U.S.C. § 4975(d)(18)–(19), (21)–(22), (f)(9), 29 U.S.C. §§ 1002(42), 1108(b)(15)–(16), (18)–(19) (2006)).

381. Andrew L. Oringer, *Ancillary Provisions of the Pension Funding Bill May Contribute to the Evolution of ERISA*, BNA Pension Protection Act Center, Aug. 18, 2006,

regulatory trend, congressional tendency until the crisis of 2008 has been to lighten or remove altogether the regulation of fiduciaries in the belief that market competition and self-regulation are sufficiently robust to prevent entrustment violations.

3. Regulation of Conflicts of Interests under the Investment Company Act of 1940[382]

The Investment Company Act of 1940 (1940 Act) regulates investment companies (mutual funds), their advisers, and their affiliates. Mutual funds are entities, usually organized as corporations or trusts, which issue securities and invest in securities.[383] Unlike the banks, that issue debt obligations to depositors, mutual funds issue securities promising security holders a pro rata share in whatever the funds hold (minus fees and expenses).[384] If the funds' assets hold less, the shareholders receive less. Unlike the banks, that are regulated debtors, advisers and directors of mutual funds are regulated fiduciaries.[385] In addition, the Act regulates as fiduciaries a large group of parties that service the funds and prohibits these parties from acting in conflict of interest with the funds (sometimes including companies controlled by the funds).[386] The prohibitions may create 25 parties that may not transact knowingly as principals with these funds or their controlled companies.[387] Other prohibitions apply to similar parties acting as agents in relation to the funds, and still others, such as underwriters, are prohibited from "partnering" with their funds except on equal terms,[388] or "dumping" securities into the funds.[389]

Section 17(a) of the Investment Company Act prohibits certain transactions between affiliates, affiliates of affiliates, promoters and affiliates of underwriters, acting as principals, and their investment companies and companies controlled by the investment companies. "Affiliates" of investment companies include their boards of directors, their advisers, portfolio managers, 5 percent shareholders, companies that are controlled by the investment companies and companies in which the investment companies own 5 percent, as well as employees and

available at http://www.subscript.bna.com/pic2/ppa.nsf/id/BNAP-6SSLZL?OpenDocument, *quoted in* Craig C. Martin & Joshua Rafsky, *The Pension Protection Act of 2006: An Overview of Sweeping Changes in the Law Governing Retirement Plans*, 40 J. Marshall L. Rev. 843, 864 (2007).

382. 15 U.S.C. § 80a-17 (2006).

383. Investment Company Act of 1940, § 80a-3(a)(1), 15 U.S.C. § 80a-3(a)(1) (2006).

384. 1 Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers § 5.01 (2d ed. 2001).

385. 15 U.S.C. § 80a-35 (2006).

386. *Id.*. § 80a-17.

387. *Id.* § 80a-2(a)(3) (defining affiliated persons).

388. *Id.* § 80a-17(d).

389. *Id.* § 80a-10(f).

partners.[390] Other subsections of the Act prohibit transactions between similar parties acting as agents.[391] The Act authorizes the Securities and Exchange Commission (SEC) to provide exemptions from these prohibitions subject to conditions. Throughout the years the SEC has indeed "deregulated" many activities, as well as "re-regulated" them by attaching conditions to the exemptions. Often the conditions strengthened the powers of the funds' boards of directors by increasing the required number of independent directors.[392] Thus, freedom from the Act's prohibitions on particular actions and structures was accompanied by other conditions or stronger internal structural supervision.

The Act imposes a broad prohibition on conflict-of-interest transactions and allows consent to such transactions only to the SEC. However, throughout the years a number of rules provided exemptions from these prohibitions on certain conditions. One of the conditions is that the board of directors of the mutual funds subject to the conflict of interest transactions would consent to the transaction.[393] In these exemptive rules the Commission followed corporate law.

4. Relaxation of Prohibition on Conflicts of Interest by Money Managers

The changes that occurred in the stock market in the 1970s raised issues concerning the fiduciary duties of investment advisers. These advisers used to receive from large brokerage houses valuable reports free of charge. As long as the brokerage houses could not compete on commissions because the New York Stock Exchange required all brokers to charge the same fee, the free research reports did not create serious conflicts of interests. In addition, investment advisers to mutual funds had a unique conflict of interest. They were charging a percentage of the assets under management, like trustees. However, unlike trustees, that could increase their fees mostly by performance of the funds under management, mutual fund managers could increase their fees by selling more fund shares. Therefore, the managers wanted to reward the brokers that sold fund sharers by awarding them fund portfolio transactions that were attractive to the brokers.

> Fiduciary principles require money managers to seek the best execution [of securities transactions] for client trades, and limit money managers from using client assets for their own benefit. Use of client commissions to pay for research and brokerage services presents money managers with significant conflicts of interest, and may give incentives for managers to disregard their best execution obligations when directing orders to obtain client commission services as well as to trade client securities inappropriately in order to earn credits for client commission services. Recognizing the value of research in managing client accounts, however, Congress enacted Section 28(e) of the Exchange Act to provide a safe harbor that protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive "brokerage and research services" provided by a broker-dealer, if the managers determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received.[394]

Congress did not require managers to pay the lowest commissions because complex transactions may require expert execution and should command higher pay.

However, when money managers receive benefits from brokers, the managers might allocate the clients' brokerage business to these brokers, even if they might not be the best to execute the transactions. Hence, Congress imposed on advisers a duty to ensure best execution (which includes best price, but not only the best price). However, this provision did not address problems involving mutual fund advisers.

While brokers are interested in mutual fund portfolio brokerage business, the funds' managers are interested in the sale of fund shares, because the managers' fees are calculated as a percentage of the assets under management. However, retail brokers are not always able to execute large transactions and large brokerage firms do not necessarily sell fund shares. Consequently, large brokerage firms "gave up," or transferred in different ways, some of their commissions to the brokers that sold fund shares. Better execution was more costly for the funds than it should have been because the commissions paid to the brokers that executed fund transactions commissions included the cost of distributing fund shares, in which the advisers were interested.[395] The rules addressing this situation are not entirely successful.[396]

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390. *Id.* § 80a-2(a)(3), 2(a)(9).

391. *Id.* § 80a-17(e).

392. 17 C.F.R. §§ 270.10f-3(c)(10), .12b-1(b)(2), (h)(2)(ii), .15a-4(b)(1)(ii), .17a-6(b)(1)(i)(H), .17a-7(e), .17a-8(a)(2)(i), .17d-1(d)(5)(ii)(A)(8), (d)(7)(iv); .18f-3(c)(1)(v); .22c-2(a)(1), .23c-3(b)(3)(i) (2007).

393. 17 C.F.R. §§ 270.10f-3(c)(10), .12b-1(b)(2), (h)(2)(ii), .15a-4(b)(1)(ii), .17a-6(b)(1)(i)(H), .17a-7(e), .17a-8(a)(2)(i), .17d-1(d)(5)(ii)(A)(8), (d)(7)(iv); .18f-3(c)(1)(v); .22c-2(a)(1), .23c-3(b)(3)(i) (2007).

394. Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54,165 (July 18, 2006), 71 Fed. Reg. 41,978, 41,978 (July 18, 2006) (interpretation; solicitation of comment) (footnotes omitted).

395. *See* 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 15.02[D], at 15-52.2 to -60 (2001 & Supp. 2008) (discussing section 28(e)).

396. *See* Securities Exchange Act of 1934, § 6(e)(1), 15 U.S.C. § 78f(e)(1) (2006) (prohibiting fixed commissions); 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 15.02[D], at 15-26.1 to -34 (2001 & Supp. 2007) (discussing give-ups).

The issue of the broker's duties is further complicated by the brokers' charges. If a broker charges a client more than is customary, and knows that the client is unaware of the higher charge, should the broker disclose the fact to the customer? If the relationship is deemed an arm's-length "market transaction," as any contract, the answer is: No. "Let the buyer beware." He can ask. The information about brokerage fees is not hard to discover and compare. Besides, the parties have not yet entered the fiduciary relationship.

However, like the client-lawyer relationship, the relationship between the parties may start earlier than the moment of binding agreement. The broker may offer "free advice" or free "financial planning" and is entrusted with information about the client's affairs. Under the rules, a broker must recommend to clients "suitable investments."[397] And in order to do that, clients must offer financial and private information to the brokers. More importantly, brokers are viewed as trusted advisers, because the very nature of the arrangement involves entrustment of the clients' money to them. Otherwise, the brokers could not sell or buy the clients' stock or other securities.[398] Most importantly, trust in brokers is one of the building blocks of the financial system. Therefore, the fees brokers charge should not be so outrageous as to undermine the trust in them even before clients entrust brokers with their assets. In this case the maintenance of the financial system must be considered. Therefore, a court held that a broker who receives a client's unsolicited order to sell stock and buys part of the stock for the broker's account without disclosing the purchase to the client is liable for breach of fiduciary duty under both state and federal law.[399]

Nonetheless, it must be clear to any client that brokers have conflicts of interest. The brokers enjoy their commission only if the clients execute transactions, although some other forms of fees have been recently devised, in which the brokers get paid by the amounts vested in them by the clients.[400] Thus, the brokers' position as fiduciaries is unclear. They are part-salespersons, part-advisers-fiduciaries. They are subject to specific rules,[401] but not to fiduciary principles generally.[402] And they seek and command trust, but insist that they are

397. NASD Manual, Rule 2310 ("a member shall have reasonable grounds for believing that the recommendation is suitable for such customer"), http://finra.complinet.com/finra/(last visited July 12, 2008).

398. *See* Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795, 809 (1983).

399. Arst v. Stifel, Nicolaus & Co., 86 F.3d 973 (10th Cir. 1996) (broker violated state and federal law on executing a client's order without disclosing the broker's purchase of some of the client's shares).

400. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 42,099 (Nov. 4, 1999), 64 Fed. Reg. 61,226, 61,227 (Nov. 10, 1999).

401. NASD Manual, Rule 2310 ("a member shall have reasonable grounds for believing that the recommendation is suitable for such customer"), http://finra.complinet.com/finra/(last visited July 12, 2008).

402. Chapter 3 B.1.a.

salespersons, and deny the applicability of fiduciary law.[403] Two cases offer examples of the difficulties of these issues.

One case concerns an elderly, inexperienced but lucid investor who gives a broker unsolicited orders, and changes her mind often without considering brokerage costs. Her account is depleted both by the commissions and by imprudent investments. To what extent should the broker be responsible for advising this investor against his own interests?[404] There is no rule on the matter, and the courts are not entirely clear either.

The case of the auction rate notes offers another example, in which the risk of the investment is created by a market maker and offered by a broker but the customer is a sophisticated investor. Auction rate notes are long-term notes whose terms are shortened in reliance on short-term auctions. The risk for a buyer is that the auctions might not bring the expected return or, worse still, that there will be no buyers. To cover this risk, the market maker implicitly or explicitly promises to buy back the notes.[405] The amounts involved were in the billions, and no one expected a complete collapse of the market. When it occurred, and the market maker could no longer repurchase the notes, some buyers faced severe losses, not only in holding long-term notes but also by their inability to meet their obligations. Arguably, the entire loss should fall on the buyer. Yet, should there be some liability on the broker's assertion that these notes were "like cash" in the bank, but paid so much more? Should long-term personal relationships and reliance on the broker count? At this point it seems that the sophisticated buyer should beware. Rules for these cases are near impossible to draft because the cases are so fact-specific. The courts must weigh the level of the risks, the assertions of the trusted sales persons, and the clarity of the market maker's repurchase obligations.[406]

The Delaware Corporation Statute protects some contracts and transactions from attack based on conflicts of interest. This protection follows the model of consent by the entrustors. However, in the case of corporations the entrustor is a legal entity (the corporation) and its representatives, some of the directors or officers, are tainted with conflict of interest. Therefore, rather than relying on consent by the entire board, the law "sanitizes" the transactions or contracts if consent is provided by directors that are not interested in the transactions

403. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 51,523 (Apr. 12, 2005), 70 Fed. Reg. 20,424, 20,426 (Apr. 19, 2005) (noting broker-dealer support for exception from Investment Advisers Act for certain broker-dealers offering fee-based compensation as opposed to commission-based compensation).

404. Brumm v. McDonald & Co. Sec., 603 N.E.2d 1141 (Ohio Ct. App. 1992).

405. Donald C. Langevoort, *Information Technology and the Structure of Securities Regulations*, 98 Harv. L. Rev. 747, 751.

406. *Cf.* Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1289–90 (S.D. Ohio 1996).

or contracts. With such consent, the contracts or transactions will not be void (struck without more) or voidable (avoided at the option of the corporation) "solely" because such conflicted directors or officers were involved.[407]

The protection covers contracts or transactions between a corporation and one or more of its directors or officers (management) or another corporation in which a member of the management is a director, officer or has a financial interest. The protection covers both claims that such transactions are void (cannot be enforced) or voidable (can be enforced only by the choice of the corporation). The conflicts that are protected also include any situation in which the management member was present or participated in the meeting that authorized the contract or transaction or voted or was counted to constitute a quorum.

There are, however, conditions attached to these protections.

- The board of directors should receive full information with respect to the contract or transaction. These material facts include information about the involved director's or officer's relationship or interest in the contract or transaction. Second, the information about the contract or transaction is disclosed or is known to the disinterested members of the board of directors or the committee, and "the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum"; or
- The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
- The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders. In that case disclosure is not necessary.[408]

407. Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976); DEL. CODE ANN. tit. 8, § 144 (2009) (the tainted transactions that the protection covers are: contracts or transactions between a corporation and one or more of its directors or officers (management) or between the corporation and another corporation in which a member of the management is a director, officer, or has a financial interest. In addition, the protected conflicts include any situation in which the management member was present or participated in the meeting which authorized the contract or transaction or voted or was counted to constitute a quorum. Such involvement does not by itself taint the contract and transaction).

408. Oberly v. Kirby, 592 A.2d 445 (Del. 1991) (The section limits the stockholders' power to "nullify an interested transaction in two ways: First, a committee of disinterested directors may approve a transaction and bring it within the scope of the business judgment rule; and second, where an independent committee is not available, the stockholders may either ratify the transaction or challenge its fairness in a judicial forum, but they lack the power automatically to nullify it.").

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After the crash of 2008, however, directors may face pressures from the regulators, especially the bank regulators, particularly concerning executive compensation. These pressures may lead not only to reducing the compensation of bank executives but also, and perhaps mainly, to containing the banks' risk taking. If that happens, lower risks are likely to lead to lower returns, which may lead to lower executive compensation that is currently linked to "performance."[409]

5. New York Corporation Law[410]

New York Corporation Law is similar to the Delaware legislation. It too, is based on consent by the independent directors or a majority of the shareholders that binds the corporation.[411] Another context in which conflict of interest appears in corporation law is when shareholders sue derivatively. In such situations the shareholders must make a demand on the board of directors unless the demand would be futile because the board members have conflicts of interest and cannot adopt the claims and sue on behalf of the corporation.[412]

409. *See* Joan S. Lublin, *Boards Face Expanded Responsibilities*, WALL ST. J. Sept. 19, 2009, at A2, LEXIS, News Library, Wsj File.

410. N.Y. BUS. CORP. LAW § 713 (McKinney 2003).

411. Sutherland v. Sutherland, No. 2399-VCL,,2009 Del. Ch. LEXIS 46 (Del. Ch. Mar. 23, 2009).

412. FED. R. CIV. P. 23.1(b)(3); DEL. CT. CH. R. 23.1(a).

4. DEFAULT RULES IN FIDUCIARY LAW

A. INTRODUCTION

The Nature and Justsification for Fiduciary Default Rules and Mandatory Rules[1]

Most fiduciary law rules are treated as default rules; that is, legal rules that both fiduciaries and entrustors can agree to change. These rules are analogized as "form ready-made contracts" that parties can adjust to their particular agreed-upon terms. Therefore, even though a fiduciary may not buy entrusted property, the entrustor can allow the fiduciary to buy the property, if the entrustor has full information about the transaction, ability to make his own decision, and is not subject to any disqualifications (usually following the disqualifications of contract law), or undue influence.

This approach is based on the philosophy that people should be free to govern their relationship unless there are good reasons to impose mandatory rules on their bargains. In addition, default rules can reduce the parties' costs of planning and transacting. The rules, like form contracts, provide a measure of uniformity and stability. They fill gaps that the parties failed to address in their initial bargain. The rules are presumed to represent the terms to which most parties would agree had they negotiated these terms.[2] Thus, default rules can be viewed as providing the basic rules for the parties' agreements.

In addition, even though the terms of the parties' relationships can deviate from the terms of default rules, legal rules can influence the parties' behavior and negotiations. "Legal rules signal community norms, society's culture, and the majority's practices. Further, legal rules may indicate to the parties a presumably objective, third-party, standard of behavior and serve as 'tools of persuasion.'"[3]

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1. This section reflects Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1231–77 (1995) (Frankel, *Default Rules*). Some parts of the article are copied verbatim but do not appear in quotes. (Most footnotes are omitted.)

2. Frankel, *Default Rules*, at 1209, 1231–77.

3. Omar M. Dajani, *Shadow or Shade? The Roles of International Law in Palestinian-Israeli Peace Talks*, 32 Yale J. Int'l L. 61, 68–69 (2007). *See also* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1 (2007) ("[C]orporate rules ultimately are and, from an efficiency perspective, should be the product of private ordering, not government regulation. Even where liability rules are appropriate, they should be regarded as standard form contractual provisions that can be drafted around.").

In contrast to default rules, mandatory rules "define a zone of lawfulness for negotiations . . . standards."[4] In fact, when courts hold that a fiduciary rule is mandatory and not subject to waiver or change, the courts generally emphasize that "the underlying equities support the result, and [use] broad language extolling the fiduciary nature of the parties' relationship . . ."[5] While contracts might allow fiduciaries to strike a "hard bargain" with weaker entrustors,[6] mandatory legal rules aim at imposing fair terms in the relationship among the parties. Yet, mandatory rules might prevent the parties from negotiating terms that may be more suitable to the parties' situation. After all, regulators cannot provide appropriate rules for every occasion.[7] In fact, when the waiver of fiduciary law rules is enforced, and equities support the results, the courts are likely to refer to "contractual freedom." Consequently, courts have adopted a "middle ground" where "judicial notions of fairness" are important.[8] Further, "non-waivable duties can be viewed as arising from the parties' agreement [in advance] to limit their ability to contract around the fiduciaries' duties. Under these circumstances fiduciary rules should generally be mandatory and non-waivable."[9] If we indulge in imagining the parties' unexpressed intentions, this condition may be added to other permissive speculative ones.

Another justification for fiduciary law as default rules derives from the very foundation of fiduciary law. Fiduciary duties prohibit the taking of entrusted property and misusing entrusted power. "A taking of property is a wrong if, and only if, the owner has not consented to the taking." Absent the owner's consent,

4. *Id.* ("standards of procedural and substantive fairness that the parties may not lawfully contravene, even if they would prefer to do so. Norms not considered mandatory rules—i.e., default rules—may . . . help parties to define their bargaining zone[,] . . . allow parties to anticipate the contours of a legal remedy should negotiations fail, . . . [provide] the parties with objective standards for choosing among potential deals[,] [a]nd . . . help a court to fill in gaps that the parties intentionally or unintentionally failed to resolve.").

5. Mark J. Loewenstein, *Discussions on Fiduciary Duty and Capital Lock-In: Fiduciary Duties and Unincorporated Business Entities: In Defense of the "Manifestly Unreasonable" Standard*, 41 Tulsa L. Rev. 411, 415 (2006).

6. *See* Omar M. Dajani, *Shadow or Shade? The Roles of International Law in Palestinian-Israeli Peace Talks*, 32 Yale J. Int'l L. 61, 69–70 (2007).

7. *Id.* at 70 (referring to the Arab-Israeli conflict, Omar M. Dajani writes: "this tension between the desire to promote adherence to legal rules that represent collective standards of fairness, on the one hand, and the desire to support any deal that will bring a dispute to an end, on the other, has been particularly acute in peacemaking efforts").

8. Mark J. Loewenstein, *Fiduciary Duties and Unincorporated Business Entities: In Defense of the "Manifestly Unreasonable" Standard*, 41 Tulsa L. Rev. 411, 415 (2006) (and advocating that "statutory drafters" avoid the "contractual freedom" adopted by Delaware's allowing parties in unincorporated business organizations to disclaim fiduciary duties, as courts have been reluctant to enforce it).

9. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1213–14 (1995) (footnotes omitted).

the taking is a fundamental "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" and transform the relationship into contract.[10]

There are good reasons for allowing 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 of society. 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. And even though the probability of an investor's flight from the financial market is low, "the harm from such an event 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."[11] This is especially so with respect to public fiduciaries.

A number of state laws draw a line between waivable and mandatory fiduciary rules. "Even where the beneficiaries [of a trust] 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. . . . Similarly, the Model Rules of Professional Conduct regulating lawyers do not permit lawyers to opt out of certain fiduciary duties. . . . Denial of entrustors' waivers can be based on a variety of reasons [such as paternalistic protection, the objective of a level playing field for all fiduciaries and fundamental tenets of society]."[12]

Some courts and legislatures have expanded the coverage of waivable rules.[13] There are court cases that have given effect to the consent of a sophisticated

10. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1232 (1995).

11. *Id.* at 1276.

12. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1243 (1995) (footnotes omitted). *See also* 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 170.1, at 312–13 (4th ed. 1987); Unif. Trusts Act, 18, 7B U.L.A. 790 (1985) (emphasis added); Model Rules of Prof'l Conduct, R. 1.8(c) (1983).

13. Burg v. Horn, 380 F.2d 897 (2d Cir. 1967).

entrustor that the other party is not a fiduciary.[14] Thus, one court held that a limited partnership agreement that allowed the general partner to compete with the partnership business permitted the general partner to use partnership opportunity, and protected this partner from liability.[15] The Delaware law allowed partners to agree on their rights and obligations to each other and to the partnership, even if its law might impose different rights and obligations on the parties absent their agreement. However, the Delaware court noted that the plaintiffs alleged no facts showing that the information which led to the partnership opportunity was originally received by the partnership in the normal course of its business, and then misappropriated by the defendants. The act of "misappropriation" was not entirely clear. The court noted that, in addition to the agreement among the parties, there seem to be no facts pointing to misappropriation of partnership opportunities. After all, if the partner received the information personally, he had no duty to offer the opportunity to the partnership or to the other partners.[16]

The Delaware Code regulating estates and fiduciary relationships sets the boundaries of the entrustors' consent and the courts' interference. Thus, entrustors may change the terms of the trust instruments except that "nothing contained in this section shall be construed to permit the exculpation or indemnification of a fiduciary for the fiduciary's own wilful [*sic*] misconduct or preclude a court of competent jurisdiction from removing a fiduciary on account of the fiduciary's wilful [*sic*] misconduct."[17] The same provision limits the courts' freedom to change the trust document, stating that "the terms of a governing instrument of a trust established and existing for religious, charitable, scientific, literary, or educational purposes or for noncharitable purposes shall not be modified by the court to change the trust's purposes unless the purposes of the trust have become unlawful under the Constitution of this State or the United States or the trust would otherwise no longer serve any religious, charitable, scientific, literary, educational, or noncharitable purpose."

14. *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).

15. DEL. CODE. ANN. tit. 6, § 17-1101(d) (2005).

16. Kahn v. Icahn, No. 15916, 1998 Del. Ch. LEXIS 223 (Del. Ch. Nov. 12, 1998).

17. DEL. CODE ANN. tit. 12, § 3303 (2009).

The Model Rules of Professional Conduct of the American Bar Association prohibit conflicts of interest.[18] However, lawyers are permitted to engage in conflicts of interest if their clients sign an informed consent. The information, however, may include future activities.[19]

Usually, legal classifications are not viewed as default rules. The parties to a legal relationship have a limited binding power to determine the legal classification of their relationship.

> 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. For example, if the parties prepare an instrument and call it a trust, and at the same time allow the trustee to do with the trust property as he wishes (e.g., give it away to whomever he chooses) and relieves him of accounting to anyone, a court is likely to 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.[20]

18. MODEL RULES OF PROF'L CONDUCT, Rule 1.7 (2002).

19. *Id.* at (20), (22) ("The effectiveness of [clients' waiver] waivers is generally determined by the extent to which the client reasonably understands the material risks that the waiver entails. The more comprehensive the explanation of the types of future representations that might arise and the actual and reasonably foreseeable adverse consequences of those representations, the greater the likelihood that the client will have the requisite understanding. Thus, if the client agrees to consent to a particular type of conflict with which the client is already familiar, then the consent ordinarily will be effective with regard to that type of conflict. If the consent is general and open-ended, then the consent ordinarily will be ineffective, because it is not reasonably likely that the client will have understood the material risks involved. On the other hand, if the client is an experienced user of the legal services involved and is reasonably informed regarding the risk that a conflict may arise, such consent is more likely to be effective, particularly if, e.g., the client is independently represented by other counsel in giving consent and the consent is limited to future conflicts unrelated to the subject of the representation. In any case, advance consent cannot be effective if the circumstances that materialize in the future are such as would make the conflict nonconsentable under paragraph (b)").

20. *See generally* Tamar Frankel, *Fiduciary Duties as Default Rules,* 74 OR. L. REV. 1209, 1247–48 (1995) (footnotes omitted). *See also* 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); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules,* 99 YALE L.J. 87 (1989); Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for Precontractual Negotiations,* 44 HASTINGS L.J. 621 (1992–93); Morice v. Bishop of Durham, 32 Eng. Rep. 947, 947 (1805) (where testator left remainder in trust "for such objects of benevolence

The consequence of the entrustors' consent to the fiduciaries' conflicts of interest or violation of the duty of care is to release the fiduciaries from strict fiduciary law. Upon the release of the fiduciaries, entrustors must fend for themselves, subject to contract law or other legal rules' protections.[21]

B. THE PROCESS OF RELEASING FIDUCIARIES FROM THEIR DUTIES UNDER FIDUCIARY RULES

The entrustors' right and habit of relying on their fiduciaries are terminated with respect to the transaction covered by the entrustors' waiver. Such a change in the relationship requires a specific procedure to ensure an effective transition from the fiduciary mode among the parties to the contract mode.

The Conditions Necessary to Give Legal Effect to the Entrustors' Consent (Waiving Their Fiduciaries' Duties)

In order to transform the fiduciary relationship mode to another relationship mode (usually contractual mode), four conditions must be met.

a. Fiduciaries Must Give Entrustors' Notice that Their Relationship is no Longer Fiduciary with Respect to a Particular Situation Because entrustors are legally entitled to trust their fiduciaries and rely on them, fiduciaries who seek waivers of their fiduciary duties must put entrustors on notice, by words, signals, or other actions, that the entrustors can no longer rely on their fiduciaries in the matters, and that the entrustors must assume full responsibility for defending and protecting their own interests.[22]

b. The Entrustors Must Be Capable of Independent Will and Judgment Contract rules determine whether entrustors are capable of an independent will. If the entrustors' 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 agree to bargains with their fiduciaries, the bargains will be unenforceable." Similarly, if the parties act under a mistake of fact the bargains will be flawed.[23]

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).

21. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1210 (1995).

22. *See* 2A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 170, at 312 (4th ed. 1987).

23. See 5 AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 496, at 500 (4th ed. 1987) (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

According to Robert S. Adler and Elliot M. Silverstein, "[n]egotiation power depends less on the other side's strength than on one's own needs, fears, and available options."[24] Negotiating parties generally seek greater power to enhance the outcome. Their skills play a role when there are power disparities. Oddly, a large power disparity may make it unlikely for the more powerful party to obtain a favorable outcome; under the "power paradox": "the harder you make it for them to say no, the harder you make it for them to say yes." This paradox works only if consent must be active. But if silence can be interpreted as consent, then passive consent may make it harder to say "no," but by default will be interpreted as "yes." In addition, the power dynamic can be influenced by information about the other party's "intentions, strength, or vulnerabilities" or its "perception of the power dynamic."[25] Individual investors may therefore not even try to object to corporate fiduciaries, but organized investors might.[26] However, during the years 2008 and 2009 changes have been occurring. "The increasing success of shareholder activists in designating or electing directors is altering the composition of public company boards. It is also posing challenges to long-held assumptions about the sanctity of board deliberations and the nature of a director's confidentiality obligations to fellow directors and the company."[27] Thus, in the near future new and different problems may arise as a result of a directors' board composed of group representatives.

in all respects fair and reasonable); E. ALLAN FARNSWORTH, CONTRACTS § 9.3 at 509 (2d ed. 1990) (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).

24. Robert S. Adler & Elliot M. Silverstein, *When David Meets Goliath: Dealing with Power Differentials in Negotiations*, 5 HARV. NEGOT. L. REV. 1, 20 (2000).

25. Robert S. Adler & Elliot M. Silverstein, *When David Meets Goliath: Dealing with Power Differentials in Negotiations*, 5 HARV. NEGOT. L. REV. 1 (2000), LEXIS, Lawrev Library, Hrvnlr File (LEXIS summary).

26. Gerald F. Davis & Tracy A. Thompson, *A Social Movement Perspective on Corporate Control*, 39 ADMIN. SCI. Q. 141 (1994) ("Where corporate managers once faced a dispersed and relatively powerless set of stockholders, they now confront an increasingly organized social movement of fund trustees and advisors that share a common ideology of shareholder activism as well as the power to vote a substantial chunk of the largest firms' equity. Moreover, activist shareholders have expanded their demands from the circumscribed realm of shareholder rights to issues of how successors to the [CEO] are chosen [and] how much executives are paid . . .).

27. CHARLES M. NATHAN, MAINTAINING BOARD CONFIDENTIALITY 1 (Harvard Law School Forum on Corporate Governance and Financial Regulation), http://www.lw.com/upload/pubContent/_pdf/pub3352_1.pdf; id. at 9 ((citing Disney v. Walt Disney Co., 2005 Del. Ch. LEXIS 94 (Del. Ch. June 20, 2005) (Delaware Chancery examined Disney's director confidentiality policy to determine the materiality of confidential board information)).

c. Entrustors Must Receive from the Fiduciaries Full Information About the Proposed Conflict-of-Interest Transaction It is assumed that in a fiduciary relationship the parties have unequal information, resulting from the nature and purpose of the relationship. The fiduciaries possess far more information about their own activities regarding entrusted property and power. Entrustors and fiduciaries are not equally informed and equipped to analyze the contemplated change in their relationship or the terms of the proposed transaction.

For example, a brokerage firm recommended that its customers switch their sweep (nearly cash) account funds into funds owned by a joint venture. Although the firm disclosed that it received a 20 percent interest in the joint venture for making this recommendation, it did not disclose how it acquired its interest. The Delaware Court noted: "The relationship between the customers and the brokerage firm was that of principal and agent. As agent, the brokerage firm had a fiduciary obligation to its customers. The trial court found that if the brokerage firm had been truly faithful to the interests of its customers, it would have negotiated a better deal for them, perhaps in the form of reduced management fees, rather than taking an equity interest for itself. Delaware law did not allow partial disclosure of material facts to suffice. As such, the customers were entitled to summary judgment on their claims of breach of the duties to disclose and of loyalty. The customers could not be said to have acquiesced in the breach, because they were not informed of all the material facts. They could bring suit without ceasing all dealings with the self-dealing fiduciary."[28]

Therefore, when the fiduciaries possess information relating to the transaction that is subject to conflict of interest, and especially if the information has come to the fiduciaries by virtue of their position as fiduciaries or by virtue of their expertise, the fiduciaries must disclose this information to the entrustors.

Statute and regulation may require disclosure. One example of law and regulation that require fiduciaries to disclose specified information to entrustors-clients and potential clients is the Investment Advisers Act of 1940.[29] Investment advisers under the Act are required to disclose to future entrustors-advisees any criminal record that they might have,[30] financial and disciplinary information, such as "[a] financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to clients, if the adviser has discretionary authority (express or implied) or custody over such client's funds or securities, or requires prepayment of advisory fees of more than $500 from such client, 6 months or more in advance . . . [and] a legal or disciplinary event that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients."[31]

28. O'Malley v. Boris, No. 15735-NC, 2002 Del. Ch. LEXIS 33 (Del. Ch. Mar. 18, 2002).
29. 15 U.S.C. §§ 80b-1 to -21 (2006).
30. 17 C.F.R. § 275.206(4)-4 (2006).
31. *Id.*

There is a rebuttable presumption that the following is "material information": procedures which involve an adviser or a person under its management, which were not resolved in the adviser's or the person's favor or reversed, suspended, or vacated: "[a] criminal or civil action in a court of competent jurisdiction in which the person—(i) Was convicted, pleaded guilty or nolo contendere ('no contest') to a felony or misdemeanor, or is the named subject of a pending criminal proceeding (any of the foregoing referred to hereafter as 'action'), and such action involved: an investment-related business; fraud, false statements, or omissions; wrongful taking of property; or bribery, forgery, counterfeiting, or extortion; (ii) Was found to have been involved in a violation of an investment-related statute or regulation; or (iii) Was the subject of any order, judgment, or decree permanently or temporarily enjoining the person from, or otherwise limiting the person from, engaging in any investment-related activity."[32]

The rule further states that the information "shall be disclosed to clients promptly, and to prospective clients not less than 48 hours prior to entering into any written or oral investment advisory contract, or no later than the time of entering into such contract if the client has the right to terminate the contract without penalty within five business days after entering into the contract."[33]

Court decisions may require disclosure. In *SEC v. Capital Gains Research Bureau, Inc.*,[34] the Supreme Court held that a fiduciary's advisory letter must disclose the adviser's "scalping," that is, trading on the effect of the advisory letter, which might raise the price of recommended stock for a short time. Scalping presenting a potential conflict of interest by the adviser is not prohibited. After all, the adviser may believe in the securities he recommends and may buy these securities for himself. The practice, however, must be disclosed because it may present a potential conflict of interest. In fact, disclosure would protect the adviser from claims of conflict of interest and shelter the adviser as the recipient of silent consent.

d. The Entrustor's Consent to the Transaction Should Be Clear and Specific Specificity and clarity would demonstrate in part the entrustors' understanding of the transaction and the validity of the entrustors' consent. The requirement of clarity relates to the conditions of the bargain, and their fairness and reasonableness. This condition, in turn, is grounded in the rationale, derived from contract law, suggesting that if the bargain is unfair or unreasonable, the consent of the disadvantaged party is highly suspect.[35] Experience has shown that people rarely agree to unreasonable terms or to terms that affect their

32. *Id.*
33. *Id.*
34. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).
35. *See* 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

interests unfairly. Because the bargain or waiver is more likely to be in the fiduciaries' interests, and less likely to be in the entrustors' interests, the entrustor's consent, by action or inaction, must be clear.[36]

Because fiduciary duties of loyalty and care are broad standard rules, the bargain around these duties must carve out explicit and specific situations. Overall, the courts are not likely to uphold bargaining around broad duties of fiduciaries far in advance when the fiduciaries have substantial discretion over the entrustors' power or property. Consenting entrustors have no way of knowing the terms of the transactions and determining in advance its benefits and disadvantages. Therefore, a general consent to future conflict of interest does not meet this criterion.[37]

A general waiver is usually insufficient to be legally binding on entrustors. A general waiver covers situations for which the entrustors did not receive any information. A waiver of all future conflict-of-interest transactions by a fiduciary lacks the information that the entrustor needs to determine whether to waive the entrustor's rights under fiduciary law. That is why the waiver must be explicit.[38]

Attempts to balance a general, but sufficiently specific consent (especially consent by numerous shareholders) have been made with respect to executives' and employees' stock options. The purpose was to empower the directors to change the terms of stock options granted to executives when the corporate share prices fell below the options' exercise price. Thus, the options became valueless. A change in the terms of the options required the shareholders' ratification. To protect the directors from shareholders' derivative suits the stock options (which

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.").

36. *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).

37. *See* UNIF. TRUSTS ACT § 18 [Power of Beneficiary]; *see also* Century Indem. Co. v. Congoleum Corp. *(In re* Congoleum Corp.), 426 F.3d 675, 690 (3d Cir. 2005) ("Although concurrent conflicts may be waived by clients . . . the effect of a waiver, particularly a prospective waiver, depends upon whether the clients have given truly informed consent."); CenTra, Inc. v. Estrin, 538 F.3d 402, 415 (6th Cir. 2008) (argument that lengthy history was sufficient enough to inform of conflict of interest, and continued retention of services served as implicit consent to future conflicts of interest, is not enough as a matter of law. "The [Court] held that simply possessing knowledge of the existence of a conflict does not mean that the client is fully informed as to the conflict's implications.").

38. Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004).

were ratified by the shareholders) included language allowing "directors to act in the face of underwater options with certain exceptions." It is unclear, however, whether and to what extent such a "consent" by the shareholders is binding"[39]

Similarly, the lawyers' clients may waive their lawyers' conflict-of-interest obligations under certain conditions. The Model Rules of Professional Conduct provide that a lawyer may represent a client in a representation involving a concurrent conflict of interest if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
(2) the representation is not prohibited by law;
(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
(4) each affected client gives informed consent, confirmed in writing.[40]

A client may consent to a possible future conflict if the above tests are met, in which case "informed consent" is determined by "the extent to which the client reasonably understands the material risks that the waiver entails." A consent to a particular type of conflict with which the client is familiar will ordinarily be effective; a general consent ordinarily will not be effective.[41]

There are exceptions to non-recognition of a general waiver. For example, a trustor who expressly put the trustees in a dual and conflicting position: as beneficiaries of a trust and as trustees for other beneficiaries as well.[42] The rationale for allowing this permanent conflict of interest is that the trustor—the entrustor of the property and power—envisioned and approved the trustees' conflict of interest with respect to the other beneficiaries. Thus, "[t]he conflict of interest between the trustees and the beneficiaries was created by the testator. He must have realized this in providing their actions should be without impeachment excepting for lack of good faith."[43]

In one case the trustees under a trust agreement were also beneficiaries of the trust. The trust property consisted of a business which the trustees managed. When the business was profitable, the trustees did not declare dividends for all beneficiaries, but reinvested the profits in the business enterprise, while they drew out salaries. Thus, they benefited from the power to declare dividends and draw salaries. Nonetheless the court held that "until there is a showing that dividends could or should have been paid by the company under sound business

39. Eric J. Wittenberg, *Underwater Stock Options: What's A Board of Directors to Do?*, 38 AM. U.L. REV. 75, 107 (1988).

40. MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2002).

41. *Id.* cmt. 22.

42. *In re* Gehl's Estate, 92 N.W.2d 372 (Wis. 1958).

43. *Id.*

practices and were arbitrarily withheld by the action of these trustees, [the trustees] cannot be charged with misconduct in failing to vote as directors for the payment of dividends."[44] However, vesting power to the hand of the deceased trustor to approve conflicts of interest requires that the trust document should clearly approve the conflict. Otherwise, the conflict of interest will not be allowed.[45]

e. The Substantive Condition of the Proposed Transaction Must Be Reasonable and Fair to the Entrustor Whether entrustors benefit from the conflict-of-interest transactions depends on their ability to sever the umbilical cord with their fiduciaries, as well as on their bargaining capabilities. Therefore, "courts will generally not enforce an unfair or unreasonable bargain . . . often based on a general presumption that entrustors' consent to unfair or unreasonable terms is uninformed or not independent. Similar presumptions operate in other areas. Consents of persons to be subject to tortious acts have been struck down by the courts because the substance of the consents signalled the likelihood that the consents were not voluntary."[46]

In addition, consent to unfair transactions with fiduciaries in conflicts of interests may provide a signal that the entrustors failed to fully recognize the fiduciaries' role-changes, and continued to rely on them, even after being warned that the fiduciaries are on the other side of the bargaining table. Unfair terms may also signal that the entrustors had no equal bargaining power. Not surprisingly, when the entrustors are sophisticated, the courts are less likely to examine the content of the transactions and more likely to uphold the entrustors' consents.[47]

In circumstances governed by specific statutes a court might seek the authority to waive fiduciary duties in the statutes. Thus, in bankruptcy proceedings a debtor may not consent to conflict of interest by a lawyer.[48] In bankruptcy

44. Russell v. Russell, 427 S.W.2d 471, 476 (Mo. 1968).

45. *Id.* at 471 (some citations omitted).

46. Tamar Frankel, *Fiduciary Duties as Default Rules,* 74 OR. L. REV. 1209, 1239 (1995) (footnotes omitted). With respect to a corporation "going private" see Comm. on Corporate Laws, *Guidelines on Going Private,* 37 BUS. LAW. 313 (1981).

47. 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.

48. *In re* Automend, Inc., 85 B.R. 173, 179 (Bankr. N.D. Ga. 1988) ("[E]ven affirmative creditor consent to employment of attorneys . . . in violation of 11 U.S.C. § 327 would not obviate the duty of the Bankruptcy Court to enforce the statutory and ethical standards which govern the employment of fiduciaries.").

proceedings the courts have dismissed the debtor's consent to conflicts of interest.[49] Another court wrote: "[T]here is nothing in the Bankruptcy Code that permits the debtor to consent to the conflict. Bankruptcy Code § 327(a) does not permit a person who is not disinterested to represent the debtor-in-possession even if the debtor consents to such representation."[50]

C. THE NATURE OF CONSENT AND SURROGATE CONSENTERS

1. Silence as Consent. Disclosure May Be Sufficient to Constitute Consent under Certain Circumstances

Rules and cases may require fiduciaries to disclose to potential entrustors certain facts. Entrustors who establish a relationship with the fiduciaries, after having received the information, are presumed to have consented to the transactions involving the disclosed facts.

Disclosure that would be sufficient in an advisory letter may not be adequate in a face-to-face discussion between the adviser and the client. In a face-to-face discussion, if the client does not react to disclosure, the client's silence might not be deemed to be consent.[51] In the case of an advisory letter, the subscribing investors control their investment. The cost of communicating with the adviser that published the advice is high as compared to the client's cost. If the adviser proposes to the clients a transaction in conflict of interest and the client is silent, the cost to the client of saying no or yes is lower. If the clients say nothing, the reaction does not necessarily signify consent. In addition, the clients may not have the control over the investment, in which case the clients' consent is doubly important and silence would not suffice.

Disclosure to numerous shareholders in a publicly held corporation may be sufficient to indicate consent. In *Smith v. Van Gorkom,*[52] the Delaware Supreme Court held that directors violated their fiduciary duty of care when they signed on behalf of the corporation a contract for the sale of the corporation without reading or discussing the contract terms except for the share prices, which was very desirable. This decision raised concern among corporate management.[53] Hence,

49. *Id.*

50. *In re* Patterson, 53 B.R. 366, 374 (Bankr. D. Neb. 1985).

51. 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).

52. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

53. *See* Delaware Department of State, Division of Corporations, http://www.corp.delaware.gov/aboutagency.shtml (last visited July 7, 2009). The decision raised concern and in Delaware as well, being the State in which about 50 percent of the large US corporations are registered.

the Delaware legislature amended the Corporation Act and substituted a mandatory rule prohibiting violation of the duty of care with a default rule that could limit the remedy of damages against directors that violated the duty of care.[54] Thereafter, the articles of associations of most if not all Delaware corporations were amended to introduce this limitation. All the states followed the Delaware version.[55] Thus, Delaware's General Corporation Law, with certain exceptions, permits a corporation to include in its certificate "a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders" for breach of the duty of care.[56] Charter option provisions such as these are controversial. For example, Professor Lucian Arye Bebchuk pointed out that the costs of obtaining information prevent shareholders from understanding the impact of provisions in corporate charters that decrease shareholder value.[57] Thus, what a court has required, the legislature has mitigated, bringing the decision back to the multitude of investors.[58]

Thus, most corporate articles protect fiduciaries, such as directors, from liability for lack of care, under certain conditions.[59] The shareholders are presumed to have consented to these provisions by vote or perhaps by buying the shares. Shareholders who did not vote are nonetheless bound by the articles.[60] Under these circumstances shareholders' silence and inaction constitutes consent to the amendment of the articles of association exonerating directors from liability for possible lack of care.

In the 1970s there was little pressure to give meaning to shareholders' silent consent. However, by the beginning of the year 2000, there arose demands to allow shareholders not merely to vote for (or against) the choice of directors but also to nominate them.[61] The rise of the shareholders' power is likely to continue

54. Del. Code Ann. tit. 8, § 102(b)(7) (2001).

55. *See* Craig W. Hammond, *Limiting Director's Duty of Care Liability: An Analysis of Delaware's Charter Amendment Approach*, 20 U. Mich. J.L. Reform 543 (1987) (discussing the Delaware duty of care amendment and application to other states).

56. *See* Del. Code Ann. tit. 8, § 102(b)(7) (2001). *See also* Model Bus. Corp. Act § 2.02(b)(4) (2005) (allowing for exculpation of directors in an even broader range of circumstances).

57. Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820, 1836–37 (1989).

58. J. Robert Brown, Jr., *Disloyalty Without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 Ky. L.J. 53, 98-106 (2006/2007) (discussing the independence test of directors, specifically those who fall under Delaware law).

59. *See* A. Mechele Dickerson, *Words That Wound: Defining, Discussing, and Defeating Bankruptcy "Corruption,"* 54 Buff. L. Rev. 365, 382 (2006).

60. *See* Dr. Ige Omotayo Bolodeoku, *Contractarianism and Corporate Law: Alternative Explanations to the Law's Mandatory and Enabling/Default Contents*, 3 Cardozo J. Int'l & Comp. L. 433, 462 (2005).

61. Disclosure Regarding Nominating Committee Functions, Exchange Act Release No. 48,825, at 4-5, 28-30 (Nov. 24, 2003).

in 2010.[62] Perhaps when surrogate consenters allow too many conflict-of-interest transactions that cost the entrustors-shareholders too much, they raise their voice publicly, and one could expect a rising demand by the shareholders for direct power to choose their fiduciaries and surrogate consenters.

2. Surrogate Consenters

There are numerous situations in which consent cannot be given by the entrustors. In some of these cases the law accords binding power to consents by surrogates on behalf of the entrustors. A child would have a surrogate consenter to a conflict-of-interest transaction by the child's trustee. Usually the child's consenter is the parent, but if the parent has conflicts of interest or is unable to provide or withhold consent, a guardian is appointed for that purpose.[63]

Surrogate consenters appear when the party entitled to consent or deny consent cannot do so. During the 1960s courts have begun to act as surrogates for shareholders of publicly held corporations. Another type of surrogate consenter is an independent administrative agency under a scheme that applies to fiduciaries of investment companies (mutual funds). For more than fifty years the Investment Company Act of 1940 authorized the Securities and Exchange Commission to exempt affiliates of investment companies from the prohibition on engaging in conflict-of-interest transactions.[64] The agency serves as a surrogate for the mutual funds' shareholders consent.

62. *See* Proxy Disclosure and Solicitation Enhancements, Securities Act Release No. 9052 (July 10, 2009), 74 Fed. Reg. 35,076 (July 17, 2009) (to be codified if adopted at 17 C.F.R. §§ 229.401-.402, .407, 240.14a-2, -4, -12, -101) (proposing enhancements to compensation and corporate governance disclosures, applicable to proxy statements and other statements; proposing amendments to proxy rules); Facilitating Shareholder Director Nominations, Securities Act Release No. 9046 (June 10, 2009), 74 Fed. Reg. 29,024 (June 18, 2009) (to be codified if adopted at 17 C.F.R. §§ 200.82a, 240.14a-11, -18, -19, .14n-1 to -101) (proposing changes to proxy rules to facilitate exercise of shareholders' rights to nominate and elect directors).

63. *See* Grimes v. Kennedy Krieger Inst., Inc., 782 A.2d 807 (Md. 2001) (action against research institute for lead paint research program; parents signed "informed consent" statements for their children's participation; court held that parent or other surrogate cannot consent to child's participation in non-therapeutic research where there is risk of injury or damage to health).

64. *See* § 17, Investment Company Act of 1940, 15 U.S.C. § 80a-17 (2006). The Commission's staff issues no-action letters, promising not to seek action by the Commission. The letters do not provide a shelter from private actions. However, the courts have given a significant attention and weight to the opinions of the staff, and its expertise. Codified exemptions in this area include a requirement for mutual fund boards' approval, reflecting corporate law format. However, the rules may also list in relative detail the considerations of the board. For a discussion of SEC "no-action" letters see Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 Cornell L. Rev. 921 (1998).

a. Surrogate Consenters Are Fiduciaries Not Entitled to Entrustors' Freedom Entrustors can give or withhold their consent arbitrarily. It is their money. They need not account to anyone.[65] While entrustors may consent to give their fiduciaries gifts, those who consent on behalf of the entrustors are themselves fiduciaries, and may not offer gifts, unless they are very explicitly authorized by entrustors to do so. In a public corporation consent for gifts must be given by all entrustors (not merely the majority).[66] Because surrogate consenters are fiduciaries, they must be accountable in giving or withholding consent. They must avoid conflicts of interest and comply with the duty of care. In all cases, the courts and the entrustors' surrogates need standards against which to make their decisions. If the courts (or other surrogates) exercise the consent function on behalf of entrustors, these surrogates too must adhere to standards; otherwise they will not be accountable for their decisions.[67]

b. Surrogate Consenters Should Be Independent of the Fiduciaries that Seek Consent Surrogate consenters are fiduciaries. For example, the boards of public corporations give or withhold consent on behalf of the shareholders.[68] The shareholders-entrustors' consent to conflict-of-interest transactions by corporate officers shifted to the boards.[69] However, if the boards are populated by the officers or directors who seek consent to conflict-of-interest transactions, the board members or at least a majority of the members must be independent to qualify as surrogate consenters. The boards' status as independent consenters was

65. *See* Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983); Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209 (1995).

66. *See generally* Victor Brudney & Allen Ferrell, *Corporate Charitable Giving*, 69 U. CHI. L. REV. 1191. "Commentators have discussed whether management's decisions to distribute corporate funds as goodwill gifts should be prohibited or be restrained by special rules (perhaps requiring shareholder collective consent) fashioned either by legislatures or by courts." *Id.* at 1195.

67. Judicial standards have narrowed the sphere of refusal to consent to conflicts of interest, for example, allowing corporate directors and officers to engage in conflict-of-interest transactions that are fair to their corporations. *See, e.g.*, Investment Company Act of 1940, § 36(b), 15 U.S.C. § 80a-35(b) (2006); Gartenberg v. Merrill Lynch Asset Mgmt, Inc., 740 F.2d 190 (2d Cir. 1984). *See also* Jones v. Harris Associates L.P., 527 F.3d 627 (7th Cir.) (the markets should determine the fees. Shareholders should vote with their dollars thereby bypassing the directors' duties to determine the fairness of mutual fund advisory fees and expenses), *reh'g denied, reh'g en banc denied*, 537 F.3d 728 (7th Cir. 2008), *vacated, remanded*, No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010) (rejecting Seventh Circuit view).

68. Courts established the standard of fairness, under which they approved conflict-of-interest transactions. 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. *See* Harold Marsh, Jr., *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966).

69. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1262–64 (1995).

strengthened by the introduction of "independent directors" who were not the corporation's officers or employees.[70] In addition, reflecting the general rules of entrustors' consent, corporations were required to disclose in their prospectuses some conflicts of interest of their management.[71] Presumably, the shareholders expressed their consent passively, by saying nothing and doing nothing. So long as the boards consented, the shareholders did not have to signal theirs.[72]

c. Who Are the Surrogate Consenters? Corporate directors are surrogate consenters. They act on behalf of the corporation that constitutes the interests of the shareholders.[73] Fiduciary relationships in the private sector can be roughly divided into personal and public relationships. The difference is related mainly to the number of entrustors to whom the fiduciaries are related and to the pooling of the entrusted property. When entrustments are large, it makes economic sense to personalize the service of managing the entrusted assets. But when entrustments are small, it makes economic sense to pool small investments and manage these investments as one. In the case of financial management, the difference between private and public relationships reflects the difference between personal and standardized management. This difference has significant consequences. First, the pool may acquire the status of a legal entity for the purpose of regulation. Thus, mutual funds[74] and pension plans[75] are deemed legal entities for the purpose of regulation. These pools may then have their own fiduciaries whose task is to protect the entrustors that contributed to the pools from the risks posed by the fiduciaries. The entrustors may play a role in the structures, such as the shareholders' role in the case of corporate mergers.

Government regulators can serve as consenters for entrustors. For example, Section 17 of the Investment Company Act of 1940[76] prohibits a large group of defined affiliated persons to an investment company from knowingly selling or buying any security or other property to such registered company or to any company controlled by such registered company, or borrowing or lending to the investment company. The Securities and Exchange Commission is authorized to exempt from the prohibition any "proposed transaction," and is required to

70. *See generally* Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855 , 868–69 (2003) (discussing the importance of director independence and equality).

71. Kohn v. Am. Metal Climax, Inc., 458 F.2d 255, 270 (3d Cir. 1972). ("[T]he shareholder is helpless unless he knows of the conflict of interest and has access to sufficient facts to reach a valid independent judgment.").

72. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1261–62 (1995).

73. *Id.* at 1263–64.

74. *See* Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006).

75. *See* Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (2006).

76. Investment Company Act of 1940, § 17(a), (b), 15 U.S.C. § 80a-17(a), (b) (2006).

exempt such a transaction if the terms "are reasonable and fair and do not involve overreaching on the part of any person concerned." In addition, the transaction should be "consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this subchapter"; and "consistent with the general purposes of this subchapter."[77]

The courts can serve as consenters for entrustors. In 1995, I ventured to predict and suggest that the courts will 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.[78] "Courts will react because the risks that such cases pose to our economic system are too great."[79] This prediction did not materialize. The courts did not react until it was too late, and in the 1990s the market was expected to regulate and discipline financial and corporate managements. A Delaware court linked the managements' and directors' standards of behavior to "market practice."[80] It is, however, unclear whether Delaware courts will take a "hands-off" approach in 2009/2010. It is questionable whether entrustors can bargain freely with those who control their property or entrusted power. Rules based on an assumption that markets function, and function efficiently under entrustors' free bargaining, may destroy rather than support a commercial and financially healthy environment.[81]

D. DEFAULT RULES AND CONTRACTS

1. Similarities and Differences

Consent rules in fiduciary law are similar to consent rules under contract law, but the burdens of proof regarding consents differ. Fiduciary law is designed mainly to deter fiduciaries from misappropriating entrusted property or power and acting without care. Similar to the crime of embezzlement and the torts of conversion and negligence, fiduciary law regulates the holders of property power that belong to entrustors. It imposes duties on the fiduciary and provides legal rights to the entrustors.

Contract law is designed to formalize and enforce mutual promises between parties. It regulates both parties more or less equally. It provides both parties

77. Investment Company Act of 1940, § 17, 15 U.S.C. § 80a-17 (2006); 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 14.02 (2001 & Supp. 2009).

78. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1258 (1995).

79. *Id.*

80. Tamar Frankel, *Court of Law and Court of Public Opinion: Symbiotic Regulation of the Corporate Management Duty of Care*, 3 NYU J.L. & BUS. 353 (2007).

81. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

with equal legal rights. 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 with respect to entrusted property and power to a greater extent than contracting parties are entitled to rely on each other with respect to promises. That is because the cost of self-protection is too high. In such cases the concern is that entrustors will not enter into fiduciary relationships even though these relationships are socially desirable.

Under contract law, when one contract party says to the other party "trust me," the trusting party bears the burden of asking for missing information.[82] Even if a contract party is defrauded, under contract law it is entitled to damages, but not to punitive damages.[83] In fiduciary law, when a fiduciary says to the entrustor: "trust me, I will deal with entrusted property and power honestly and in accordance with your directives," the entrustor is entitled to trust the fiduciary with respect to the entrusted property or power. If the fiduciary breaches the promise the entrustor may be entitled not only to damages but also to punitive damages, as he would in the case of misappropriation—stealing. Punitive damages, as the word punitive signals, is not merely making the other party whole, but also punishing the other party.[84] The effect of the entrustor's consent to a conflict-of-interest transaction is to convert the relationship from fiduciary mode into a contract model. There are, however, situations in which courts do not give effect to consents. These are usually consents to the kind of terms that raise a suspicion of fraud or undue influence.[85]

In contract law, the burden of proving that a party's consent is flawed is on the party asserting the flaw.[86] In contrast, the burden of proving that the transaction in conflict of interest is binding because the entrustor consented to it is usually

82. *See* RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. a (1981) ("A party making a contract is not expected to tell all that he knows to the other party, even if he knows that the other party lacks knowledge on some aspects of the transaction."; nondisclosure of a fact "has no legal effect" except in certain situations); *id.* § 161 (nondisclosure is equivalent to an assertion only if the party knows disclosure is necessary to prevent a previous assertion from being a misrepresentation or fraudulent or material, if the party knows disclosure is necessary to prevent a mistake of the other party in certain circumstances, or if "the other person is entitled to know the fact because of a relation of trust and confidence between them"). *See also* Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303 (1999).

83. RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981).

84. *See* Chapter 6.

85. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1242 (1995) (citing 2A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 170.1, at 312, 313 (4th ed. 1987)).

86. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1240 (1995).

on the fiduciaries, although the entrustor must prove that the transaction was in conflict of interest.[87]

One may criticize the legal scheme of consents and waivers to fiduciary law violations as imposing on fiduciaries much of the cost of contracting around their fiduciary duties. In defense of the legal scheme one may argue that the costs are lower for the fiduciaries than for the entrustors because, even though the rules are uncertain, the fiduciaries have better information about the law, about the cost of the conflict-of-interest rules that they wish to avoid, and about the transaction with respect to which they seek the entrustors' consent. In addition, some rules reduce the fiduciaries' cost of obtaining consent (e.g., when the entrustors' silence or inaction to the fiduciaries' disclosures is deemed binding).[88]

2. Consequences of Default Rules as Contract Terms Subject to Disclosure

If we adopt a contractarian view, we will recognize all fiduciary rules as default rules and give effect to broad consent by public entrustors' voice or silence. In 1995 I wrote that if we continue to do so, we will move toward creating property rights in fiduciary positions, such as corporate office. This result will bring us back to the seventeenth century.[89] Until the nineteenth century, "office" in England was a species of property. Office could be bought from the monarch. For example, army "commissioned officers" were those who purchased their office for a commission.[90] An "office" had the features of property: it could be bought, sold, inherited, and delegated.[91] Then a radical change occurred. The idea of "offices" as property was abolished by legislation in the beginning of the nineteenth century.[92] "Office" was shorn of its property rights. Office holders became fiduciaries, holding governing power in trust for the benefit of the realm or the monarch or the citizens or the shareholders.

87. 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* AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 496, at 501 (4th ed. 1987).

88. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1241–42 (1995). *See also* JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS 415–17 (1995).

89. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1266.

90. *See generally* Douglas W. Allen, *Compatible Incentives and the Purchase of Military Commissions*, 27 J. LEGAL STUD. 45 (1998).

91. Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 803 n.24 (1983) (citing J. H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 242 (1971); 2 WILLIAM BLACKSTONE, COMMENTARIES *36).

92. 4 WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 520 (3d ed. 1945); *see also* 1 *id.* at 248 (7th ed. 1956); *see* 2 *id.* at 262–64 (7th ed. 1956) (detailing abolition of offices).

Unlike many private fiduciary relationships, corporations mirror political institutions, in which the rulers were the owners of the realm.[93] Corporate law has eliminated the features of property. Those who hold corporate office today may not buy, sell, inherit, bequeath, or delegate their position. Thus, the proprietary aspects of offices were eliminated. Officers became, like all trustees, entrusted with legal powers while all the beneficial powers belonged to the entrustors.[94]

E. THE DEBATE

The nature of fiduciary rules as default rules can best be summarized by conflicting principles. The view of fiduciary rules as default rules balances the freedom of the parties to design the relationship among themselves, with protection of entrustors and the establishment of social norms of behavior that are crucial to the maintenance of society's financial system, the economy, and the well-being of the population. Fiduciary law rules are designed to protect entrustors from a fiduciaries' misappropriation of entrusted property or power. Since entrustors are the true owners of entrusted assets or power, they may consider select conflict-of-interest transactions to be beneficial or they may wish to show their gratitude to their fiduciaries and consent to give them a gift. In both cases they should have the power to waive their protection under the law. However, in light of the entrustors' vulnerability, the law requires that the entrustors' consent must be informed and be independent of their fiduciary. There are however, activities, which are unacceptable to society regardless of the parties' consent, such as consent to a clearly unfair bargain. The suspicion (though not proof) is that the consent was flawed: it was not free or the consenting entrustors did not fully understand the nature of the transaction to which they consented. In addition, fiduciaries should not benefit from such bargains. Such benefits might drive

93. *See generally* O. Lee Reed, *What is "Property"?*, 41 AM. BUS. L.J. 459 (2004). "In Western political theory, the state comes into existence in response to how individuals in society have access to limited resources." *Id.* at 465.

94. *See generally* Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1178 (2004) (Natelson) (comparing Founding Era texts and concluding that "one of [the] general purposes [of the Constitution] was to erect a government in which public officials would be bound by fiduciary duties. . . ."). On the other hand, there is no evidence that the Founders understood the Constitution to impose general fiduciary standards on the states. Under the unamended Constitution, the standards of adjudication described here are most applicable to federal, not state, actions. Of course, the Constitution, both in its original text and as amended, does impose a few specific fiduciary-style rules on the states, particularly the duty of impartiality. *See, e.g.*, U.S. CONST. art. I, § 10, cl. 1 (prohibiting the states from passing bills of attainder or ex post facto laws); *id.* amend. XIV, §1 (forbidding states from depriving any person of equal protection of the laws).

them to seek bargains that might be unfair. Therefore, consents of this sort should not be upheld by the courts.

In addition, the consent of numerous, public entrustors to their fiduciaries' conflicts of interest is weak, and is similar to a theoretical model, the "social contract."[95] That is why implicit in traditional corporate law is the recognition that shareholders cannot and do not give fully informed independent consent, and structure publicly held corporations to include surrogate consenters to represent the shareholders.[96] Shareholders receive proxy statements proposing, for example, to protect the board of directors who have not paid sufficient attention to the corporation's business. Theoretically, the shareholders consented to the change, whether or not they read the proposal. After all, they had the opportunity to object. However, in practice most shareholders with relatively few shares do not read the proxy statements nor vote their shares. Perhaps in 2010 large shareholders may find it in their interest to use more clout on proposals they consider undesirable. They might organize the smaller shareholders to vote. But until this change takes place the votes by shareholders in large publicly held corporations are empty or imaginary consents, as they have been for many years.

95. Jean Jacques Rousseau, The Social Contract, or Principles of Political Right (1762).

96. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1262 (1995).

5. WHY VIEW FIDUCIARY LAW AS A SEPARATE CATEGORY?

A. INTRODUCTION

Generally, fiduciaries are not treated as one category. Historically, each species of fiduciaries developed as a separate legal area and rules. As noted in the introduction, the entrustors to the various fiduciaries were called by different names. They were beneficiaries to trustees, agents to principals, clients to lawyers, patients to physicians, students to teachers, advisees to investment advisers and shareholders to corporations and their directors. Some courts have attempted to put all fiduciaries under one roof of contract and some courts have collected fiduciaries under the category of torts, viewing torts as their origin. And this Book proposes to combine all fiduciaries into one category: fiduciary law.

The question is why should we be concerned with the issue of categorization? Why not leave the law applicable to particular fiduciaries where it is? Alternatively, why not deal with all fiduciaries as contract parties with their entrustors or view violations of fiduciary laws as torts? Besides, what difference does classification of rules make? This chapter starts with the discussion of this last question. Categories matter. We then proceed to outline the process of categorization, the elements that drive the pooling of items into one category, and the signals that the category sends about the items it contains. The chapter moves from there to the question of who classifies categories. This issue is closely related to the issue discussed in Chapter 1 concerning the party that decides whether a relationship is fiduciary[1] and how courts categorize fiduciary relationships, including the role of the business environment in judicial categorizing. The last part of the chapter focuses on the debate of whether fiduciary law should be accorded the recognition of a legal category or be subsumed in other legal categories, especially contract and tort.

B. CATEGORIES MATTER

1. Humans Need to Categorize Information

"Categories are important, efficient, and inevitable. Unlike computers, our brain is unable to store and remember many details. Humans need to organize details, and usually do so in related groups and hierarchies. For this reason, theories,

1. *See* Chapter 1.

paradigms, categories and classifications as well as professional disciplines are crucial to memory and understanding. Not surprisingly, categories of a discipline have been referred to as 'a table of contents.'"[2] Without categories and organized data we cannot find the items we search for. A legal category is a heading under which we file related legal information; it is the key to the book of rules that applies to particular relationships.

What is the process of categorization? Studies have shown that to retain memory humans classify data both in a top-down and in a bottom-up process. Both processes require categories, headed by generalizations. The top-down process starts with generalizations under which details are grouped. This "processing relies on prior and more long term experience. In contrast, 'bottom-up' (data-driven) processing governs memory-based effects that clearly go beyond those implicated in immediate perception, effects of elaboration, question answering, comprehension of complex passages, etc."[3]

The United States and the United Kingdom—the principal common law countries—and the European Community States—civil law countries—categorize their laws in different ways. Generally, the common law is categorized by a "bottom-up" and perhaps "sideways" method, while the civil law is categorized to a greater extent by a "top-down" method.[4]

The bottom-up process is triggered by specific events that are generalized and combined into categories. In U.S. law, for example, categories "are often generated by events, not by scholars, and can always be abolished by those same

2. Tamar Frankel & Joshua Getzler, *Fiduciary Law* (Draft) (on file with the author) (citing Fulvio Cortese et al., *Back to Government? The Pluralistic Deficit in the Decisionmaking Processes and Before the Courts*, 12 IND. J. GLOBAL LEG. STUD. 409, 409 (2005); John Henry Schlegel, *From High in the Paper Tower, an Essay on von Humboldt's University*, 52 BUFFALO L. REV. 865, 881 (2004) ("disciplines . . . provide useful categories and clearly, thought is impossible without categories")). For the definition of category, *see* MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 180 (10th ed. 1999) ("any of several fundamental and distinct classes to which entities or concepts belong;" "a division within a system of classification"). To classify is defined as "to assign . . . to a category." *Id.* at 212.

3. Tamar Frankel & Joshua Getzler, *Fiduciary Law* (Draft) (on file with the author) (citing Marcia K. Johnson & William Hirst, *MEM: Memory Subsystems as Processes, in* THEORIES OF MEMORY 241, 260 (Alan F. Collins et al. eds., 1993)) (stating that "top-down" processing relies on prior experience; distinguishing from "bottom-up" (data-driven) processing; stating that top-down processes "govern memory-based effects that clearly go beyond those implicated in immediate perception, effects of elaboration, question answering, comprehension of complex passages, etc.") (citation omitted).

4. William S. Blatt, *Interpretive Communities: The Missing Element in Statutory Interpretation*, 95 NW. U. L. REV. 629, 643 (2001). *See also* George M. Cohen, Comment, *Posnerian Jurisprudence and Economic Analysis of Law: The View from the Bench*, 133 U. PA. L. REV. 1117, 1164 (1985) (contrasting top-down approach of economics with bottom-up approach of jurisprudence).

events."[5] A first step to generalization in a bottom-up process is usually an analogy by which American lawyers and judges often reason.[6] This method is used by the *American Law Institute Restatement of Law* that combines cases under general principles, accompanied by examples,[7] as well as *Corpus Juris*,[8] *Black's Law Dictionary*,[9] and treatises.[10] States may follow these model statutes, with changes to fit local demand.[11]

Items can be drawn into a category by analogy to other items already inhabiting the category. For example, agents represent principals and unions represent the employees, therefore unions are fiduciaries,[12] even if the controls of the principals in each case differ.[13] Union leadership can also be analogized to corporate directors even though their powers differ. Thus, analogies may start with the basic category of the fiduciaries and then move to distinguishing between them by the details.

2. What Can Categories Tell Us

The grouping of items in a category demonstrates the importance of the items in the group. Items can belong to more than one category. For example, fruit is a category, and so is color. If we search for apples, we search in the fruit category. But if our search is more refined, seeking a red apple, then we might resort to the category of fruit as well as to the category of color to find our red apple. And if we use the concept of red apple and its varieties very frequently, we may create a special category under the heading of "red apple." Thus, categories can signal the objectives and values of those who establish the categories and those who search for information. Legal categories can tell us about the frequency with which we focus on certain concepts or ways of behavior. The more often the

5. Edward L. Rubin, *Law and the Methodology of Law*, 1997 WIS. L. REV. 521, 536 (1997).

6. Cass R. Sunstein, *On Analogical Reasoning*, 106 HARV. L. REV. 741, 746 (1993).

7. About the ALI, http://www.ali.org/ali_old/thisali.htm (last visited July 14, 2009).

8. C.J.S. (2009).

9. BLACK'S LAW DICTIONARY (9th ed. 2009).

10. RAFAEL CHODUS, THE LAW OF FIDUCIARY DUTIES (2000); TAMAR FRANKEL, SECURITIZATION (Ann Schwing ed., 2d ed. 2006).

11. Nuno Garoupa & Thomas S Ulen, *The Market for Legal Innovation: Law and Economics in Europe and the United States*, 59 ALA. L. REV. 1555, 1558 (2008) (concluding that the ALI offers broad theories, in contrast with state law systems that offer very specific answers and mold theory case by case).

12. RESTATEMENT (THIRD) OF AGENCY § 2.01 (2006) ("An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent so to act.").

13. In a one-to-one agency the principal may have the opportunity to direct the agent in minute details while the union leaders are subject formally to the union members' votes.

concepts are discussed and ways of behavior are used, the more entrenched is the category that contains them.[14] The categories' names have a similar informational value. In sum, categories provide a mechanism for organizing information and values, and signaling the importance that we assign to them.

3. The Judicial Process of Recognizing New Fiduciaries

A prominent feature of fiduciary law is its "open-door" nature. This feature also signals the process by which fiduciary law is expanded to new situations posing similar problems. This feature may explain why fiduciaries have two names, while the parties to relationships with fiduciaries have only one name. Fiduciaries have the general name of "fiduciary" as well as specific names, such as agents, advisers, money managers, lawyers, or physicians. But those that relate to fiduciaries: principals (who engage agents), investors (who engage advisers and money managers), clients (who engage lawyers), and patients (who engage physicians) have only one name: their specific name; but not a shared name. The explanation may be that when relationships arose, which posed problems similar to those that fiduciary relationships raised, the courts noted the similarity and said: Aha! This person is a fiduciary, like those other fiduciaries we already know! A related explanation for the naming of fiduciaries is that the main thrust of fiduciary law is to impose duties and prohibitions on fiduciaries. Both the court decisions and legislation are phrased in these terms. Therefore, it is not surprising that the subjects of these duties will carry a name in common, even though their duties might differ somewhat. They are members of the same family; similar, but not identical.[15]

It should be emphasized that fiduciary relationships can be addressed in different legal contexts. The relationships can arise in the context of contract, tort, voting in an organization or without any legal context, such as using one's expertise to buy precious jewelry for a friend as a favor. Fiduciary relationships can arise in all these contexts, if the relationships meet the characteristics described in Chapter 1.

The courts' treatment of fiduciary law differs. For example, the Seventh Circuit denied the existence of fiduciary law as a category and subsumed fiduciary rules within the contract category. It viewed the relationships as a special type of contracts that require disclosure of a fiduciary to the other party to the relationship.[16]

14. In contrast see MICHAEL WALZER, SPHERES OF JUSTICE: A DEFENSE OF PLURALISM AND EQUALITY 10 (1983) ("When meanings are distinct, distributions must be autonomous.").

15. Note in contrast, that contract law refers to both parties as the "contract parties," imposes on them the same duties and entitles them to the same rights.

16. Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.), *reh'g denied, reh'g en banc denied,* 537 F.3d 728 (7th Cir. 2008), *vacated, remanded,* No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010) (rejecting Seventh Circuit view).

The Supreme Court rejected this view and adopted a traditional formulation of the concept of fiduciary duty.[17]

Other decisions may decline to classify fiduciary relationship implicitly, based on the fact that alternative specifications in a contract might provide adequate protection to the party, especially if the party is sophisticated and powerful.[18] Courts may recognize fiduciary law as a category but limit additional new situations under its umbrella.[19] These approaches require a heavier burden of proof before the court recognizes new types of fiduciary relationships. Thus, the California Supreme Court declined to automatically recognize the relationship between Disney Corporation and an author as fiduciary. The author argued that he did not receive reports from Disney Corporation with respect to the development of his book.[20] Similarly, the Court did not recognize a fiduciary relationship between inventors who did not receive their due payments under their contract with the commercial developers of their invention.[21]

Yet other courts add new situations to the fiduciary law category, guided by the fundamental principles which underlie fiduciary law.[22] The Connecticut court added to the fiduciary category the situation in which a priest molested a child.[23]

17. Jones v. Harris Assocs. L.P., No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).

18. United States v. York, 112 F.3d 1218 (D.D.C. 1997).

19. City of Hope Nat'l Med. Ctr. v. Genentech, 20 Cal. Rptr. 3d 234 (2004), *modified, reh'g denied,* No. B161549, 2004 Cal. App. LEXIS 1962 (Ct. App. Nov. 22, 2004), *review granted, depublished,* 105 P.3d 543 (2005). *City of Hope* is an unpublished disposition issued before January 1, 2007, and as such may not be cited to Ninth Circuit courts except in certain limited circumstances. 9TH CIR. R. 36-3(c); Wolf v. Superior Court, 107 Cal. App. 4th 25 (Ct. App. 2003), *remanded,* 114 Cal. App. 4th 1343 (Ct. App. 2004) (some citations omitted).

20. *See, e.g.,* the approach of the California Supreme Court in Wolf v. Superior Court, 107 Cal. App. 4th 25 (Ct. App. 2003), *remanded,* 114 Cal. App. 4th 1343 (Ct. App. 2004) (some citations omitted).

21. City of Hope Nat'l Med. Ctr.v. Genentech, Inc., 20 Cal. Rptr. 3d 234 (Ct. App. 2004), *modified, reh'g denied,* No. B161549, 2004 Cal. App. LEXIS 1962 (Ct. App. Nov. 22, 2004), *review granted, depublished,* 24 Cal. Rptr. 3d 178, 105 P.3d 543 (Cal. 2005). *City of Hope* is an unpublished disposition issued before January 1, 2007, and as such may not be cited to Ninth Circuit courts except in certain limited circumstances, 9TH CIR. R. 36-3(c). *See* Reed C. McBride, Note, City of Hope v. Genentech: *Keeping Fiduciary Duties Where They Belong,* 24 BERKELEY TECH. L.J. 179 (2009) (arguing that the decision in *City of Hope* was correct).

22. Martinelli v. Bridgeport Roman Catholic Diocesan Corp., 10 F. Supp. 2d 138 (D. Conn. 1998).

23. Martinelli v. Bridgeport Roman Catholic Diocesan Corp., 10 F. Supp. 2d 138 (D. Conn. 1998); *see also* Mark E. Chopko, *Stating Claims Against Religious Institutions,* 44 B.C. L. REV. 1089, 1123 (2003) ("The minister who practices psychiatry owes his or her patients a fiduciary duty not to engage in sexual relationships with them in the same manner as

Adding a situation to the relationship may require adjustment of the law to the added situation. In these cases the courts determined that the relationships were fiduciary and then adjusted the rules governing the prototypes in light of the differences between them and the new fiduciaries. Courts drew analogies from existing fiduciary prototypes, such as agency, trust, or bailment,[24] to new situations, and distinguished from or analogized the existing prototypes to the new situations. For example, partnerships that appeared in the sixteenth century[25] evolved later into joint stock companies and corporations, governed by somewhat different rules.[26] Similarly, courts started to impose legal duties on directors by analogizing them to trustees,[27] agents,[28] and managing partners.[29] Emancipated servants and employees emerged from relations of apprentices in householders to become agents and factors.[30] One court explained why some similarities between directors and trustees are relevant and others are not. The court allowed directors far more freedom in dealing with corporate assets than trustees would have, noting that in most trust cases the trustees can be guided by the trust document; directors should not be similarly constrained in operating a business effectively.[31]

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any other on a psychiatrist."); Hodgkinson v. Simms, [Can. 1994] S.C.R. 377, 420–21, 469–70 (citing Tamar Frankel, *Fiduciary Law: The Judicial Process and the Duty of Care*, *in* 1993 Isaac Pitblado Lectures 144–45); MacDonald v. Clinger, 84 A.D.2d 482, 487 (N.Y. App. Div. 1982) (psychiatrists are fiduciaries with respect to confidential information).

24. *Compare* Wolf, 107 Cal. App. 4th at 25 (Ct. App. 2003), *remanded*, 114 Cal. App. 4th 1343 (Ct. App. 2004) (*see, e.g.*, the general approach of the California Supreme Court) *with* Warsofsky v. Sherman, 93 N.E.2d 612 (Mass. 1950) (citations omitted).

25. Ron Harris, Industrializing English Law: Entrepreneurship and Business Organization, 1720–1844 (2000); Timur Kuran, *The Logic of Financial Westernization in the Middle East*, 56 J. Econ. Behav. & Org. 593 (2005).

26. Timur Kuran, *The Logic of Financial Westernization in the Middle East*, 56 J. Econ. Behav. & Org. 593, 604 (2005).

27. Whiteston REIT v. Hartman, 252 Fed. Appx. 631, 633 (5th Cir. 2007) (this opinion identifies "trustees" and "directors" as synonymous and interchangeable); Beck v. Pace Int'l Union, 427 F.3d 668, 671 (9th Cir. 2005) ("Members of [the] board of directors were also the trustees for its eighteen pension plans.").

28. *In re* Tsikouris, 340 B.R. 604, 613 (Bankr. N.D. Ind. 2006) ("[T]he position may be one that requires the principal to repose a special confidence in the fiduciary . . . [such as] the relation between director and shareholder or managing partner and limited partner").

29. Sanford v. Nat'l Ass'n for the Self-Employed, Inc., No. 09-22-P-H, 2009 U.S. App. LEXIS 47977, at *7 (D. Me. May 26, 2009) ("[D]irectors and officers acted as agents."), *mot. granted in part, mot. denied in part*, 640 F. Supp. 2d 82 (D. Me. 2009).

30. 2 William Blackstone, Commentaries 422 (1766) (expressing the view that master-servant relations were one of the three branches of domestic relations at common law, along with parent-child and husband-wife); Charles Claflin Allen, *Agent and Servant Essentially Identical*, 28 Am. L. Rev. 9, 18 n.1 (1894).

31. Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940).

4. The Role of the Business Environment in Judicial Categorizing

A court may consider the business activities of the parties to determine the category of their relationship. For example, in *Washington Steel Corp. v. TW Corp.* the court considered a bank's use of the borrower's information. The court was concerned that imposing fiduciary duties with respect to the borrowers' information could impair banks' ability to manage carefully their lending departments. This concern trumped the right of a long-term borrower to prevent its bank from financing the takeover of this borrower-client.[32] "[T]he adoption of such a rule [of fiduciary relationship with respect to the borrower's information] would make unwise banking policy. To prohibit a bank from considering all available information in making its own loan decisions might engender one or both of two undesirable outcomes. First, it might force banks to go blindly into loan transactions, arguably violating its duties to its own depositors. Alternatively, such a rule might discourage banks from lending money to any company which expresses an interest in purchasing shares of stock of another of the bank's customers. The adverse implication of this result for the free flow of funds is precisely the reason why we rejected the per se rule urged by Washington [Steel Corporation]. Bank credit is, after all, the largest part, by far, of the national money supply."[33] The court did not express an opinion about the transfer of information from the bank's loan department to another department, and held "only that the use within that loan department of information received from one borrower, in evaluating a loan to another borrower, does not, without more, state a cause of action against the bank."[34] However, another court held that if the bank does not use the information for the bank's business, but for the private benefit of the bank's loan officer, the officer and the bank may be considered fiduciaries with respect to the information.[35]

C. SHOULD FIDUCIARY LAW BE VIEWED AS A CATEGORY?

1. The Issue of "Coherence"

What makes a category "coherent?" Is a category incoherent if it is open to similar (but not identical) items, or if the items within the category are insufficiently specific? Arguably, such a category creates confused thinking and erroneous application of the rules.[36] However, a category whose doors are too hard to open

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32. Wash. Steel Corp. v. TW Corp., 602 F.2d 594 (3d Cir. 1979) (footnotes and citations omitted).

33. *Id.* at 603.

34. *Id.* at 604.

35. Warsofsky v. Sherman, 93 N.E.2d 612 (Mass. 1950) (citations omitted).

36. John Henry Schlegel, *From High in the Paper Tower, an Essay on von Humboldt's University*, 52 Buffalo L. Rev. 865, 881 (2004) ("[D]isciplines . . . provide useful categories

to similar items and whose items are too specific might make it harder for users to "think outside the box" and innovate. Indeed, such a category might trigger the creation of too many categories with few items. As always, the right category's parameters are the most difficult to establish, and even when the parameters are established, they ought to be reviewed and adjusted from time to time, as the social environment and culture change. Thus, categorization is an ongoing process, subject to an ongoing debate. Fiduciary law is not unique in this sense.

"Coherence" in a legal category is influenced by the viewers' attitude toward law. Believers in freedom from legal constraints in certain areas of activity may seek rules of narrow and defined scope in categories of clear, specific boundaries. For the followers of specificity and clarity "incoherence" is a bad word.[37] Believers in greater law's intrusion on freedom of actors for the good for society may seek more flexible rules in a more open-ended category that accepts new situations.[38] For them, lack of clear "coherence" has many advantages. The items within categories may then depend on their features (the problems they raise and solutions they require) rather than on how they are created. If the features of relationships are similar, they belong to the same category, even if they arose in different circumstances, legal or otherwise.

Some academics are alarmed by the unlimited development of new fiduciary relationships.[39] One writer emphasized the "relative lack of consensus even among those advocating a unifying theory of fiduciary obligation." Therefore, "it is unsurprising that other legal scholars have charged that fiduciary law is largely incoherent, inconsistent in application" and "long on generalities and short on substance."[40] I argue that no alarm is justified. Most, if not all, legal categories are "incoherent."

and clearly, thought is impossible without categories.")). For the definition of category, *see* MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 180 (10th ed. 1999) ("any of several fundamental and distinct classes to which entities or concepts belong;" "a division within a system of classification").

37. *See* Ian MacNeil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340 (1983); GRANT GILMORE, THE DEATH OF CONTRACT 87–102 (1974); Ian Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978). *See also* Richard E. Speidel, *The New Spirit of Contract*, 2 J.L. & COM. 193 (1982).

38. *See* e.g., Ruth Colker, *Abortion and Violence*, 1 WM. & MARY J. OF WOMEN & L. 93, 97 (1994) (complaining that legal categories follow abstract and "frozen" categories instead of more desirable "tentative, relational, and unstable" categories).

39. Donald Waack, *Developments in Banking and Financial Law*, 26 ANN. REV. BANKING & FIN. LAW 186 (2007).

40. Robert W. Hillman, *Closely-Held Firms and the Common Law of Fiduciary Duty: What Explains the Enduring Qualities of a Punctilio?*, 41 TULSA L. REV. 441, 442 (2006) [hereinafter *Closely-Held Firms*].

Is the Contract Category Coherent? It has been argued that fiduciary law is too open-ended and not sufficiently specific, in contrast to contract, for example.[41] Yet, a quick look at contract law demonstrates that this legal category is not only open-ended but is incongruous and self-contradictory.[42] Contract law has evolved from logic-based rules to environment-based rules. The contract category contains enormous variations of contractual arrangements that pose different problems and result in different rules.[43]

Contract law constructed by Williston created "a [pragmatic] system under which contracting parties with more-or-less equal bargaining power engaged in arm's-length bargaining over discrete transactions. In this system, obligations of the parties were expressed in documents, which memorialized completely the agreed-upon terms of the deal."[44] The next, neoclassical contract doctrine included a "doctrine of unconscionability, the duty of good faith, trade usage, and the increased use of reliance as a basis for liability."[45] Yet the duties reflected the image of an exchange among the parties. In 1974 Ian MacNeil introduced another view of contracts as "relations among people who have exchanged, are exchanging, or expect to be exchanging in the future." He emphasized that "all exchange occurs in relations. . . . [E]very contractual relation comprises certain behaviors, and the patterns of behavior across many relationships give rise to norms."[46] Thus, even though exchange remained a basic concept in contract law the law evolved to recognize the impact of the relationships and context in which people interact. Thus, "[s]cholars have expended considerable energy in the effort to "discover" a normative theory of Contract . . . [but] "something fundamental about Contract has been missed and has frustrated the search from the outset. Succinctly, Contract doctrine resists the neat formulation theory requires."[47]

41. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, (1988).

42. *Id.*

43. G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 CAL. L. REV. 431 (1993) ("In contrast to commentators such as Cass Sunstein, the author contends that the modern Court has looked beyond libertarian common law baselines such at those supported by the Lochner Court to new visions of common law rules inspired by the appealing—but dangerously oversimplistic—reasoning of law and economics scholarship. Most crucially, the modern Court has given short shrift to the importance of public interest and participation. As an alternative, the author suggests that scholars revitalize the neoclassical theory of contract, integrating a realistic consideration for efficiency with the vital concerns of fair process and morality.").

44. D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1 (2009).

45. *Id.*

46. *Id.*

47. Peter A. Alces, *Unintelligent Design in Contract*, 2008 U. ILL. L. REV. 505.

Moreover, freedom of contract and its category may relate to, and reflect, changes in the culture rather than in the law.[48]

> [W]hen American courts apply the doctrines of consideration, promissory reliance, and offer and acceptance they are not concerned with the presence of a bargained-for detriment, reliance, or meeting of the minds. They are concerned with the effect of the transaction on the wealth of the parties. Promises intended to enrich the promisee at the promisor's expense are enforced if the promisor's decision is likely to have been sensible. Promises that impose no costs on the promisor are enforced freely. Promises to exchange resources are enforced subject to safeguards that prevent one party from being enriched at the other's expense.[49]

Contract law is therefore not as coherent as claimed, and not much different than fiduciary law in that respect.

Contract approaches changed over time. "Gilmore declared 'dead' the objectivist approach and, with it, the distinctive character of contract law that made it different from the law of torts from which it emerged in the nineteenth century."[50] Arthur Leff, Ian MacNeil and others had different views.[51] "[W]e might expect the internationalization of business to influence our individualistic, horse-trade, contract-law paradigm and the binary thinking that comes with it."[52] Yet, in the years 1980 to 2010 it is doubtful whether contract law has "mellowed" to seriously account for fairness and morality. Even a subcategory of contract, is "incoherent." "Modern attempts to define and apply the doctrine [of duress] illustrate the inherent ambiguity and indeterminacy of legal reasoning in general." While for some commentators "the doctrine protects the free will of participants in the

48. Mark Pettit, Jr., *Freedom, Freedom of Contract, and The "Rise and Fall,"* 79 B.U.L. Rev. 263 (1999), LEXIS, Lawrev Library, Allrev file (LEXIS summary) ("In two cases involving land conveyed to a railroad where part of the railroad's consideration was a promise either to build or not to build a depot, the courts declared the contracts illegal. Minnesota law, however, provided that contracts made on Sunday were void and unenforceable . . . Other quasi-gambling cases show that courts in the 1880s differed significantly on whether public policy should render such contracts void. . . . Although the late-nineteenth-century cases do suggest a somewhat more restricted role for freedom of contract in the personal and family contexts than in the present day, this development may indicate less about changes in the concept of freedom of contract than it does about the shifting public policy in this area.").

49. James Gordley, *Enforcing Promises*, 83 Calif. L. Rev. 547 (1995).

50. William J. Woodward, Jr., *Clearing the Underbrush for Real-Life Contracting*, 24 Law & Soc. Inquiry 99, 99 (1999); Grant Gilmore, The Death of Contract (1974).

51. William J. Woodward, Jr., *Clearing the Underbrush for Real-Life Contracting*, 24 Law & Soc. Inquiry 99, 115 (1999).

52. William J. Woodward, Jr., *Clearing the Underbrush for Real-Life Contracting*, 24 Law & Soc. Inquiry 97, 137 (1999) (noting the conflicting character of contract law).

market, . . . skeptics . . . exposed the concept of the overborne will as a fallacy." While the doctrine is "fuzzy" and the concept indeterminate and self-contradictory "the doctrine of economic duress has ideological significance for the participants in the mainstream legal culture (and, by diffusion, for the rest of us). The continuing emphasis on free will sends the message that we really do have a 'free market' . . . [and] the theoretical availability of duress as an excuse for avoiding a contract sends the message that the free market rests on a baseline standard of business ethics, and that transactions resulting from the unfair exploitation of another's weakness will not be enforced."[53]

Are the categories of Tort, Health Law, Procedure, and Administrative Law coherent? Tort law has not escaped the debate of "coherence." Academics have long been arguing about the specificity of the rules and the parameters of the category.[54] Health law was also caught in the fire of the "coherence" debate.[55] Neither have procedure[56] and administrative law[57] escaped the debate. The

53. Frank C. Huntington, "One Truth Is Clear, Whatever Is, Is Right": The History of Indeterminacy and Ideological Significant of the Doctrine of Economic Duress 1-3 (2009) (unpublished manuscript, on file with author).

54. Michael S. Moore, *Symposium on Causation in the Law of Torts: Thomson's Preliminaries About Causation and Rights*, 63 Chi.-Kent L. Rev. 497 (1987) ("Kelman claims we must "wake up" from the nightmare of liberal tort law because it is based on a notion of causation that is incoherent and unknowable" and defending the liberal view); Patricia Sanchez Abril, *Recasting Privacy Torts in a Spaceless World*, 21 Harv. J.L. & Tech. 1 (2007) ("While the behavioral sciences have enjoyed great success in characterizing the use of space and its relationship to different expectations, the law has struggled to definitively articulate human expectations of privacy. In particular, the tort law of privacy is a convoluted area of law. Its incoherent and haphazard methodology has engendered confusion and sparked extensive debate." (footnote omitted)).

55. Theodore W. Ruger, *Health Law's Coherence Anxiety*, 96 Geo. L.J. 625–626 (2008) ("leading health law scholars, who have effectively answered the first critique about the uniqueness of various health law doctrines, but continue to struggle with the second one about overall theoretical coherence. This debate carries meaningful stakes, both for the future direction and impact of health law scholarship as well as its ultimate status and representation within the legal academy") (footnote omitted).

56. Robert G. Bone, *Agreeing to Fair Process: The Problem With Contractarian Theories of Procedural Fairness*, 83 B.U. L. Rev. 485 (2003) (outlining various views of procedure and ending with the following: "[P]roceduralists who care about fairness have to think much harder about what fairness means for procedure. This Article will have succeeded if it challenges readers to engage in this deliberative process and reconsider commonly held views. Nothing less is at stake than a coherent and normatively defensible system of civil adjudication.").

57. Victor G. Rosenblum, *Contrasting Perspectives on the Deeds and Demise of the Administrative Conference: Is There a Determinable Legacy?*, 30 Ariz. St. L.J. 1 (1998) ("The community of administrative law experts has become more specialized and incoherent, no longer inclined toward common goals or common dialogue. . . . Devoid of the capacity to compel administrators or agencies to do or refrain from doing anything, the

surprising part of the literature is that the debates on other areas of the law as well as on fiduciary law are based on the same or very similar types of approaches.[58] Should the rules and their categories be more specific, and show clearer parameters? Should they be affected by logic, by principles, or by the environment?

2. A Question of Fairness When a Category is Open-Ended

Is recognizing an open-door category fair to those subject to the rules in the category? Concerns about imposing new rules on unsuspecting innocent actors have been debated in many areas.[59] Fairness requires that people should know the rules so that they can comply with them; they should not be punished for violating new rules. However, under a similar principle, people should not be subject to rules if they do not know that the rules exist. Yet a fundamental principle in the law is that ignorance of the law is no excuse. A person who violated the law unknowingly will be liable for the violation. This principle is imposed because a defense of ignorance of the law might undermine the enforcement of any rule of law.[60] Implicitly, the principle imposes on people a duty to inquire and find out what the law is. An open-ended category imposes on people the requirement of understanding the principles on which the rules of the category are based, such as the prohibition on misappropriating entrusted property or power. This issue applies not only to fiduciary law but to laws in general.

In fact, the issue of fairness is raised in every court case. Neither party knows what the law is until the court announces it.[61] And yet, the parties are bound by the court's decision. Therefore, the argument that the courts may not expand the

Administrative Conference—as these Symposium articles make clear from diverse perspectives—achieved over its three-decade lifetime remarkable feats of research, recommendation and guidance affecting both microscopic and macroscopic dimensions of the administrative process.").

58. Robert Cooter, *Doing What You Say: Contracts and Economic Development*, 59 ALA. L. REV. 1107 (2008) (emphasizing the importance of maintaining trust among contract parties).

59. Solem v. Stumes, 465 U.S. 638, 642 (1984) (a legal system based on precedent presumes that judicial decisions, as rules, are applied retroactively. However, retroactivity is not compelled); David Frisch, *Rational Retroactivity in a Commercial Context*, 58 ALA. L. REV. 765, 765 (2007) (using analogy of parking ticket to describe retroactive laws punishing past conduct); Meir Katz, Note, *Plainly Not "Error": Adjudicative Retroactivity on Direct Review*, 25 CARDOZO L. REV. 1979 (2004) (discusses the clarity of adjudicative retroactivity regarding constitutional decisions on direct review).

60. Peter J. Smith, *New Legal Fictions*, 95 GEO. L.J. 1435, 1479 (2007) ("Courts assert [ignorance of the law is no excuse] because they fear that if they made clear that sometimes ignorance is an excuse, people likely would claim (or seek to attain) ignorance more often.").

61. Gerald Leonard, Comment, *Comment of Fredrick Schauer's Prediction and Particularity*, 78 B.U. L. REV. 931 (1998).

incidences to which fiduciary law would apply falls into the same vast category of rules and specific actions in which law is not fully predictable.

Besides, specificity has its dark side. Bright-line rules can be more easily circumvented, and an area of legal risk that may rob fiduciaries of benefits may be beneficial to society by reducing the cost of enforcing fiduciary duties, since their violations may be costly to uncover.[62] After all, fiduciaries or "may be fiduciaries" could resort to the general principles that underlie fiduciary law, even though the principles are not specific, and ask themselves whether their contemplated actions are compatible with these principles. To be sure, if the category's parameters and its laws are not specific, some fiduciaries might take the risks for which the courts will hold them in violation of the law. But others may be more reluctant to take the risk. A view of the 2008 crisis in the financial area may suggest that fiduciary principles have not been followed strictly by those who held entrusted money and power. If the interpretation of the rules requires specificity, then anything that is not specifically prohibited is permitted.[63] In addition, some activities that started in the "gray zone" have reached and entered the specifically prohibited zone. Market timing, which started in an unclear legal issue and ended in a clear violation of the law, is one such example.[64] Enron Corporation started with changing the valuation of existing contracts to securitizing losing assets in order to clear its balance sheet, and ended in a fraudulent use of its own shares to guarantee these assets.[65] E.F. Hutton started by using time lag to benefit from "free loans" in a time of inflation and ended in check-kiting.[66]

D. THE DEBATE

1. The Arguments for Classifying Fiduciary Rules as Contract Rules

During the past twenty-five years there developed a struggle among lawyers, academics, and judges on the status of the fiduciary law rules. The Delaware Supreme Court took the position that good faith is a fiduciary duty, but subsequent Delaware cases speak of "the contractual duty of good faith [that] is not qualitatively different" in the limited partnership/LLC context from the duty in

62. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 49 (2006) ("Trust saves time and money. It allows people to believe other persons' statements without checking their truth. . . ." It costs time and money to verify that a fiduciary has its client's best interest in mind, and not its own interest).

63. TAMAR FRANKEL, TRUST AND HONESTY 146–49 (2006).

64. MARK FAGAN & TAMAR FRANKEL, TRUST AND HONESTY IN THE REAL WORLD 21–36 (2007).

65. TAMAR FRANKEL, TRUST AND HONESTY 150–69 (2006).

66. *Id.* at 65–77.

an ordinary contract.[67] There are arguments that, in the context of the corporation, the relationship among shareholders and management is essentially contractual.[68] The market price of corporate shares can press "toward development of optimal contract terms, including the optimal reliance on legal constraints such as fiduciary duties," and contract terms allowing or permitting amendment should be enforceable "since market forces constrain both the scope of the amendment power in the initial contract and the amendment process itself."[69] Even if there are deficiencies in the markets, there are doubts about the efficiency of mandatory terms dictated by law.[70]

The protection of market participants trumps the protection of entrustors under a trust. Under current law, "even if the trustee . . . specifically pledges trust property as security for credit extended to the trustee by a third party creditor who is unaware that the property is held in trust, the creditor will not be permitted to enforce his security interest in the trust property."[71] The basis for this rule is property law and the concept of entrustment. A thief cannot bestow property rights that the thief did not have. In contracts, contract law may view the fiduciary as merely breaching a promise. Such a contract party may transfer property rights to another, leaving trust beneficiaries in a weaker position and the settler becomes essentially a third-party beneficiary in contract. Therefore, a buyer of misappropriated trust property gains title to the property. Similarly, a contract model has been applied to aggregate fiduciary relationships. A corporation was defined as criss-crossing contracts among the different corporate actors, and partnership relationships as contractual.[72]

67. Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123 (2006), LEXIS, Lawrev Library, Wakelr File (LEXIS summary); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399 (2005); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004).

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

69. *Id.* at 7.

70. *Id.* at 6–7.

71. Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 455 (1998) (citing RESTATEMENT (SECOND) OF TRUSTS § 286 (1959)) (suggesting that agency and contract could substitute for trust law).

72. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1209–11 (1995) (edited, footnotes omitted). For a "contractarian" view, see Judge Posner's dissent in the dissenting opinion in Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 444–52 (7th Cir. 1987). *See also* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993) (advocating the view of fiduciary law as contract law); *id.* at 427 (stating that "a 'fiduciary' relation is a contractual one, characterized by unusually high costs of specification and monitoring"); John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 671 (1995) (concluding that "the norms of trust law" are "consensual formation and consensual terms"). *See also* Roberta Romano, Comment on Easterbrook and Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 447 (1993) (responding to the Easterbrook-Fischel article. Noting theories of fiduciary law other than the contractual approach, for example, relying on unequal information between fiduciaries and entrustors, or property-based theories that appear to be compatible with the contractual approach and noting that some property-based relations (e.g., trustee-beneficiary, manager-stockholder) involve greater fiduciary duties than some other relations (e.g., manager-debtholder, franchisor-franchisee, majority-minority stockholder), and "expertise in handling the property in trust could provide the rationale for imposing a higher level of duty," as well as relationships better regulated by statute (e.g., Employee Retirement Income Security Act of 1974)).

Some academics have nicknamed fiduciary relationships "contractarian." Then they proceeded to chip off the protective rules against conflicting interests, thereby reclassifying them under the same name. Courts that lean toward a contractarian view of fiduciary relationships do not necessarily base their decisions by re-categorizing the relationships or the rules of the law. Yet, their rationales and the results of their decisions speak louder than any categorization would. For example, one judge stated that investors in a mutual fund may not complain if their adviser-fiduciary charges them the market price for brokerage transactions, even though the adviser was supposed to charge them "cost" and paid the broker only one third of the amount charged the fund. The court noted that a violation of the adviser's fiduciary duty of care remained without a remedy, thus in fact negating the existence of the duty.[73] The California Supreme Court denied an automatic recognition of this relationship to an author who did not receive reports from Disney Corporation with respect to the development of his book.[74] The Court rejected such recognition to inventors who did not receive their due payments under their contract with the commercial developers of their invention.[75]

One argument against recognizing the category of fiduciary law is based on the roots and history of some species of fiduciaries. Partnership duties were developed by the church, acting against the rise of markets and commercialism. Therefore,

73. Wsol v. Fiduciary Mgmt Associates, 266 F.3d 654 (7th Cir. 2001); Tamar Frankel, *The Seventh Circuit Decision on* Wsol v. Fiduciary Management Associates *and the Amendment to Rule 12b-1*, INV. LAW., Aug. 2004, at 11.

74. *See, e.g.,* the approach of the California Supreme Court in Wolf v. Superior Court, 107 Cal. App. 4th 25 (Ct. App. 2003), *remanded,* 114 Cal. App. 4th 1343 (Ct. App. 2004) (some citations omitted).

75. City of Hope Nat'l Med. Ctr.v. Genentech, Inc., 20 Cal. Rptr. 3d 234 (Ct. App. 2004), *modified, reh'g denied,* No. B161549, 2004 Cal. App. LEXIS 1962 (Ct. App. Nov. 22, 2004), *review granted, depublished,* 24 Cal. Rptr. 3d 178, 105 P.3d 543 (Cal. 2005). *City of Hope* is an unpublished disposition issued before January 1, 2007, and as such may not be cited to Ninth Circuit courts except in certain limited circumstances, 9TH CIR. R. 36-3(c).

fiduciary duty rules "are vestiges of partnership law's medieval religious origins, and are ill-suited to the modern, secular business world," and were not "founded on their inherent practical value." Instead, "fiduciary duties between partners should be default provisions amendable by partnership agreements."[76] Another commentator disagreed: The law of partners based on contract law, he protested, "is transforming the duty of loyalty into a contractarian construct."[77] This transformation is based on "doctrinal confusion, outworn economics, and weak policy," and "[i]f anything, the duty of loyalty needs to be strengthened." "Contractarianism ignores externalities, assumes perfect bargaining within a static analytic framework, and slights transaction costs and institutional analysis."[78] Translating the economics language into plain English, this means that viewing fiduciary relationships as contracts ignores the unequal position among the parties. It threatens the withdrawal of the weak party from engaging in such relationships. This withdrawal can be disastrous to our economy, financial system and society in general.

2. Counter Arguments

The corporation as a "nexus of contracts." The move from fiduciary law to "contract" or "contractarian" does not advocate the application of the entire body of contract law or the conversion of fiduciary law constraints to contract law constraints. It "muddies the waters." For example, a corporation model that became a popular expression is a corporation as a "nexus of contracts" involving a modicum of trust.[79] However, in law, the participants' relationship in a corporation is not a contract. It is far closer to trust.[80] In the contract-corporate model the beneficiaries' interests may depend almost exclusively on the terms of the contract.[81] The so-called "nexus of contracts" is not a legal concept. It is far from the true model of contract. The "nexus" is not necessarily written; it may be ambiguous or self-contradictory or not an agreement at all. The move from fiduciary to contract "constructs" an agreement based on certain assumptions: that the parties would have chosen terms that maximized their joint wealth; that the parties had "full information;" and that their interaction was "costless." These assumptions may not reflect the situation in which the relationships were established. Joint "wealth maximization" of entrustors is not necessarily the appropriate guide to legal construction of fiduciary relationships.

In contrast, a number of parties within the corporation are expected to act as fiduciaries. These are the managers, directors, and majority shareholders. The fiduciary model uses the same duties of loyalty and care, while a contract model allows far greater flexibility to fit the relationships. The name, "nexus of contracts," however, may signify a change in the duties of corporate fiduciaries and the protection of investors-entrustors.

Voluntary uncompensated services. Another argument demonstrating the inapplicability of contract to fiduciary relationships is the fact that voluntary and non-compensated service may result in fiduciary relationships if accompanied by entrustment. The parties may have objectives other than personal or joint wealth. In addition, actors (e.g., shareholders) may disagree on the plan for maximizing joint wealth; and joint wealth maximization might contradict contract terms that do not maximize wealth. Finally, there are two definitions of "ideal contract": the "complete contingent claims" contract (which covers "each possible state of the world"), and the "full information and costless contracting" contract.[82] The two definitions are not identical, and the parties may not have full information about the presumed terms of the presumed contract. Reclassifying fiduciary relationships as contracts results in a fundamental legal change. The reclassification reduces entrustors' protections, reverses traditional default rules, and results in conflicts among the rules' objectives and details.

Theories of fiduciary law do not follow a contractual approach. Professor Roberta Romano notes that some theories rely on unequal information by fiduciaries and their entrustors. Some theories are property-based, (e.g., trustee-beneficiary, manager-stockholder), which involve stricter fiduciary duties than other relationships (e.g., manager-debt holder, franchisor-franchisee, majority-minority stockholder), and some involve power, that is, "expertise in handling the property in trust could provide the rationale for imposing a higher level of duty."[83]

Contract as a promise not to misappropriate entrusted property. Under contract law entrustment of property would become an exchange (buying or selling) of the property or payment for services. Contract law may add explicit or assumed legal obligations such as the duty of disclosure to entrustors, and explicit or implicit limits on the use of the entrusted property for any purpose other than

76. Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 Cardozo L. Rev. 215, 218 (2004).

77. Reza Dibadj, *The Misguided Transformation of Loyalty into Contract*, 41 Tulsa L. Rev. 451, 452 (2006) (footnotes omitted).

78. *Id.* at 452, 470.

79. Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 Colum. L. Rev. 1449 (1989).

80. *Id.*

81. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 254 n.17 (1999) (stating that under "nexus of contracts" view, "relationships in the firm should be understood as an intertwined set of relationships between parties who agree to work with each other in pursuit of mutual benefit, even though not all the relationships that comprise a firm are necessarily spelled out in complete 'contracts'").

82. Kornhauser, *supra* note 79, at 1453–54.

83. Roberta Romano, *Comment on Easterbrook and Fischel: Contract and Fiduciary Duty*, 36 J.L. & Econ. 447, 448–49 (1993).

the purpose for which it was "exchanged," as well as returning the property after the conclusion of the service or the purpose.

Under contract law entrustment of property will be viewed as money debt, and self-limiting obligations. However, a fiduciary's obligations concerning the use of entrusted property contradict the essence of debt. A debtor may use loaned property as it pleases. Conditions to ensure the repayment of the debt cannot be so onerous as to restrict the debtor's use of the loaned property for its own benefit. Besides, in a debt transaction the obligation of the debtor is to return a specific amount (or subject to a certain predetermined formula), or the specific property. The risk is of losing the entrusted "debt" should be on the debtor, and not on the creditor-entrustor.

Further, if entrusted property is not returned, in violation of the promise, contract remedies will apply. Yet, in some cases of misappropriation greater punishment would be more appropriate. After all, if the so-called debt is used for another purpose without the permission of the entrustors, the use comes close to theft.[84] In "contractual exchange," agency is viewed as the sale and purchase of service, including professional expertise. Lawyers, money managers, expert agents, financial advisers, and physicians are viewed as sellers. Their power is not held in trust and their conflicting interests are recognized and accepted.

In contrast, in fiduciary law entrusted property is beneficially owned by the entrustor even when the property is in the hands of the fiduciary. The entrustor bears the risk of the property's changing value. A violation of fiduciary duties will be deemed embezzlement, and a breach of trust. Agents and professionals that hold entrusted power owe more than salespersons' duties with respect to the exercise of the power.

The conversion of fiduciary duties to contract has other effects. Professor Romano wrote:

> 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 and relate the rules to 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. 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.[85]

84. In fact, the misuse is worse than theft. A thief takes a risk to gain possession or hold of stolen money. In fiduciary relationship the owner hands the money or power over to the thief on a golden platter and pays the thief for services.

85. *Id.*

Thus, if law is earmarked as a separate category, the importance of the problems it addresses is highlighted. If the problems are devalued and considered unimportant, no category of fiduciary law need arise. The "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."[86]

3. Similarities and Differences between Fiduciary and Contract Law

a. **Similarities between Fiduciary Law and Contract Law** Fiduciary relationships and contract relationships are based on the parties' consent. Those who advocate the termination of fiduciary law as an independent legal category and its absorption into the law of contract note that both relationships are "consensual" and "voluntary." That is true in most fiduciary relationships, although in a trust relationship the trustor rather than the beneficiaries of a trust choose their trustee. But, in many cases, such as agency, partnership, and patient-physician or client-lawyer relationships, the relationship is indeed consensual and both parties can terminate the relationship, subject to agreed-upon limits.[87] "A person cannot create obligations on the part of another by merely trusting the other."[88] Contract law duties require each party to tell the truth when asked by the other, and each must perform its promises according to its undertaking in the contract. In addition, each contract party must deal fairly with the other.[89]

Fiduciary law includes "a duty of good faith." It may be that this duty is actually "the implied covenant of good faith and fair dealing in a fiduciary setting." Courts do not agree on whether good faith is "a distinct fiduciary duty." The Delaware Supreme Court has taken the position that it is; however, some Delaware cases speak of "the ability of limited partnership or LLC agreements to replace fiduciary duties with contractual alternatives," suggesting that "the contractual duty of good faith is not qualitatively different" in the limited partnership/LLC context from the duty in an ordinary contract.[90]

b. **Differences between Fiduciary Law and Contract** The parties' duty of disclosure to one another differs in fiduciary law and contract. A fiduciary must

86. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1209–11 (1995) (edited, footnotes omitted).

87. Lincoln Benefit Life Co. v. Edwards, 966 F. Supp. 911 (D. Neb. 1997) (court upheld the agent's termination of a principal-agent relationship); Reginald Martin Agency, Inc. v. Conseco Medical Ins. Co., No. 1:03-CV-3810-RWS, 2005 U.S. Dist. LEXIS 28802 (N.D. Ga. Sept. 10, 2005).

88. Branson Sch. Dist. RE-82 v. Romer, 161 F.3d 619, 633 (10th Cir. 1998).

89. 17A Am. Jur. 2d *Contracts* § 370. For example, a party may not take steps that would make it hard or impossible to perform its promises.

90. Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 Wake Forest L. Rev. 123 (2006), LEXIS, Lawrev Library, Wakelr File (LEXIS summary).

provide an entrustor with relevant information, including information about conflicts of interest, even if the entrustor does not ask for it. A fiduciary must account for its actions. Further, it is doubtful whether an entrustor can effectively waive the right to truthful information. A contract party need not offer information unless the other party asks for it or unless it is required by the contract terms or specific law to do so.

With respect to entrusted property and power a fiduciary must act for the benefit of the entrustor. No such duty exists in contract law. With respect to services in relationship to entrusted property and sometimes in general, the fiduciary must perform the services with care. A contract party is less bound by such a duty under contract law.

With respect to entrusted property and power, fiduciary law is drawn from property law, even though the relationship reflects promises as contracts do. That is why entrustors have the right to follow and reclaim entrusted property from anyone, except from a purchaser of the property who gave full value for the property, and had no notice of the trust imposed on the property.[91] Contract duties are only promise-based, and their remedies are unlikely to include resulting trust.[92]

Courts are far more inclined to follow and enforce the terms of contracts and less inclined to create a contract among the parties.[93] "Hard bargains" are enforced in contract[94] but far less likely in fiduciary law. Fiduciary duties are judge-made, based on the judges' interpretation and evaluation of the parties' terms. Even today, after the onslaught of contractarianism on fiduciary law, and

91. York v. Jones, 717 F. Supp. 421, 425 (E.D. Va. 1989) (a bailment (entrusted property) imports the obligation, express or implied, that the property will be held in trust until the bailor (entrustor) reclaims it); Kotis v. Nowlin Jewelry, Inc., 844 S.W.2d 920, 923 (Tex. App. 1992) (a good faith purchaser can claim ownership to property as long as he actually and honestly believed he was buying the property from the owner. A good faith purchaser is someone who gave value for the property and believed the seller was the owner); U.C.C. § 2-403 (2004) ("A person with voidable title has power to transfer a good title to a good-faith purchaser for value.").

92. Tamar Frankel, Trust and Honesty: America's Business Culture at a Cross Road 123 (2006) (in a contract relationship, a trusted party is neither a fiduciary nor a trustee to the money he receives in an exchange. He has the right to money he receives and can use the money for his own benefit).

93. Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. Pa. L. Rev. 1619, 1650 (2001) ("judges enforce contracts according to their terms"); *see also* Fleetwood Enters. Inc. v. Gaskamp, 280 F.3d 1069, 1076 (5th Cir. 2002) (stating a court will not create a third-party contract by implication).

94. See Tamar Frankel, Essay, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U.L. Rev. 389, 395 (1993) ("'Hard bargains' are enforced'" so long as the initial bargain met the traditional conditions for contract formation.") (footnotes omitted).

the search for what the parties would have agreed upon had they known about the new circumstances that resulted in conflict, judges exercise more discretion in presuming the parties' agreements and producing judge-made fiduciary rules. Most importantly, fiduciary law assumes that fiduciary relationships are fair; fiduciaries are presumed to be reliable and truthful.[95] No such presumptions are made in contract law.

Breaches of fiduciary duties as well as contract obligations can result in damages. However, it is unlikely that damages for breach of fiduciary obligations will be limited by the theory of "efficient breach."[96] Such breach does not involve any wrongful intent or action. One commentator suggests that some breaches of contract are "voluntary but . . . efficient,"[97] suggesting "that it is not the policy of the law to compel adherence to contracts, but only to require each party to choose between performing in accordance with the contract and compensating the other party for any injury resulting from a failure to perform."[98]

Some actors may be deterred from following "efficient breach approach." The deterrent, however, is not in the law. It may be in shame and moral level of the community. A situation that is analogous to an "efficient breach" is the home mortgage holder whose mortgage balance is higher than the value of their home, who would benefit by not paying the debt, but such individuals may be deterred from so doing by a belief that it is morally wrong not to repay a debt.[99]

In addition, breach of fiduciary duties can involve accounting for profits, somewhat similar to restitution under contract law.[100] However, in contrast to

95. Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. Rev. 591, 600 (2001) ("[F]iduciary duty must rely on the willingness of business actors to trust and be trusted.").

96. A. Mitchell Polinsky, An Introduction to Law and Economics 31–34 (2d ed. 1989).

97. Richard A. Posner, Economic Analysis of Law 119 (2007); *see id.* at 119–20 (providing examples)

98. *Id.* at 119 (citing Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 462 (1897)).

99. *See* Brett Arends, *When It's OK to Walk Away from Your Home*, WSJ.com, Feb. 26, 2010, http://online.wsj.com/article/SB10001424052748703795004575087843144657512.html (suggesting that mortgage holders who owe more than the property is worth "walk away" from their debts; stating that "many . . . are held back by a sense of morality," "feel it's wrong to abandon their obligations," and "don't want to be a deadbeat"; but noting that companies often file for bankruptcy and do not have to repay their debts).

100. 2 Alan R. Bromberg & Larry E. Ribstein, Bromberg & Ribstein on Partnership § 6.07(i), at 6:92 (1991) ("[T]he remedy for breach of fiduciary duty provided for . . . is an accounting for the benefit derived, which may be enforced by an action for accounting."); Sandra K. Miller, *What Remedies Should Be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 Am. L. Rev. 465, 479 (1994) ("The primary remedy for enforcing the rights and duties of partners, and for a breach of fiduciary duty, is an action for an accounting.").

contract law, breach of fiduciary duties may result in punitive damages in egregious cases. In that respect fiduciary law abuts the law of torts.[101]

A fiduciary is expected to control the temptation to take what is not his, even when there are no police around.[102] In contrast, a contract party is allowed or perhaps encouraged to maximize his own interests and fend for himself against the other party's attempt to maximize its own interests. As the saying goes, a complaining contract party "made its bed and must sleep in it." This saying does not apply to an entrustor.

In contrast to contract law, a moral taint of violating fiduciary duties appears in many areas of the law. For example, in bankruptcy proceedings, a fiduciary who fails to pay investors—the partners who financed his venture—will not be discharged from paying his debt to the entrustors.[103] Similarly, the U.S. Sentencing Guidelines[104] authorize a court to apply sentencing enhancement to egregious crimes. This enhancement was applied to a person who over the course of a number of years defrauded investors by misappropriating their money for his personal use. The court applied the Sentencing Enhancements to the accused offense level.[105]

In contrast "[c]ontract law is at least formally strict liability." A party may be "liable for a contract breach even if he is not at fault and made every effort to perform the contract as promised."[106] Perhaps for this reason, a breach of contract carries less stigma as compared to a violation of criminal law and some forms of tort liability. As Lon Fuller noted: Although "there is an element of social condemnation in almost all adverse legal judgments, . . . [t]o be found guilty of negligent driving or of breaking a contract does not carry the stigma of a criminal conviction."[107] "Apart from exceptional cases of punitive damages, Anglo-American theory treats contract breach as an amoral act, thereby relieving the non-performing party from guilt, shame, and the stigma of moral disapproval."[108] Punitive damages are ordinarily not awarded in contract.[109]

101. Rafael Chodus suggests that fiduciary law is indeed part of tort law.

102. *See* Tamar Frankel, Trust and Honesty: America's Business Culture at a Cross Road 122–24 (2006) (it is costly and inefficient for the client to be involve in a fiduciary's every move, so the fiduciary must act in the client's best interest even when he is not being watched).

103. Lewis v. Scott (*In re* Lewis) No. 94-15516, 97 F.3d 1182 (9th Cir. 1996).

104. U.S. Sentencing Guidelines Manual, §3E1.1 (Nov. 2005).

105. United States v. Iannone, 184 F.3d 214 (3d Cir. 1999); U.S. Sentencing Guidelines Manual §§ 3A1.1, 3B1.3, 5K2.0.

106. Dan B. Dobbs, The Law of Torts § 2, at 5 (2000).

107. Lon L. Fuller, *The Adversary System*, *in* Talks on American Law 30, 38–39 (Harold J. Berman ed., 1961).

108. Alexander J. Bolla, Jr., *The (Im)Probable Future in Japanese Charter Parties: The Language of Law*, 29 J. Mar. L. & Com. 107, 112 (1998).

109. 3 E. Allan Farnsworth, Farnsworth on Contracts § 12.8, at 194 (3d ed. 2004).

However, they have been awarded "for a breach of contract that is in some respect" a civil wrong.[110]

The consequences of the sub-categorization of fiduciary law into contract is not only to reduce the duties of fiduciaries to the contractual level but also to water down the remedies on their breach-avoiding punitive damages and lift the stigma that is attached to breach of trust (a stigma attached to a thief that was trusted). Finally, an important reason to treat fiduciary law as a distinct body of law is the growing need for regulating fiduciary relations.[111] After a long period of negation,[112] recognition of the importance of singling out fiduciary relationships is emerging again.[113]

4. Reasons for Recognizing Fiduciary Law as an Independent Legal Category

The debate over the status of fiduciary law leads to practical results as well as theory. First and foremost, contract would relieve fiduciaries of certain duties, or, at the very least, water down some duties, such as the duty to act solely for the benefit of the entrustors. These fiduciaries may act for the best benefit of the entrustors as well as themselves or others. The result of re-categorizing fiduciaries as contract parties leads to educating and requiring entrustors to fend for themselves. Entrustors might have to combine and create a counter-power to those who control their entrusted property or power. This solution, however, does not fully solve the problem. If management controls, and shareholders-entrustors unite, to gain counter-power, individual entrustors must select an agent to represent them and this agent would control the fate of their assets.

In addition, if managers are free of controls by the courts or Congress or other government regulators, what might emerge is what some call "managerial capitalism."[114] A new kind of property rights, denoting not owners but those who control money or power entrusted to them by other people, regressing to the Middle Ages when "office" was deemed property.[115]

110. *Id.* at 196.

111. Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795, 804–07 (1983) (abridged and footnotes omitted).

112. Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression 45–46 (2009).

113. *Id.* at 290–303 (discussing the possible areas of improvement in banking regulation); Dept. of the Treasury, Financial Regulatory Reform: A New Foundation 71 (2009) (proposing that SEC should "establish a fiduciary duty for broker-dealers offering investment advice and harmonize the regulation of investment advisers and broker-dealers").

114. *See* Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 Bus. Law. 59 (1992) (noting that "the historian Alfred Chandler declared in 1977 that America had created a system of 'Managerial Capitalism'").

115. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1272 (1995) (citing 2 Sir William Blackstone, Commentaries 36).

Finally, as diverse as fiduciary law is in terms of the contexts in which it arises, this area of the law is quite cohesive in terms of the problems it addresses, the principles it establishes, and the solutions it mandates. Most of all, this area of law takes into account the balance of power among the parties and society's needs in maintaining fiduciary relationships.[116] Moreover, in a changing environment, a principled and analytic view of a "grab bag" of different fiduciaries helps apply and shape fiduciary rules to new situations or to relieve existing situations from the burdens of legal restrictions. Such a view may help predict who the new members in the fiduciary family are likely to be, and which of the existing ones will die out.

5. Fiduciary Law as a Civil Wrong (Tort)

Fiduciary law may be viewed as a civil wrong, and some have argued that historically, it was deemed to be a civil wrong. And yet, the similarities do not seem sufficiently strong to trump the existence of fiduciary law as a separate legal category. Such a view might result in imposing draconian remedies on fiduciaries. The fact that fiduciary law may have had its sources in civil wrongs is not decisive today. While the problems of the past exist today the approaches and limitations of the past are not necessarily appropriate today. The following is a list of the similarities and differences between these two legal categories.

a. Similarities between Civil Wrongs and Fiduciary Relationships Like fiduciary rules, many, but not all, tort rules are default rules,[117] that can be negotiated away.[118] In addition, tort remedies, like fiduciary remedies, are not limited to actual damages. In cases of egregious tort, the injuring parties can be charged with punitive damages—money punishment. These two threads bind fiduciary law with tort law.

b. Differences between Tort Law and Fiduciary Law Civil wrongs and fiduciary relationships are quite distinct. While fiduciary relationships aim at benefiting both parties, and only violation of the terms of the relationship produces harm to one of the parties, tort law is focused on injuries that one party inflicts on another.[119]

In addition, tort "relationship" is not consensual. An injured party is not assumed to have agreed to the injury in advance. To be sure, under some economics theory, which seeks to wrap all relationships in consent (contract), the rules and remedies of civil wrongs reflect the presumed agreement between the injured party and the injuring party on the amount of damages that the injuring party should pay the injured, if and when injury occurred.[120] However, the rules apply to all parties even though some may agree to receive more compensation than others for the injuries they might sustain. And even with respect to one pair of actors, it is difficult to determine what the parties would have decided had they had proper foresight. And even if the terms of the agreement were known before the fact, these terms might change after the injuries were sustained. In addition, this view of tort imposes the one-to-one relationship and agreement as a model for rules to govern society. Yet, society's interests may differ from the interests of the tort victims.

6. Concluding the Debate

There are two main views that attack the integrity of fiduciary law as a separate legal category. One reclassifies fiduciary law as contract. The second moves to the other extreme, and views fiduciary law as a civil wrong—a tort.

Alternatively, we might consider the environment and the problems that are not satisfactorily solved by other branches of the law. This approach leads to viewing fiduciary law as special, addressing specific problems in its unique way. As frayed as its edges are, this approach offers a guide to resolving similar social problems that have existed for thousands of years in a very similar way, subject

116. For example, both trustees and corporate directors manage other people's money. Trustees receive the money or assets under directions to manage and distribute the assets in specific ways for specific recipients. Their power is more limited by the trust instrument, but they have more freedom from supervision. Directors have more power and discretion to manage the corporation but the shareholders choose the directors, at least under the law, and can remove or avoid re-electing them. In addition, shareholders can liquidate their investments more easily than beneficiaries usually can. A comparison between these two fiduciaries helps understand each of them and the rules that govern them. The seemingly disparate rules, which apply to the different types of fiduciaries, are in fact consistent with one another. Viewing all types of fiduciaries together makes it easier to rationally design different rules that apply to each. If we deal with each situation separately, in different legal categories, the meaning of, and need for, fiduciary law, its underlying principles, and the arguments about them, are hard to grasp and harder to remember. If we view all fiduciaries together, then fiduciary rules make far more sense and are easier to understand, to evaluate and to criticize.

117. RESTATEMENT (SECOND) OF TORTS § 892A (1979) (injured parties may not waive tort rules if they are mentally incompetent, if they are a child, or if a statute expressly bars waiver. An example of such a statute would be one restricting child labor).

118. E. Haavi Morreim, *Cost Containment and the Standard of Medical Care*, 75 CAL. L. REV. 1719, 1752 (1987) (discussing how courts do not allow patients to negotiate away a physician's set standard of care because it is contrary to public policy and inappropriate for a responsible and learned profession.).

119. 22 AM. JUR. 2d § 28 *Torts* (2d ed. 2008) ("The sole object of compensatory damages [in tort law] is to make the injured party whole for losses actually suffered.").

120. Contemporary tort law scholarship draws on economic theories and incentives, and on the imposition of damages. Under these theories tort law reflects the agreement between the injured party and the injuring party on the amount of damages that the injuring party should pay the injured. The problem is to figure out what the parties would have decided had they had proper foresight. Even if we knew the agreement before the fact it might be different after the injurious fact. In addition, this view of tort imposes the one-to-one relationship and agreement as a model for rules to govern society. That may be questionable.

to a different environment and public mores. The "problem" approach not only helps identify the members of the fiduciary category, but also leads to establishing their similarities and distinctions, and rationalizing the rules that should govern them. Thus, some situations may fall outside the fiduciary law category, but if such situations evolve to present serious social problems they may be brought into the fiduciary category at that point. If, however, other fiduciary duties rarely present problems over time, they may be shifted to the contract category. Yet, the move of situations at the fringes of a category does not determine the validity of the category's existence.

6. THE COURTS' REGULATION OF FIDUCIARIES, REMEDIES, AND PROCEDURES

A. INTRODUCTION

This chapter covers three related subjects. The first is the extent to which the courts use their discretion to recognize fiduciary relationships and shape fiduciary rules. The prior materials demonstrated some courts' "activism" and other courts' "conservatism" in shaping the law. In this chapter we view the rules that courts employ to both expand and limit the use of their own discretion. Courts may impose fiduciary duties to protect public interest, like public health. On the other hand, courts may limit their exercise of judicial discretion in the area of the fiduciaries' expertise, especially if the entrustors themselves have chosen the fiduciaries.

The second part of the chapter surveys the remedies for breach of fiduciary duties.[1] Throughout this Book we have touched on the subject of remedies. Here we return to focus on the remedies and their distinctive character. Like fiduciary law generally, the remedies for breach of fiduciary duties draw on other branches of the law, and add their own flavor and emphasis, addressing misappropriation of entrusted property and power.

The third part of this chapter covers the courts' procedures that distinguish between equity and the common law. This part notes the historical judicial sources of the English common law and equity courts and the American courts' adaptation of these sources as applied to fiduciary law.

B. COURTS' USE OF JUDICIAL DISCRETION

The courts' intrusion into fiduciary relationships varies depending on the degree of the courts' policy of "activism,"[2] the type of fiduciaries, and the context in which the courts are asked to interfere. Another aspect of judicial intervention involves the maintenance of social mores. For those who believe that what is good for the parties is not always good for society as a whole, fiduciary rules are

1. *See generally* DAN B. DOBBS, LAW OF REMEDIES (2d ed. 1993); HOMER H. CLARK, JR., THE LAW OF DOMESTIC RELATIONS IN THE UNITED STATES (2d ed. 1988).

2. TAMAR FRANKEL, FIDUCIARY LAW 237 (2007) (noting authorities that demonstrate courts' varying degrees of activism).

necessary to trump the parties' agreements that might conflict with the social good.[3] In fact, courts follow these approaches, at different times or in different contexts.

1. Judicial "Activism" and Self-Limitation

There are periods in which courts impose on fiduciaries higher standards of behavior, and other periods in which they relax the limitations. For example, in 1928 Justice Cardozo, addressing the duties of co-adventurers, wrote his famous statement: "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 [fiduciary] is held to something stricter than the morals of the market place."[4] In 2005 the Delaware court, addressing the duties of corporate directors and officers, held that market corporate practice is stricter than the courts' law that imposes on corporate fiduciaries the duty of care, mixed with some ingredients of self-interest.[5] Similarly, while the Seventh Circuit has taken a strict interpretation of the very nature of fiduciary rules, equating them to contract with a duty to disclose,[6] the Eighth Circuit has taken a far more intrusive approach.[7] The Supreme Court adopted the view of the Eighth Circuit and other courts, recognizing specific factors to determine the fiduciary duty standard.[8]

3. *Id.* at 238–40 (quoting Greisman v. Newcomb Hosp., 192 A.2d 817, 823 (N.J. 1963)) (noting that court factored public interest into organization's duties).

4. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

5. *In re* Walt Disney Co. Derivative. Litig., 907 A.2d 693 (Del. Ch. 2005). *See also* Tamar Frankel, *Court of Law and Court of Public Opinion: Symbiotic Regulation of the Corporate Management Duty of Care*, 3 N.Y.U. J. L. & Bus. 353 (2007). Further, by declaring a relationship to be fiduciary, the courts shift to the entrustors the beneficial ownership in the subject matter property or power. The shift of the property entitlement enables the court to award fiduciary law remedies, broader than contract remedies. The classification of a person as a fiduciary limits the fiduciary's use of entrusted power. If the beneficial ownership does not "belong" to the fiduciary, the fiduciary can deal with the property only according to the terms of the delegation of power and for the entrustor's benefit.

6. Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir.), *reh'g denied, reh'g en banc denied*, 537 F.3d 728 (7th Cir. 2008), *vacated, remanded*, No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).

7. Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 822–23 (8th Cir. 2009). *See also* Dennis Honabach & Roger Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 Chi.-Kent L. Rev. 681 (1989) ("Judge Cudahy implicitly adopted a method of legislative interpretation that reflects the 'liberal purposive' technique. That is, he employed a mode of statutory analysis which holds that in interpreting legislation a court should not limit itself to the statutory text. Rather, Judge Cudahy reasoned, a court should be informed by an expansive review of the legislative context in which the act was passed as well as the structure, purpose, and history of the statutory scheme. Such a broad based review, he believed, is necessary if the court is to discover the complete intent of Congress") (footnote omitted).

8. Jones v. Harris Assocs. L.P., No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).

The courts refrain from freely interfering in the decisions of fiduciaries in detailed everyday-management of organizations and in "intra-association disputes about whether certain conduct breaches an association's bylaws unless that conduct 'plainly contravenes' the association's bylaws."[9] This self-restraint demonstrates judicial self-limitations in exercising their supervision over fiduciaries' decisions.[10] The rule has appeared under different names. It has been named the Business Judgment Rule, while the Supreme Court of California has applied an "abstention doctrine" with a similar result. "In many disputes in which such rights and duties are at issue, however, the courts may decline to exercise jurisdiction. Their determination not to intervene reflects their judgment that the resulting burdens on the judiciary outweigh the interests of the parties at stake. One concern in such cases is that judicial attempts to construe ritual or obscure rules and laws of private organizations may lead the courts into what Professor Chafee called the 'dismal swamp.' Another is with preserving the autonomy of such organizations. . . . 'in adjudicating a challenge to the society's rule as arbitrary a court properly exercises only a limited role of review.'" The court should not substitute its judgment for that of the society, which has more competence on the matter than the court. Interference is justified if the society's management clearly acted in violation of its bylaws. "Courts must guard against unduly interfering with an organization's autonomy by substituting judicial judgment" for the organization's decisions.[11]

Courts recognize that in most cases fiduciaries were chosen by the entrustors, and that often the fiduciaries have significant expertise in performing their services. Therefore, so long as there is no evidence that the fiduciaries have acted in violation of their fiduciary duties,[12] the courts apply a "hands-off" attitude to the fiduciaries' decisions.

However, when the fiduciaries' actions are devious and self-interested the courts will interfere. For example, one court interfered in the actions of a board of directors designed to use bankruptcy proceedings in order to cause the corporation to breach its contract of sale.[13] Similarly, courts might be more intrusive in

9. Oakland Raiders v. Nat'l Football League, 32 Cal. Rptr. 3d 266 (Ct. App. 2005) (citations and footnote omitted).

10. *See* Stephen A. Radin, The Business Judgment Rule (2009); Selectica, Inc. v. Versata Enters., Inc., No. 4241-VCN, 2010 Del. Ch. LEXIS 39 (Del. Ch. Feb. 26, 2010) (deferring to the board of directors' establishing a poison pill to deter a takeover and focusing on the board's documentation and good faith).

11. Cal. Dental Ass'n v. Am. Dental Ass'n, 152 Cal. Rptr. 546, 550 (Cal. 1979) (citing, quoting authorities). *See also* E. Norman Veasey and Christine T. Di Guglielmo, *What Happened In Delaware Corporate Law And Governance From* 1992–2004? *A Retrospective on Some Key Developments*, 153 U. Pa. L. Rev. 1399 (2005).

12. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

13. Bal Harbor Club, Inc. v. AVA Dev., Inc. (*In re* Bal Harbor Club, Inc.), 316 F.3d 1192 (11th Cir. 2003) (some footnotes omitted) (citations omitted) ("A court will not call upon a

the cases of corporate takeover. Such situations can raise conflicts of interest because the fortunes of the board of directors and management may be at stake. In addition, the impact of these transactions on the shareholders is very great. Hence the Business Judgment Rule plays a lesser role in these cases.[14]

However, unincorporated entities such as partnerships, and entities such as limited partnerships are usually subject to a more ambiguous Business Judgment Rule. In addition, some courts give credence to the agreement among the parties.[15] These courts' approach could be part of the movement toward the viewing of fiduciary relationships as contracts, or to rely on the markets' constraints over fiduciaries. In these cases the entrustors may be more involved in the management of the enterprise, for example, as partners. Even in the case of limited partnerships, the number of the limited partners could be (although not necessarily is) small, and their contacts with, and influence on, the fiduciary managers are more frequent. Thus, entrustors are more likely to receive increasingly frequent information about the enterprise, and the agreements among the parties is more likely to be negotiated rather than signed on a "take it or leave it" basis, as would corporate shares "contracts."

2. Factoring in Public Interest

In some cases the courts impose on persons or entities fiduciary duties to society. *Greisman v. Newcomb Hospital* demonstrates this approach.[16] In this case, a qualified physician was denied user-privileges at a private hospital—the only hospital near his home and practice. The hospital's denial was based on the reason that the physician graduated from a school that was not approved by the American Medical Association and was not a member of the County Medical Society—two conditions required under the hospital's bylaws. But many professional medical associations accepted physicians whose backgrounds were similar to that of the physician. The court held that the bylaws of the hospital conflicted with the State's public policy. And although the hospital was a private hospital that could operate at its discretion, its position as the only hospital in the physician's area within at least one hundred miles, and its services concerning

director to account for his action in the absence of a showing of abuse of discretion, fraud, bad faith, or illegality." But this was not such a case and the court interfered).

14. *See*, e.g., Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003), *courts and fees proceeding*, *In re* NCS Healthcare, Inc., 2003 Del. Ch. LEXIS 56 (Del. Ch. May 28, 2003) and cases cited in this decision.

15. Elizabeth S. Miller & Thomas E. Rutledge, *The Duty Of Finest Loyalty And Reasonable Decisions: The Business Judgment Rule In Unincorporated Business Organizations?*, 30 DEL. J. CORP. L. 343 (2005).

16. Greisman v. Newcomb Hosp., 192 A.2d 817 (N.J. 1963) (abridged and citations omitted).

people's health, imposed upon it additional duties, including acceptance of the plaintiff.

The *Greisman* court's views of its role in the development of fiduciary law are instructive:

> The persistent movement of the common law towards satisfying the needs of the times is soundly marked by gradualness. Its step by step process affords the light of continual experience to guide its future course. When courts originally declined to scrutinize admission practices of membership associations they were dealing with social clubs, religious organizations and fraternal associations. Here the policies against judicial intervention were strong and there were no significant countervailing policies. When the courts were later called upon to deal with trade and professional associations exercising virtually monopolistic control, different factors were involved. . . . [Where a case involves] sufficiently compelling factual and policy considerations, judicial relief will be available to compel admission to membership. . . .[17]
>
> In this day there should be no hesitancy in rejecting as arbitrary, the stand that a doctor of osteopathy, though fully licensed by State authority and reputably engaged in the general practice of medicine and as the local school and plant physician, is nonetheless automatically, and without individual evaluation, to be considered unfit for staff membership at the only available hospital in the rather populous metropolitan area where he resides and practices. The public interest and considerations of fairness and justness point unerringly away from the hospital's position and we agree fully with the Law Division's judgment rejecting it. . . .
>
> . . . [H]ospitals are operated not for private ends but for the benefit of the public, . . . their existence is for the purpose of faithfully furnishing facilities to the members of the medical profession in aid of their service to the public. They must recognize that their powers, particularly those relating to the selection of staff members, are powers in trust which are always to be dealt with as such. While reasonable and constructive exercises of judgment should be honored, courts would indeed be remiss if they declined to intervene where, as here, the powers were invoked at the threshold to preclude an application for staff membership, not because of any lack of individual merit, but for a reason unrelated to sound hospital standards and not in furtherance of the common good.[18]

A conflicting approach was adopted by a court when the public good was gained at the expense of a child, subject to a non-therapeutic experiment to

17. *Id.* at 823 (citing Falcone v. Middlesex County Med. Soc'y, 34 N.J. 582, 597 (1961)).

18. *Id.* at 403–04.

reduce the cost of removing lead paint from old homes.[19] In that case, the public good did not trump the child's rights. The two cases can be distinguished. In the one, the public would have been deprived of the services of a qualified physician. In the second case, the public would have been deprived of benefits at the expense of exposing a child to serious health danger. The public's entitlement to benefit at the expense of an individual is far more limited.

C. REMEDIES PROVIDING RELIEF ON VIOLATIONS OF FIDUCIARY DUTIES

1. Introduction

How should remedies be discussed without repeating the legal rules whose violation triggers the remedies? One solution is to link the remedies to the severity of the risks that fiduciary relationships pose to entrustors and the alternative protections from these risks. Remedies are aimed at compensating the victims of wrongs as well as deterring the violators. This approach helps generalize the large number and variations of remedies and explain their rationale in general terms. In addition, this approach can help rationalize and guide the appropriate scope of the applicable remedies.[20] In addition, remedies are not unique to violations of fiduciary law neither do courts single out one type of remedy for a violation. Damages can be coupled with an injunction prohibiting future behavior in a certain way and accounting for profits as well.

The source of remedies on violations of fiduciary law can be found in remedies applicable to breach of contract (e.g., damages)[21] and torts (e.g., punitive damages). In this chapter there is no detailed analysis of the differences among the remedies but rather a mention of their source for the reader that seeks a more detailed discussion. However, the difference between legal and equitable remedies is recognized in more detail, because of its procedural consequences.

Finally, there are remedies that do not address past violations of fiduciary law, but aim at possible future wrongful or unfair behavior. In these situations legitimate holding of property is viewed as entrusted property and the appropriate remedies are applied. In fact, wrongful behavior is created by the continued previous legitimate holding of property under changed circumstances.

19. Grimes v. Kennedy Krieger Inst, Inc., 782 A.2d 807, 823–25 (Md. 2001), *reconsideration denied,* (Oct. 11, 2001) (in this case the child's mother signed a consent to periodic examinations of the child. Cases in which adults have clearly agreed to non-therapeutic experiments may be distinguished from the case of the child).

20. Dan B. Dobbs, Law of Remedies § 1.1, at 1–2 (2d ed. 1993).

21. *Id.* at 3 ("The damages remedy is a money remedy aimed at making good the plaintiff's losses."). *Id.* at 9 (historically damage remedies were considered legal while coercive remedies such as injunctions were deemed equitable).

2. Remedies for Breach of Fiduciary Duties: Courts' Approach

The courts view remedies for breach of fiduciary duties more strictly than they view breaches of contract. Drawing on the origin and source of equity a court's approach to remedies for breach of fiduciary duties is demonstrated in the following case. When the corporate president and treasurer committed multiple breaches of their fiduciary obligations wasting corporate assets and a former director had breached his duty to the corporation, the court wrote: "In determining the appropriate remedy to resolve dissension in a closely held corporation, a court must consider the reasonable expectations of the aggrieved shareholders and the best interests of the corporation. There is no adequate remedy at law to compensate the shareholders for the [the defendant's conduct of thoroughly looting the corporation which he controlled]."[22]

3. Injunction

An injunction can be used to require the defendant to act in a certain way, or to refrain from acting in a certain way. Thus, the Third Circuit upheld an injunction reinstating a medical plan for plaintiffs. The court held that enjoining changes to the plan did not exceed the remedial authority under ERISA Section 502(a),[23] which permits equitable relief. And because the injunction concerns a future and uncertain amount of money rather than a past due amount, the injunction is equitable rather than legal in nature.[24] ERISA has adopted a similar approach to cover both uses of an injunction. Section 502(a)(3) of ERISA provides that "a participant, beneficiary, or fiduciary" may "enjoin any act or practice which violates any provision of this subchapter or the terms of the plan" or "to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this subchapter or the terms of the plan."[25] The legislative history of the statute states that "appropriate equitable relief" may include "injunctions . . . to prevent a violation of fiduciary duty."[26]

22. "Declaratory relief is appropriate where: 1) an actual controversy has arisen in the case presented; 2) the plaintiffs have an interest therein; and 3) and the granting of declaratory relief will terminate the controversy." *Id.*

23. 29 U.S.C. § 1132(a)(3) (2006).

24. Adair v. Unisys Corp. (*In re* Unisys Corp. Retiree Medical Benefits ERISA Litig.), 579 F.3d 220, 236–37 (3d Cir. 2009), *cert. denied,* No. 09-789, 2010 U.S. LEXIS 1208 (U.S. Feb. 22, 2010); 29 U.S.C. § 1132(a)(3) (2006) (Section 502(a)(3) of ERISA provides that "a participant, beneficiary, or fiduciary" may "enjoin any act or practice which violates any provision of this subchapter or the terms of the plan" or "to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this subchapter or the terms of the plan").

25. 29 U.S.C. § 1132(a)(3) (2006).

26. S. Rep. No. 93-383, at 105–06 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4890, 4989, *quoted in* Novak v. Andersen Corp., 962 F.2d 757, 760 (9th Cir. 1992). A district court found that separate state law claims for "breach of fiduciary duty" and "accounting and

Similarly, Section 21(d) of the Securities Exchange Act of 1934 authorizes the Securities and Exchange Commission to seek judicial injunctive relief against a party that has violated or is about to violate a provision of the Act or its rules or regulations, to enjoin the relevant acts or practices.[27] In such a proceeding the Commission may prohibit any person who has violated section 10(b) of the Act[28] or its rules or regulations from serving as officer or director of any issuer with securities registered under the Act or subject to its reporting provisions "if the person's conduct demonstrates unfitness to serve as an officer or director of any such issuer."[29]

In *E. I. Du Pont de Nemours Powder Company*, the court issued an injunction to prohibit a former employee from using the company's trade secrets.[30] Similarly, departing employees might be prohibited from enticing the employers' customers to join the employees' new business, but the enticement must be clear and unambiguous.[31] Similarly, a manufacturer and seller of printing equipment was granted an injunction against a competitor, prohibiting the competitor's use of misappropriated trade secret information.[32] In the corporate area, a court upheld an injunction against the director and officer of a corporation who violated his fiduciary duty to the corporation by entering a competing business and misappropriating opportunities in the same line of business. The injunction prohibited the director and officer from continuing to compete.[33] "[I]njunctive relief may be the only relief reasonably available to shareholders for certain

injunction" arising from the same conduct as ERISA claims were preempted by ERISA. Elmore v. Cone Mills Corp., No. 6:88-3258-17, 1990 U.S. Dist. LEXIS 15347, at *26–31 (D.S.C. Aug. 13, 1990).

27. 15 U.S.C. § 78u(d)(1) (2006); *see* SEC v. Goldinger, No. CV-91-3445 JMI (GHKx), 1995 U.S. Dist. LEXIS 22168 (C.D. Cal. May 12, 1995) (finding evidence insufficient to support violation).

28. 15 U.S.C. § 78j (2006).

29. 15 U.S.C. § 78u(d)(2) (2006).

30. E.I. Du Pont de Nemours Powder Co. v. Masland, 244 U.S. 100 (1917); DK Prods., Inc. v. Miller, Case No. CA2008-05-060, 2009 WL 243089 (Ohio Ct. App. 12 Dist. Feb. 2, 2009) (appellate court upheld a lower court's injunction against two former employees and their new employer in light of defendants' apparent breach of duty of loyalty, misappropriation of trade secrets, and tortious interference with business relations).

31. Baker v. Battershell, No. 5, 1986 Tenn. App. LEXIS 3124 (Ct. App. July 9, 1986) (injunction against employees who left their employer is more limited. The employer was denied an injunction against departing employees even though they informed clients that they were leaving and took customer lists. The court found no compensable breach of fiduciary duty where the employees did not actively solicit business or attempt to harm the employer and the customer lists were easily ascertainable information).

32. Rockwell Graphic Sys. v. DEV Indus., Inc., 91 F.3d 914, 917–18 (7th Cir. 1996).

33. Sequoia Vacuum Sys. v. Stransky, 40 Cal. Rptr. 203 (Ct. App. 1964).

breaches of fiduciary duty in connection with a sale of control transaction."[34] A preliminary injunction can be imposed upon breach of fiduciary duty, copyright infringement, and other claims.[35]

Under contract law a court may grant an injunction against breach of a contract duty "if the duty is one of forbearance"[36] that is a prohibition on "an inconsistent action."[37] Thus, an injunction is not granted if damages are adequate to protect the injured party's expectation damages.[38] In determining adequacy of damages, there are three principal factors: "(a) the difficulty of proving damages with reasonable certainty, (b) the difficulty of procuring a suitable substitute performance by means of money awarded as damages, and (c) the likelihood that an award of damages could not be collected."[39] Traditionally, injunctions have been subject to equitable defenses such as laches and "unclean hands."[40]

An injunction award may be refused if "unfair" because "(a) the contract was induced by mistake or by unfair practices, (b) the relief would cause unreasonable hardship or loss to the party in breach or to third persons, or (c) the exchange is grossly inadequate or the terms of the contract are otherwise unfair."[41] It may be denied if it would be contrary to public policy[42] or if judicial enforcement or supervision would be disproportionately burdensome.[43]

4. Constructive Trust

a. A Constructive Trust is a Remedy. It Does Not Create a Fiduciary Relationship[44] "A constructive trust is not a true trust: . . . it does not impose extensive fiduciary duties on the trustee, but only the duty to make restitution."[45] In fact, the "constructive trustee" denies that the constructive trustee has any duties to the entrustor. A constructive trust is "[a]n equitable remedy that a court imposes against one who has obtained property by wrongdoing. . . . 'When property has

34. Police & Fire Ret. Sys. of Detroit v. Bernal, No. 4663-CC, 2009 WL 1873144, at 3 (Del. Ch. June 26, 2009) (noting that and citing to Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243–44 (Del. 2009), which found that a plaintiff faces a significant burden in showing that a board acted in bad faith by failing to reasonably inform themselves or otherwise carry out their fiduciary duties in a sale of control).

35. PFS Distribution Co. v. Raduechel, 2009 WL 2225812 (8th Cir. July 28, 2009).

36. Restatement (Second) of Contracts § 357(2)(a) (1981).

37. Restatement (Second) of Contracts § 357 cmt. b (1981).

38. Restatement (Second) of Contracts § 359(1) (1981).

39. Restatement (Second) of Contracts § 360 (1981).

40. Restatement (Second) of Contracts § 357 cmt. c (1981).

41. Restatement (Second) of Contracts § 364(1) (1981).

42. Restatement (Second) of Contracts § 365 (1981).

43. Restatement (Second) of Contracts § 366 (1981).

44. Black's Law Dictionary 1649 (9th ed. 2009).

45. United States v. Fontana, 528 F. Supp. 137, 143 (S.D.N.Y. 1981) (citing 5 Scott, Trusts § 462.4 (3d ed.)).

been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee.'"[46] It is a remedy for a wrongful act,[47] which requires enforcement of breached obligations rather than payment of damages. This remedy usually depends on whether the defendant was unjustly enriched.[48] Therefore, the intent of the parties in such a case is not significant. Rather, the emphasis of a constructive trust is on its remedial purpose.[49]

Constructive trust arises when "for any reason, the legal title to property is placed in one person under such circumstances as to make it inequitable for him to enjoy the beneficial interest, a trust will be implied in favor of the persons entitled thereto. This arises by construction of equity, independently of the intention of the parties. Equity will raise a constructive trust and compel restoration, where one through actual fraud, abuse of confidence reposed and accepted, or through other questionable means, gains something for himself which, in equity and good conscience, he should not be permitted to hold."[50]

A constructive trust is a judicial declaration that the defendant, holding a certain property, holds only the legal title to the property, whereas the plaintiff is entitled to the beneficial ownership. Therefore, the court requires the constructive trustee to transfer the property to the beneficial owner as if the constructive trustee was in fact a trustee.

The remedy for breach of contract differs from the remedy for breach of fiduciary duties. The usual remedy for a breach of contract is the payment of damages rather than requiring the defendant to perform his specific duties under the contract and transfer particular property to the plaintiff. But if the injured party is entitled to land or unique property, the injured party may demand specific performance, that is, he may demand that the wrongdoer transfer to him

46. Black's Law Dictionary 1649 (9th ed. 2009) (citing Beatty v. Guggenheim Exploration Co., 122 N.E. 378, 380 (N.Y. 1919)).

47. Restatement (Third) of Trusts § 1 cmt. e (2003); Restatement (First) of Restitution § 160 (1935). The *Restatement (Third) of Trusts* does not apply to constructive trusts (unless an express trust is involved). The *Restatement (First) of Restitution* applies instead. Restatement (Third) of Trusts § 1 cmt. e (2003).

48. Nash v. Schock, No. 14721, 1997 Del. Ch. LEXIS 174 (Del. Ch. Dec. 3, 1997) (fiduciary is liable to the entrustors for improper gifts from the estate to itself and others. Gifts to the fiduciary must be clearly authorized. The court ordered a constructive trust against the fiduciary for active wrongdoing, and restitution against others, who were unjustly enriched, but who were not engaged in active wrongdoing).

49. Jennifer Liotta, Comment, *ERISA Fiduciaries in Bankruptcy: Preserving Individual Liability for Defalcation and Fraud Debts Under 11 U.S.C. 523(a)(4)*, 22 Bank. Dev. J. 725, 731 n.53 (2006).

50. Seventh Elect Church in Israel v. First Seattle Dexter Horton Nat'l Bank, 299 P. 359, 360 (Wash. 1931); *see also* Restatement (Third) of Trusts § 1 cmt. e (2003); Restatement (First) of Restitution § 160 (1937).

the land or other property, rather than the money equivalent.[51] The injured party may make a similar demand when the defendant is insolvent.[52]

When property was obtained in violation of fiduciary duties, specific enforcement is more readily granted, regardless of whether there is an adequate remedy at law; that is, regardless of whether money damages would be adequate.[53] A constructive trust remedy was imposed when there was a breach of fiduciary obligations. Thus, when a former Central Intelligence Agency employee divulged information in an unauthorized publication, the court found the former employee breached a fiduciary obligation, and "[t]he proceeds of his breach are impressed with a constructive trust for the benefit of the Government."[54] Similarly, when fiduciaries, in violation of their duties, acquire property, even with their own money, they are imposed with a constructive trust.[55] For example, agents, acting for their principals, discover an opportunity which is then appropriated by the agents, who acquire the property *with their own money*. These agents will be imposed with a constructive trust with respect to the acquired property.[56]

b. Property to Which Constructive Trust is Attached and the Effect of Entrustors' Consent Constructive trust that is attached to entrusted property may attach to any substituted property, even if the current holder of the property has not acted wrongfully.[57] The remedy for fraudulent transactions may apply to

51. Restatement (First) of Restitution § 160 cmt. e (1937).

52. *Id.* cmt. f.

53. *Id.* cmt. e; *see also*, e.g., Unicure, Inc. v. Thurman, 599 P.2d 925, 928 (Colo. Ct. App. 1979).

54. Snepp v. United States, 444 U.S. 507 (1980) (Lexis Syllabus); Restatement of Restitution § 190 (1937) ("Where a person in a fiduciary relation to another acquires property, and the acquisition or retention of the property is in violation of his duty as fiduciary, he holds it upon a constructive trust for the other."); *see also*, e.g., Gagnon v. Coombs, 654 N.E.2d 54, 63 (Mass. App. 1995) (agent who violated fiduciary duties to principal "stands as constructive trustee for [principal's] benefit" with respect to property involved) (citing Restatement)).

55. Restatement (First) of Restitution § 190 (1937).

56. 2 Restatement (Second) of Trusts 392 (1959) ("A constructive trust will arise . . . where a person in a fiduciary relation to another uses his own money in purchasing property in his own name if the purchase is in violation of his duty as fiduciary."); Restatement (First) of Restitution § 194(1) (1937) ("A fiduciary who purchases from a third person for himself individually property which it is his duty to purchase for the beneficiary holds it upon a constructive trust for the beneficiary.").

57. Simonds v. Simonds, 380 N.E.2d 189 (N.Y. 1978) (in a separation agreement with his first wife the decedent husband had promised to maintain insurance policies and name his first wife as the beneficiary. Upon the husband's death no policy existed and the first wife claimed a constructive trust on the proceeds of another insurance policy in which the beneficiary was the second wife of her former husband. The first wife won in recognition of a constructive trust—she had an equitable interest in the insurance policies of the second wife. The husband had a duty of fairness in financial matters toward the first

such transactions as well. Therefore, when an apartment complex was fraudulently obtained, and later exchanged for another property, the owners of the fraudulently-obtained property were "entitled to the imposition of a constructive trust" on the *exchanged property*.[58] However, a constructive trust will not be imposed on a vague one-sided "understanding" but only on a violation of a clear obligation.[59] In addition, the right to the remedy of constructive trust may be waived. Even an oral consent of an entrustor (principal) to his fiduciary agent's actions protects the agent from the imposition of a constructive trust (and perhaps from liability altogether).[60]

5. Accounting for Entrusted Money, and for Profits Made in Violation of Fiduciary Duties

a. Accounting and Accounting for Profits If fiduciary relationships arise from entrustment of assets, then accounting is a by-product of these fiduciary relationships. Therefore, accounting is a fiduciary duty. If the duty is not met, the court will require the defendants to account for the money or property that they hold as fiduciaries.

The remedy of accounting for profits is based on the principle that fiduciaries should never benefit from their wrongful acts. Just as the fiduciaries are prohibited from misappropriating entrusted property, they are prohibited from misappropriating the profits from entrusted property. The fiduciaries are no more entitled to these profits than to the entrusted property or power. Therefore, any profit derived from a breach of trust should be paid to the entrustor, even if the entrustor did not suffer damages from the fiduciary's breach of trust. Even though the profits may be due to the fiduciaries' efforts and talents, the profits do not belong to them, and a court may impose a constructive trust on the profits, and require the fiduciaries to account to the entrustor for all illicit profits.[61]

Profits can involve any form of asset. In the case of *Essex Trust Company*[62] a newspaper reporter who learned by eavesdropping that his employer wished to renew the lease of the property in which its business was being conducted secretly acquired the lease for himself. He was held to be a constructive trustee with respect to the lease, and was required to transfer the lease to his employer. The information the employee acquired and used had no connection with his duties as a newspaper reporter. Yet, "[w]hen, therefore, a person 'in a confidential or fiduciary position, in breach of his duty, uses his knowledge to make a profit for himself, he is accountable for such profit. . . .'"[63]

Insider trading in the securities area is an example of misappropriated entrusted information. The prohibition on this use of information by insiders is demonstrated in Rule 10b-5 under the Securities Exchange Act of 1934[64] and section 16 of the Securities Exchange Act of 1934.[65] Section 16 lists a number of insiders, such as directors, officers, and 10 percent shareholders who must account for their profits in selling or buying (or buying and selling) corporate equity securities within six months. Presumably, in the securities markets, in six months this information will become public. A related remedy to accounting for profit is forfeiture of fees. This remedy is imposed on attorneys who violated their duties.[66]

A breach of trust/loyalty can be remedied by holding the trustee accountable for profits, by surcharging the trustee for loss (as well as gain the trust has foregone). The trustee may also be subject to additional liability to prevent personal benefits.

If there is an inadequately priced trust sale but no self-dealing, the trustee is ordinarily accountable only for the difference between the received price and the adequate price. If the trustee sells property in violation of the directions he received, the beneficiaries are entitled to set aside the sale of its value at time of violative sale. If the trustee committed self-dealing, the beneficiary may recoup the property, or the value of the property at time of sale, regardless of whether the trustee was authorized to sell and whether the price was fair. For example, in the case of the *Estate of Rothko* the trustees sold paintings for inadequate prices. The trustees who sold in conflict of interest were required to pay for the paintings' value at the time of the diversion, while the disinterested executor was required to pay only the value of the paintings at the time of sale.[67]

If a trustee purchases trust property for his own account in violation of his duty of loyalty violation, the beneficiaries can affirm the purchase or reject it. If

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wife, and an obligation to name the first wife a beneficiary. Therefore, the first wife's equitable interest attached to all the substituted insurance policies. Another result would lead to the second wife's unjust enrichment, even if she did not perform any wrongful act).

58. Meadows v. Bierschwale, 516 S.W.2d 125 (Tex. 1974); Crossman v. Keister, 79 N.E. 58 (Ill. 1906) (constructive trust imposed on land that was transferred upon a fraudulent promise to a deceased).

59. Yamins v. Zeitz, 76 N.E.2d 769 (Mass. 1948).

60. Beatty v. Guggenheim Exploration Co., 122 N.E. 378 (N.Y. 1919) (such oral consent may be binding under contract law as well.

61. *See* Henderson v. Axiam, Inc., No. 96-2572-D, 1999 Mass. Super. LEXIS 580 (Mass. Super. Ct. June 22, 1999); *see also* Sommers v. Apalachicola Northern Railroad Co., 78 So. 25 (Fla. 1918) (accounting ordered against agents due to the number and complexity of the accounts).

62. Essex Trust Co. v. Enwright, 102 N.E. 441 (Mass. 1913).

63. Brophy v. Cities Service Co, 70 A.2d 5 (Del. Ch. 1949) (footnotes added) (citations omitted).

64. 17 C.F.R. § 240.10b-5 (2009).

65. 15 U.S.C. § 78p (2006); *see also* Brophy v. Cities Service Co, 70 A.2d 5 (Del. Ch. 1949) (citations omitted).

66. Jeffrey A. Webb & Blake W. Stribling, *Ten Years After* Burrow v. Arce: *The Current State of Attorney Fee Forfeiture*, 40 St. Mary's L.J. 967 (2009).

67. *In re* Estate of Rothko, 372 N.E.2d 291 (N.Y. 1977).

they reject the sale they can require the trustee to account for the property, and seek to surcharge the trustee for the difference between his payment for the property and the value of the property when he purchased it. The beneficiaries can seek to compel the trustee to repay the purchase price in exchange for the property or hold the trustee liable for any loss realized by the trust from disposition of the property.[68] Two Courts of Appeals have held that in the bankruptcy context when attorneys fail to disclose the source of their retainer (other than the clients' payments), the proper remedy was the denial of all fees the attorneys have received.[69]

b. Accounting and Restitution Damages Accounting can be appropriate for determining the remedy of restitution damages. The two are very similar, even though their origins may differ. When shareholders-parties misappropriated corporate funds, the court ordered these shareholders to pay the other shareholders their share of the misappropriated funds. The accounting approach was limited to those assets that were diverted from the corporation to the fraudulent shareholders' benefits. In fact, the court traced the misappropriated money from the misappropriating shareholders' assets to the corporation, and from the corporation, upon its dissolution, to the parties. Yet the violating fiduciaries did not lose the money that was due to them as shareholders.[70]

D. EQUITABLE REMEDIES

Doctrinally, equity is the source of the remedies for violations of fiduciary obligations, because fiduciary obligations originated in the English equity courts.[71] As the Ninth Circuit Court of Appeals noted, "[s]uits against corporate directors for violations of fiduciary duties are equitable in nature. It is unlikely that the Oregon courts would allow a director to misappropriate funds and leave those injured without a remedy."[72]

68. 4 Austin Wakeman Scott et al., Scott and Ascher on Trusts § 24.10, at 1710–11 (5th ed. 2007).

69. C.R. Bowles, Jr. & Nancy B. Rapoport, *Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?*, 5 Am. Bankr. Inst. L. Rev. 47, 62 (1997) (in addition, attorneys have a duty not to charge large retainers that might hinder ongoing operations.).

70. Bostic v. Goodnight, 443 F.3d 1044, 1046, 1049 (8th Cir. 2006).

71. Deborah DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L. J. 879 ("As Equity evolved, concrete rules in many instances . . . replaced an earlier and imprecise vocabulary. The term 'fiduciary' itself was adopted to apply to situations falling short of 'trusts,' but in which one person was nonetheless obliged to act like a trustee.").

72. Watson v. Button, 235 F.2d 235, 237 (9th Cir. 1956).

1. Restitution

Restitution is a close relative to accounting and in some cases to constructive trust. One of the distinctive features of restitution is its origin. It is a remedy for contract violations. As Professor E. Allan Farnsworth noted,[73] in a contract relationship, the promisor may have violated his promise while the promisee may have benefited the promisor. For example, by being paid for goods in advance, the promisor has the use of the money. In such a case the court may award the promisee (who paid) restitution: an amount that would deprive the promisor of his benefit, even if the award would be higher than the amount that the promisee lost. In addition, restitution would likely be awarded if the promise involved other than money.[74] In sum, a defendant may not benefit from his breach of contract. In the past, the grant of restitution was available in the common law, or in equity.[75] The same remedy would apply when the benefit to the party that breached its contract obligations was other than money. An action for specific restitution, such as restitution of specific property, "lies in equity"[76] and may be available if the legal remedy is inadequate.[77]

A remedy similar to restitution is available in fiduciary law. For example, a controlling shareholder may not use its control to obtain the corporation's service for a lower rate. If the controlling shareholder does abuse its power in this way, the court will impose on the controlling shareholder the remedy of restitution and require the shareholder to pay the difference between the amount it paid for the service and the amount it should have paid for the service.[78]

73. 1 E. Allan Farnsworth, Farnsworth on Contracts § 2.1, at 77; 3 *id.* § 12.20, at 329–32 (3d ed. 2004) (footnotes omitted). See also Nash v. Schock, No. 14721, 1997 Del. Ch. LEXIS 174 (Del. Ch. Dec. 3, 1997) (fiduciary is liable to the entrustors for improper gifts from the estate to itself and others. Gifts to the fiduciary must be clearly authorized. The court ordered a constructive trust against the fiduciary for active wrongdoing, and restitution against others, who were unjustly enriched, but who were not engaged in active wrongdoing).

74. 3 E. Allan Farnsworth, Farnsworth on Contracts § 12.20, at 329–31 (3d ed. 2004) (quoting Bush v. Canfield, 2 Conn. 485, 488 (1818)) (the buyer advanced $5,000 of the $14,000 price for flour. Even though the market price of the flour fell to $3,000, the seller failed to deliver. The buyer claimed restitution of the advance payment of $5,000. The court held: "The defendant has violated his contract; and it is not for him to say, that if he had fulfilled it, the plaintiffs would have sustained a great loss, and that this ought to be deducted from the money advanced.").

75. *See* Joseph M. Perillo, Calamari and Perillo on Contracts § 15.3, at 543 (6th ed. 2009) (noting that at common law plaintiff had to tender back any benefits under the contract; in equity the court "could condition its decree upon restitution by the plaintiff or offset the value of the benefits received").

76. *Id.* § 15.5, at 545.

77. *Id.* at 545–47 (examples of special circumstances where legal remedy is inadequate).

78. Ripley v. Int'l Rys. of Cent. Am., 171 N.E.2d 443 (N.Y. 1960); *id.* at 444 (railroad provided transportation for United Fruit Company's ("United") subsidiary in Guatemala.

2. Specific Performance

Specific performance—forcing the performance of fiduciary services as agreed by the parties—is not a likely remedy for violations of fiduciary duties. The assumption is that money damages are a sufficient alternative. Nonetheless, an "injunction for specific performance is equitable relief that is available when legal relief is, for some reason, inadequate."[79] Sometimes the delivery of a unique entrusted property, such as a Picasso painting, should be mandated. The same approach applies to land, but less to personal property.[80] Because most fiduciary relationships involve services, and because fiduciary relationships are based on trust, an entrustor is unlikely to seek specific performance against the fiduciary the entrustor no longer trusts. The courts are unlikely to require a fiduciary to continue serving the entrustor because of the difficulty of enforcing the injunction. Personal service contracts will not be specifically enforced,[81] as courts do not wish to require parties in dispute to associate with each other.[82] Personal services under this rule include certain non-delegable duties and have been held to include "actors, singers, and athletes" and the rule has been applied to "master and servant" employment contracts.[83] Similarly, an injunction against personal service for another employer will not be issued if it would in effect force the employee to work for the employer.[84]

E. PUNITIVE DAMAGES

As their name implies, punitive damages represent punishment. For example, in the case of a broker who acted as agent for a seller of land, and violated his fiduciary duties punitive damages have been allowed on the ground that it is necessary to deter conduct so improper.[85]

A jury determines the amount of the damages, and this amount exceeds actual damages. However, courts do not allow juries to award unlimited punitive damages. The courts examine three factors to determine whether punitive

The court noted that "United was in practical control of IRCA at least after the creation of the voting trust in 1928, and [therefore] stood in a fiduciary relationship to [Railroad] as respects the latter's minority shareholders insofar as concerned business transactions between [Railroad] and United or its subsidiary."). *See also id.* at 448.

79. Randy E. Barnett, Contracts: Cases and Doctrine 197 (3d ed. 2003).

80. *Id.* at 183.

81. Restatement (Second) of Contracts § 367(1) (1981).

82. Restatement (Second) of Contracts § 367 cmt. b (1981).

83. Restatement (Second) of Contracts § 367 cmt. a (1981).

84. Restatement (Second) of Contracts § 367(2) (1981). Under contract law a court may order specific performance of a contract duty, if the party has breached or threatened to breach the duty. Restatement (Second) of Contracts § 357(1) (1981).

85. Dan B. Dobbs, Law of Remedies § 10.5(1), at 723 (2d ed. 1993).

damages are excessive. The nature of the fiduciaries' acts and their "reprehensible" nature; the amount of the damages awarded; and the fiduciaries'-defendants' wealth. These measures are designed to render punitive damages deterrents to the defendant. Therefore, "[a]cting in accordance with a legally tenable (though erroneous) contract interpretation" can "be deemed 'despicable,' 'reprehensible,' 'vile,' or 'contemptible.' . . . The dispositive question is whether the fiduciary was relying upon an interpretation it knew to be wrong in order to take advantage of the other party. Impliedly, the jury found that Genentech did exactly that. . . ."[86] The United States Supreme Court instructed the "courts to determine the reprehensibility of a defendant by considering whether: the harm caused was physical as opposed to economic; the [wrongful tort] conduct evinced an indifference to or a reckless disregard of the health or safety of others; the target of the conduct had financial vulnerability; the conduct involved repeated actions or was an isolated incident; and the harm was the result of intentional malice, trickery, or deceit, or mere accident."[87] The courts disagree on whether or not ERISA allows plaintiffs to recover punitive damages from a breach of fiduciary duty by a pension fund manager.[88]

Punitive damages can be awarded in addition to other remedies.[89] Even though a plaintiff was fully compensated for the damage,[90] "a plaintiff has been made whole for his injuries by compensatory damages, so punitive damages should only be awarded if the defendant's culpability, after having paid

86. City of Hope Nat'l Med. Ctr. v, Genentech, 20 Cal. Rptr. 3d 234 (2004), *modified, reh'g denied,* No. B161549, 2004 Cal. App. LEXIS 1962 (Ct. App. Nov. 22, 2004), *review granted, depublished,* 105 P.3d 543 (Cal. 2005). *City of Hope* is an unpublished disposition issued before January 1, 2007, and as such may not be cited to Ninth Circuit courts except in certain limited circumstances. 9th Cir. R. 36-3(c).

87. *Id.* at 270–73 (citations omitted) ("In TXO Production Corp. v. Alliance Resources Corp., the plaintiff suffered economic damages between $1 million and $4 million and was awarded $10 million in punitive damages. The Supreme Court upheld the punitive damages award, noting that the defendant had embarked on illicit, bad faith scheme to cheat the plaintiff out of lucrative oil and gas royalties. If the award and its proportion in TXO was constitutional, then the award against Genentech was constitutional as well"). Note that municipalities are immune from punitive damages. *See* City of Newport v. Fact Concerts, Inc., 453 U.S. 247 (1981).

88. *See* Russell v. Mass. Mutual Life Ins., 722 F.2d 482, 490–92 (9th Cir. 1982); Dependahl v. Falstaff Brewing Co., 653 F.2d 1208, 1216–17 (8th Cir.), *cert. denied,* 454 U.S. 968 (1981); Deborah A. Geier, *ERISA: Punitive Damages for Breach of Fiduciary Duty,* 33 Case W. Res. 743 (1985).

89. Action Marine, Inc. v. Continental Carbon Inc., 481 F.3d 1302 (11th Cir. 2007) (manufacturing plant emitted a pollutant into the air that damaged property).

90. *Id.* at 1307–08, 1316.

compensatory damages, is so reprehensible as to warrant the imposition of further sanctions to achieve punishment or deterrence."[91]

F. DISSOLUTION OF A CORPORATION

When no other equitable remedies are available, a court may consider ordering the dissolution of a corporation involved in wrongdoing under fiduciary law.[92] When the majority shareholders changed the corporation's "long-standing policy to distribute corporate earnings on the basis of stock ownership," the court considered this change to be a "'fraudulent and oppressive' conduct by the company's board of directors such as to render petitioners' stock a 'virtually worthless asset.'"[93] The court found that "[l]iquidation of the corporate assets was found the only means by which petitioners would receive a fair return" even if it is a "serious and severe remedy."[94]

G. CRIMINAL SANCTIONS

Violations of fiduciary duties can constitute an element of a crime; criminal activity can result in violation of fiduciary duties. For example Rule 10b-5 under the Securities Exchange Act of 1934[95] imposes criminal liability on persons who trade on insider information, that is, entrusted information. These are the persons who have acquired the information by being fiduciaries to the source of information such as corporate management or lawyers.[96] Another example of a breach of fiduciary duty that may constitute an element of crime is the criminal prohibition imposed on investment

91. *Id.* at 1317–22 (citations omitted). *See also* OnePoint Solutions, LLC v. Borchert, 486 F.3d 342 (8th Cir. 2007) (corporate founders allegedly authorized payments to themselves from the company after they were removed from the office); *id.* at 350–53 (claiming "treble damages under the Minnesota receipt of stolen property statute; punitive damages under the Minnesota civil theft statute; and attorney's fees and costs based on the 'third-party litigation' exception." The company alleged that the founders violated their fiduciary duty by misappropriating corporate funds and alleged damages of $66,000 for the value of the property stolen, plus $66,000 in punitive damages. The company, however, was not entitled to recover the attorney's fees and costs).

92. *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173 (N.Y. 1984).

93. *Id.* at 1175–76.

94. *Id.* at 1176, 1177–78; 1180–81 (liquidation was the only possible solution).

95. 15 U.S.C. § 78j (2006); 17 C.F.R. § 240.10b-5 (2009); 15 U.S.C. § 78ff(a) (2006) (providing criminal penalties for violation of Act).

96. *See* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); United States v. O'Hagan, 521 U.S. 642 (1997).

advisers under the Investment Advisers Act of 1940.[97] These criminal provisions apply to the advisers by virtue of their being, and acting as, fiduciaries.

The crime of embezzlement is directly related to breach of fiduciary duties. In fact, for many years embezzlement did not fall within the definition of the crime of larceny because one of the elements of "larceny" was absence of the owner's consent. In the case of fiduciaries, the owners consent to the entrustment of their property to the fiduciaries. This difficulty, however, has been overcome, because the conversion of the *use of the entrusted property* was not made with the consent of the owner.[98]

In addition, embezzlement involves criminal forfeiture. "There are two primary reasons for permitting money judgments as part of criminal forfeiture orders. First, criminal forfeiture is a sanction against the individual defendant rather than a judgment against the property itself. Because the sanction 'follows the defendant as a part of the penalty,' the government need not prove that the defendant actually has the forfeited proceeds in his possession at the time of conviction. Second, permitting a money judgment, as part of a forfeiture order, prevents a [convicted defendant] from ridding himself of his ill-gotten gains to avoid the forfeiture sanction."[99]

Bribery. The bribery of officials both foreign and local is a criminal violation, and if performed by fiduciaries, the bribery is likely to constitute a violation of fiduciary duties as well. In the 1970s one court held that bribery of foreign officials constituted a violation of corporate directors.[100] Since then, anti-bribery legislation seems to have imposed stricter duties on corporations and perhaps their board of directors.[101] From the beginning of the year 2006 the Securities and Exchange Commission and the Justice Department have increased their investigations and prosecutions under the Act.[102]

Securities regulation. In the area of securities regulation, a breach of fiduciary duties can constitute a criminal offense such as misappropriation. Insider trading can constitute a crime as well as a violation of a fiduciary duty.[103] Like anybody else, if fiduciaries knowingly assist their entrustors to commit crimes, the

97. 15 U.S.C. § 80b-7 (2006) (prohibiting certain transactions by investment advisers); *id.* § 80b-17 (providing criminal penalties for violation of Act).

98. *See* Wayne R. LaFave, Criminal Law § 19.6(a), at 947 (4th ed. 2003).

99. United States v. Hall, 434 F.3d 42, 59 (1st Cir. 2006) (quoting United States v. Robilotto, 828 F.2d 940, 948–49 (2d Cir. 1987)) (citations omitted).

100. Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979).

101. Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1 to -3 (2006).

102. *See, e.g.*, *The Year of the FCPA Trial*, 2009 Year-End FCPA Update (Gibson, Dunn & Crutcher, Los Angeles, Cal.), Jan. 4, 2010, http://www.gibsondunn.com/Publications/Pages/2009Year-EndFCPAUpdate.aspx.

103. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007). *See also* Investment Company Act of 1940, § 35, 15 U.S.C. § 80a-34 (2000); SEC v. Cuban, 634 F. Supp. 2d (D.C. Tex. 2009).

fiduciaries, by virtue of their position, may be liable as aiders and abettors.[104] Thus, while not all the criminal violations involve breach of fiduciary duties, many criminal violations are likely to constitute also violations of fiduciary duties, though not automatically.

H. STANDING TO SUE AND PROCEDURAL ISSUES; COMMON LAW AND EQUITY

1. A Glimpse at History

The distinction between the common law and equity derives from English law. Historically English plaintiffs had access to the common law courts by purchasing a writ.[105] The writ and form of action informed the defendants of the claims against them, the remedies which the plaintiffs demanded, and whether the actions would be tried by a jury. Writs narrowed the cases to specific issues of law or fact.[106] Because available remedies in common law courts were limited, there arose Courts of Chancery and Courts of Request that asserted jurisdiction to grant equitable reliefs of specific performance and injunctions.[107]

After the American Revolution, the American colonists adopted the English complex court systems and practices, following the differences between claims in common law and claims in equity. However, the Equity Rules of 1912 merged law and equity.[108] In 1915, the Law and Equity Act merged the courts' jurisdiction to allow one court to determine matters both of the common law and equity.[109] After the passage of these two acts, few distinctions remained between cases in law and cases in equity. Rule 2 of the Federal Rules of Civil Procedure further eliminated most procedural distinctions based on whether a plaintiff's claims are legal, equitable, or both.[110] These procedural distinctions were eliminated in order to minimize the significance of the separate pleading in law and equity causes of action.[111]

104. *See* WAYNE R. LAFAVE, CRIMINAL LAW § 13.2 (4th ed. 2003) (discussing accomplice liability).

105. J.H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 63-83 (3d ed. 1990).

106. 1 JAMES WILLIAM MOORE, MOORE'S FEDERAL PRACTICE § 2 App. 100 (Daniel R. Coquilette et al. eds., 3d ed. 1997).

107. J.H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 135–44 (3d ed. 1990).

108. 1 JAMES WILLIAM MOORE, MOORE'S FEDERAL PRACTICE § 2 App. 102 (Daniel R. Coquilette et al. eds., 3d ed. 1997).

109. Ch. 90, 38 Stat. 956 (1915) (repealed 1938).

110. Morgantown v. Royal Ins. Co., 337 U.S. 254 (1949) (stating that there is identical procedure for all actions, whether cognizable formerly at law or in equity); 1 JAMES WILLIAM MOORE, MOORE'S FEDERAL PRACTICE § 2.02(3)(a) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

111. United Mine Workers v. Gibbs, 383 U.S. 715, 724 ("With Fed. R. Civ. P. 2, much of the controversy over cause of action is abated"); 1 JAMES WILLIAM MOORE, MOORE'S FEDERAL PRACTICE § 2.02(5)(b) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

Generally, civil procedure should not depend on the obsolete labels of law and equity, unless there is a rational and coherent policy to justify the distinction.[112] The merger of law and equity offered a uniform procedure by which a litigant could present his claim and recover the appropriate remedy, whether the claim was based in equity or the common law.[113] The merger eliminated the procedural barriers to asserting defenses, such as the use of equitable defenses against common law claims.[114] Cases in law and equity could be brought together in one court rather than split among two types of courts.[115]

Because the merger of law and equity was designed mainly to increase the efficiency of the judicial system, the merger applied consistently in procedural areas.[116] In other areas, however, courts seem to follow and enforce the distinction to maintain flexibility and fairness, which equitable relief allows.[117] Equity offers too much flexibility to justify incorporation into law; yet judges can more fairly reward complainants with equitable relief than with legal relief.[118]

2. The Remaining Differences between the Principles of Common Law and Equity

The current differences between common law and equity are based mostly on substantive elements,[119] such as fraud, misrepresentation, and misconduct.

112. Things Remembered v. Petrarca, 516 U.S. 124 (1995) (the authorization of a court to remand claims related to bankruptcy cases on "any equitable ground" refers not to pre-merger doctrines but simply to general fairness); Gulfstream Aerospace Corp. v. Mayacamas Corp., 485 U.S. 271 (1988) (the Supreme Court rejected the longstanding doctrine that a court's stay of its own proceedings is appealable interlocutory only if original action is legal and stay arises from equitable defense or counterclaim); 1 JAMES WILLIAM MOORE, MOORE'S FEDERAL PRACTICE § 2.02(3)(a) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

113. 4 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE: CIVIL § 1043 (3d ed. 2002).

114. 1 JAMES WILLIAM MOORE, MOORE'S FEDERAL PRACTICE at § 2.05.

115. *Id.* § 2 App. 102(3)(d) (stating that the prompt dispatch of business requires that all known issues, of law and of equity, be tried in one suit so the parties are required to bring them forward in the regular course of pleading).

116. DAN B. DOBBS, LAW OF REMEDIES (1993); ROBERT CHILDRES & WILLIAM F. JOHNSON, JR., EQUITY, RESTITUTION, AND DAMAGES: THE STUDY OF LITIGATION THEORY § 2.3(4) (1974).

117. Bereslavsky v. Caffey, 161 F.2d 499, 500 (2d Cir. 1947) ("[P]rocedural fusion may cause a substantive hardening of equity."); M. T. Van Hecke, *Trials by Jury in Equity Cases,* 31 N.C. L. REV. 157, 174 (1953).

118. Bereslavsky, 161 F.2d at 500. *But see* Bank Line, Ltd. v. United States, 163 F.2d 133, 139 (2d Cir. 1947) (Clark, J., concurring) ("I. . . . express disagreement . . . with the old separation of law and equity").

119. Hoover v. Wagner, 47 F.3d 845, 850 (7th Cir. 1995) (modern equity procedure is a "system of rules administered by regular judges" preserving "traces of the ancient practice"); NLRB v. Americana Healthcare Ctr., 782 F.2d 941, 946 (11th Cir. 1986) (stating

These are recognized grounds for equitable relief.[120] In addition, a plaintiff may be granted equitable relief, absent adequate remedy at law. However, equitable relief will be denied if the complaining party cannot demonstrate that it came to court in "clean hands." That is, without fault or negligence on its part.[121] Other differences between law and equity include the period of limitations,[122] the right to an interlocutory appeal of a court order staying an action,[123] and the right to a jury trial.[124]

a. Common Law Period of Limitation v. Laches in Equity The period of limitations for a claim in equity may differ from a statute of limitation for a claim in law. The nature of the complaint will determine what period of limitations will apply.[125] The use of a defense to a claim depends on the applicable substantive law.[126] For example, laches, the equitable defense paralleling the statute of limitation, is accepted as a defense to legal claims in certain jurisdictions, but not in all.[127] Laches can be asserted only when the party asserting the defense shows

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that the party seeking relief in equity subjects itself to questioning as to whether its own conduct is equitable); Myzel v. Fields, 386 F.2d 718, 741–42 (8th Cir. 1967) (Fed. R. Civ. P. 2 does not allow jury to confer equitable relief of rescinding contract, although jury may award rescissional damages) (disapproved on other grounds); Coca-Cola Co. v. Dixi-Cola Lab., Inc., 155 F.2d 59, 63 (4th Cir. 1946) (stating that a court in equity lacks power to assess legal remedies of *punitive* damages absent statutory authorization) (emphasis added); 1 James William Moore, Moore's Federal Practice § 2.02(3)(b) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

120. Cresswell v. Sullivan & Cromwell, 922 F.2d 60 (2d Cir. 1990).

121. Ostrander v. Gardner, 474 F.3d 4, 6 (1st Cir. 2007) (petitioner barred from equitable relief because he was negligent); Cresswell, 922 F.2d at 60.

122. 1 James William Moore, Moore's Federal Practice § 2.02(3)(b) (Daniel R. Coquilette et al. eds., 3d ed. 1997) (citing Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938)) (the statute of limitations is substantive for *Erie* Doctrine purposes, and therefore is not affected by the merger of law and equity actions).

123. 4 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure: Civil § 1045 (3d ed. 2002).

124. 1 James William Moore, Moore's Federal Practice § 2.06(1)(a) (Daniel R. Coquilette et al. eds., 3d ed. 1997) (citing Dairy Queen, Inc. v. Wood, 369 U.S. 469 (1962)).

125. Lift-a-Loft Corp. v. Rodes-Roper-Love Ins. Agency, Inc., 975 F.2d 1305, 1311–12 (7th Cir. 1992) (the court applies a statute of limitations based on the true nature of the action, not the form alleged by the pleader); 1 James William Moore, Moore's Federal Practice § 2.02(3)(b) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

126. 1 James William Moore, Moore's Federal Practice § 2.05 (Daniel R. Coquilette et al. eds., 3d ed. 1997).

127. Robins Island Preservation Fund v. Southold Dev. Corp., 959 F.2d 409, 423–35 (2d Cir. 1992) (applying laches to legal ejectment claim brought two centuries after alleged wrongful possession); Maksym v. Loesch, 937 F.2d 1237, 1247–48 (7th Cir. 1991) (in Illinois, laches is defense only to equitable claims and "[l]aches is . . . increasingly applied to cases at law"); FDIC v. Fuller, 994 F.2d 223, 224 (5th Cir. 1993) (laches not available

that the length of time in bringing the claim acted to its prejudice.[128] Other than that, courts only accept the equitable defense of laches in specific cases, and deny its application to common law claims on the grounds that it is an equitable defense.[129] The courts will resolve the statute of limitations questions according to the legal issue involved in the case.[130]

b. The Right to a Jury Trial The right to a jury trial is appended to actions in law.[131] Thus, if the suit is in equity, such as the right of the shareholders to bring derivative claims if their directors and officers are involved in conflicts of interest or are truly defendants, the parties bringing legal counterclaims in such an equity suit have a right to a jury trial.[132] The party's right to trial by jury is not affected by whether the action is in law or in equity.[133]

The right to a trial by jury depends on a two-part inquiry. First, whether the plaintiff's claim is similar to historical forms of equity. And second, whether the plaintiff seeks equitable relief.[134] A jury trial is required when the relief sought is designed to punish culpable individuals.[135] Since today federal courts have

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as defense to claim in law to enforce note); Sun Oil v. Fleming, 469 F.2d 211, 213–14 (10th Cir. 1972); 1 James William Moore, Moore's Federal Practice § 2.05 (Daniel R. Coquilette et al. eds., 3d ed. 1997).

128. Sun Oil, 469 F.2d at 214 (10th Cir. 1972).

129. County of Oneida v. Oneida Indian Nation, 470 U.S. 226, 245 (1985) ("We note . . . that the application of the equitable defense of laches in an action at law would be novel indeed."); Ewert v. Bluejacket, 259 U.S. 129, 138 (1922) ("[T]he equitable doctrine of laches, developed and designed to protect good faith transactions against those who have slept upon their rights, with knowledge and ample opportunity to assert them, cannot properly have application to give vitality to a void deed").

130. Sun Oil Co. v. Wortman, 486 U.S. 717, 726–29 (1998) (the statute of limitations is procedural for purposes of Full Faith and Credit Clause); Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938) (in diversity case, apply substantive law of state unless case is controlled by federal Constitution or act of Congress); 1 James William Moore, Moore's Federal Practice § 2.02(3)(b) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

131. Liberty Oil Co. v. Condon Nat'l Bank, 260 U.S. 235 (1922); 1 James William Moore, Moore's Federal Practice § 2 App. 102(3)I. (Daniel R. Coquilette et al. eds., 3d ed. 1997).

132. Chase Nat'l Bank v. Sayles, 30 F.2d 178 (D.R.I. 1927); 1 James William Moore, Moore's Federal Practice § 2 App. 102(3)(b) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

133. Dairy Queen, Inc. v. Wood, 369 U.S. 469 (1962) (rules did not change the basic principle that the right to trial by jury of legal claims must be preserved); 1 James William Moore, Moore's Federal Practice § 2.06(1)(a) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

134. Tull v. United States, 481 U.S. 412 (1987) (the Court must examine the nature of the claim and the remedy sought); 1 James William Moore, Moore's Federal Practice § 2.06(1)I(b) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

135. 1 James William Moore, Moore's Federal Practice § 2.06(1)I(a) (Daniel R. Coquilette et al. eds., 3d ed. 1997) (citing *Tull*, 481 U.S. at 422 ("[r]emedies intended to

merged principles of law and equity, shareholder derivative actions can involve a jury trial.[136] However, in cases where principles of law and equity commingle, the courts may decide whether or not to allow a jury trial.

Shareholders have standing to assert the rights of the corporation on two conditions: if the corporation's directors have failed to assert corporate rights (thereby breaching their fiduciary duty), and if the litigating shareholder can fairly and adequately represent the shareholders. Only then may the shareholders bring the case on behalf of the shareholders and on behalf of the corporation. Unless these two requirements are satisfied, derivative actions cannot be maintained.[137] If the plaintiff shareholder is allowed to sue, then the shareholder has the right to a trial by jury on the corporation's legal claim, even though the shareholder's right to sue arises under equity. The complaint based on a legal claim is sufficient to warrant a jury trial.[138]

c. Interlocutory Review When an interlocutory review is sought, the name of the initial pleadings determines whether an appeal can be taken.[139] If the claim is one at law, a stay is appealable.[140] If the claim is in equity, a motion to stay is not reviewable because an equity court cannot enjoin itself.[141] When a claim in law and a claim in equity are combined, they are distinguished by either recognizing which claim is dominant (the "dominant purpose" test)[142] or according to traditional principles of equity jurisdiction (the "historical" test).[143]

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punish culpable individuals, as opposed to those simply to extract compensation or restore the status quo, [are] issued by courts of law, not courts of equity.")).

136. Ross v. Bernhard, 396 U.S. 531 (1970) (the jury right for claims asserted in a derivative action is the same as if the corporation asserted the claims directly.); 1 James William Moore, Moore's Federal Practice § 2.04(2) (Daniel R. Coquilette et al. eds., 3d ed. 1997).

137. Fed. R. Civ. P. 23.1(a). Fed. R. Civ. P. 23.1(b). In addition, the shareholder's complaint must include: (1) an allegation that the complainant was a shareholder at the time of the transaction or that his share devolved by operation of law thereafter; (2) an allegation that the action is not a collusive one to confer jurisdiction that the court would not ordinarily confer and; (3) allegations of efforts by the complainant to obtain the directors' action and the reasons for either not obtaining the action or not making the effort.

138. Ross, 396 U.S. at 539 (a corporation's claim is the "heart of the action," and, if legal, the right to a jury is not forfeited); 1 James William Moore, Moore's Federal Practice § 2.04(2) (Daniel R. Coquilette et al. eds., 3d ed. 1997) (the efficient resolution of all issues in a single action and granting these actions a jury trial simplifies the procedure of shareholder derivative claims).

139. Gatliff Coal Co. v. Cox, 142 F.2d 876 (6th Cir. 1944); 4 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure: Civil § 1045 (3d ed. 2002).

140. Seminole Tribe v. Florida, 11 F.3d 1016 (11th Cir. 1994).

141. 4 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure: Civil § 1045 (3d ed. 2002).

142. Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176 (1955); Morgantown v. Royal Ins. Co., 337 U.S. 254, 254 (1949); Kirschner v. West Co., 300 F.2d 133 (3rd Cir. 1962).

143. Note, *Interlocutory Appeals from Orders Staying Proceedings*, 21 Sw. L.J. 850, 853 (1967).

Thus, even though law and equity live side by side in the same court and in the same claims, their differences have not been completely eliminated. The source of the differences has remained important, especially in the area of fiduciary law. That is perhaps because the need for equitable remedies draws to a great extent from the same reasoning on which fiduciary is based. These are the recognition of a wrongful breach of trust, sometimes accompanied by misappropriation of entrusted property that never belonged and never was intended to belong to the defendant fiduciary, and involving actions tainted with moral turpitude.

I. LIABILITY OF THE TRANSFEREE OF ENTRUSTED PROPERTY WHO KNEW OF THE ENTRUSTMENT

An important benefit of fiduciary relationships is the fiduciary's ability to deal as owner with entrusted property and power. This ability allows the fiduciary to perform its services more efficiently and shelters innocent third parties, who received entrusted assets in violation of fiduciary duties, from the claims of the entrustors. The rule protects the buyers of entrusted property that paid reasonable value for the property and did not know that the property was sold or transferred in violation of fiduciary duties. Such buyers are entitled to keep the bargain. However, such buyers are not sheltered if they had notice that the property was transferred to the buyers in violation of fiduciary duties.[144]

J. RESULTING TRUSTS

A resulting trust is a "remedy imposed by equity when property is transferred under circumstances suggesting that the transferor did not intend for the transferee to have the beneficial interest in the property."[145] A resulting trust is distinguished from constructive trust, which is a remedy against a person who has acquired property by wrongdoing.[146] The following circumstances can lead to the remedy of a resulting trust.

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144. Harris Trust & Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250 (2000) (citing authorities) ("[I]t has long been settled that when a trustee in breach of his fiduciary duty to the beneficiaries transfers trust property to a third person, the third person takes the property subject to the trust, unless he has purchased the property for value and without notice of the fiduciary's breach of duty. The trustee or beneficiaries may then maintain an action for restitution of the property (if not already disposed of) or disgorgement of proceeds (if already disposed of), and disgorgement of the third person's profits derived therefrom."); *see also* Restatement (Second) of Trusts § 291 (1959).

145. Black's Law Dictionary 1653 (9th ed. 2009).

146. *See* Chapter 6 C.1.

When an express trust fails entirely. According to the Third Restatement of Trusts, when "a person . . . makes or causes to be made a disposition of property under circumstances (i) in which some or all of the transferor's beneficial interest is not effectively transferred to others (and yet not expressly retained by the transferor) and (ii) which raise an unrebutted presumption that the transferor does not intend the one who receives the property . . . to have the remaining beneficial interest," a resulting trust occurs.[147] For example, A may devise property to B in trust for the use of C for life and upon C's death, to distribute the property to C's heirs. When C dies without heirs, B holds the remainder on resulting trust for A's heirs. Trust interests may fail when they conflict with the rules against prolonged accumulations, remoteness of vesting, or simply a beneficiary disclaiming their trust interest,[148] or the trust is "fully performed without exhausting the trust" property.[149]

An express trust can fail for other reasons, such as when it conflicts with public policy, or is illegal, or is not established in compliance with the Statute of Frauds.[150] In these cases as well, the transfer that constitutes the trust starts as one type of transaction and only later turns to be another kind, which requires the holder of the assets to use the assets in another way. Similarly, a charitable trust may fail when the trust's charitable purpose failed to conform to specific standards or comply with limited exceptions.[151] Uncertainty can lead to the demise of an express trust.[152] Similar to the American law, Canadian law holds that the failure of express trusts may be the result of a misrepresentation, undue influence, duress, or a fundamental mistake.[153] The remedy and recognition of a resulting trust prevents the trustee from being enriched at the expense of the settler.[154]

147. Jennifer Liotta, Comment, *ERISA Fiduciaries in Bankruptcy: Preserving Individual Liability for Defalcation and Fraud Debts Under 11 U.S.C. 523(a)(4)*, 22 BANK. DEV. J. 725, 731 n.54 (2006).

148. *See* GARY WATT & PAUL TODD, TODD & WATT'S CASES AND MATERIALS ON EQUITY AND TRUSTS, 172–73 (6th ed. 2007).

149. Estate of Hann v. Hann, 614 N.E.2d 973, 978 (Ind. App. 1993) (finding a resulting trust when two individuals contributed funds to a joint checking account and intended to own a joint savings account for both of their funds, but only one name appeared on the savings account); Moses v. Moses, 53 A.2d 805, 807 (N.J. 1947); *see also* 2 RESTATEMENT (SECOND) OF TRUSTS 392 (1959).

150. 2 RESTATEMENT (SECOND) OF TRUSTS 392 (1959).

151. *Id.*

152. *See* GEORGE L. CLARK, EQUITY: AN ANALYSIS & DISCUSSION OF MODERN EQUITY PROBLEMS, 382–83 (1920).

153. JEFFREY BRUCE BERRYMAN ET AL., THE LAW OF TRUST: A CONTEXTUAL APPROACH 517 (2d ed. 2008).

154. *Id.*

A resulting trust arises when the purchaser of property directs the seller to put title of the property in the name of another.[155] The payee is then required to transfer the property as directed. In this respect the payee is the trustee. A purchaser requiring title of property in the name of a third party creates a resulting trust. Such "purchase money resulting trust" is especially common in charitable organization litigation. For example, when "a local entity provides the purchase price but title is taken in the name of a regional or statewide representative of the national religious organization,"[156] a resulting trust arises. Most people do not furnish property without receiving something in return. Without an expressed intention to do just that, the charitable organization holds a purchase money resulting trust for the purchaser. If the purchaser does not want a resulting trust, they must express an intention that the charitable organizations have the interest in the property.[157] Similarly, if two parties intended to establish a joint bank account but the account was established in the name of one of them, the holder of the account will be deemed to hold the other party's money in a resulting trust.[158]

K. CONCLUSION

Judicial remedies for violations of fiduciary law seem to lack a systematic design. However, identifying the sources of these remedies can make them clearer and help both their choice and their justification. One source of most remedies is the design of fiduciary duties themselves. Courts draw on the fiduciary duties and relationships, and impose one or more of the elements of these duties as remedies, for example, the remedies of constructive trust and resulting trust. A second source of the remedies for violations of fiduciary duties is tort law, especially with respect to misappropriation of entrusted property or power. These are likely to be accompanied by punitive damages.

A third source of court remedies is their jurisdictional origin of the equity courts as compared to the common law courts. This source is especially noted in respect to the right to a jury trial and the procedural relief. The fourth source of

155. Moses v. Moses, 53 A.2d 805, 807 (N.J. 1947); *see also* 2 RESTATEMENT (SECOND) OF TRUSTS 392 (1959); Patty Gerstenblith, *Civil Court Resolution of Property Disputes Among Religious Organization*, 39 AM. U.L. REV. 513 (1990) (footnote omitted).

156. Patty Gerstenblith, *Civil Court Resolution of Property Disputes Among Religious Organization*, 39 AM. U.L. REV. 513, 554 n.238 (1990).

157. 8 WEST'S ENCYCLOPEDIA OF AMERICAN LAW 342 (2d ed. 2005).

158. Estate of Hann v. Hann, 614 N.E.2d 973, 978 (finding a resulting trust when two individuals contributed funds to a joint checking account and intended to own a joint savings account for both of their funds, but only one name appeared on the savings account).

remedies is modern legislation. And if legislation is not specific and clear, courts are likely to interpret the legislation by drawing on the three prior sources mentioned, assuming that the legislators derived the remedies from these sources and adjusted them.[159] These guidelines are likely to point to the remedies on violations of fiduciary duties.

159. Cass Sunstein, *Interpreting Statutes in the Regulatory State,* 103 HARV. L. REV. 405, 506 (1989).

7. THE ROLE OF FIDUCIARY LAW IN FACILITATING ENTRUSTMENT AND TRUST

A. THE NATURE AND ROLE OF TRUST

Trust in others has many definitions, varying by description and emphasis. In this Book I define trust as "reasonably believing that others tell the truth and will keep their promises."[1] Because trust constitutes a human relationship, this straightforward definition becomes as complicated as humans and their society. But to some extent we recognize trust when we see it.

Trust is generally essential to society, as we rely on others for the products and services we purchase, including the competence and ethics of physicians, lawyers, and financial services firms. Trust allows us to rely on others without the time and expense of verification or guarantees.[2] To be sure, the perceptions of human motivations vary. Consider the following story. A New York cab driver was scantily tipped by a passenger. But when the cab driver found that his passenger left a bagful of diamond rings in his car, the driver spent hours to locate the passenger and return the rings. For all his trouble the driver was willing to accept only the money he lost during the hours of search. Some may view the cab driver as highly moral and trustworthy. But others would suggest that the driver had no choice. It was very likely that the customer would contact the company that employed him. To avoid suspicion that he intended to keep the diamonds, he had no choice but to find the passenger. The sooner he returned the jewelry the better. Besides, he may have hoped for (and received) the positive publicity, which he valued.[3] These two views reflect two possible and different ways of trusting the cab driver. In one view he is trustworthy because he is a self-limiting person. In the other view he is trustworthy because he is coerced to be, in order to keep his job, and perhaps avoid possible legal repercussions.

This story represents the Russian proverb: "trust but verify,"[4] which the late president Ronald Reagan borrowed often during the Cold War. Although that statement seems self-contradictory, it is correct in that trust is desirable, while

1. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 49 (2006).
2. *Id.* at 49 (2006) (summarized; footnote and cite to authority omitted).
3. TAMAR FRANKEL, FIDUCIARY LAW 301-02 (2006) (citing Verena Dobnik, *NYC Cabbie Returns Bag of Diamond Rings,* AP, Feb. 7, 2007, http://abcnews.go.com/US/wirestory?id=2857742).
4. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 50 (2006).

unreasonable reliance on others is not. "Thus, trust presents a paradox."[5] To survive, individuals must both trust and verify. They must trust to obtain the support of others, but must verify to protect themselves from others. Trust presents a second paradox in that individuals must specialize. Individuals must trust to enjoy the goods and services created by specialization. To specialize, individuals must be independent (i.e., the opposite of trust), but to have time to develop expertise in order to specialize, they must trust others.

The risk from deception and the acceptable level of trust depends on the society and its social mores. In the United States, the eBay auction site provides an incentive for honesty. Buyers and sellers are rated by their counterparties. Traders with lower ratings and thus a poorer reputation present greater risks; therefore, they may have to sell for lower prices or buy for higher prices.

> The need for trust may depend on the cost of verification and the potential loss. For example, a person buying a newspaper need not trust, as the buyer can easily verify its completeness and price, and since there is no need for trust, the seller need not incur the cost of a guarantee. In contrast, investors must trust a mutual fund adviser as it would be costly to verify the adviser's competence and ethics, and the investors' risk is high.[6]
> One way to manage these paradoxes is through trustworthy institutions and systems. Americans likely trust their financial system more than brokers, advisers, or investment bankers, and the legal system more than lawyers, judges, or regulators. They may trust a system more than individuals because of its impersonal nature, or because they see it as representing a consensus. In addition, it is more efficient to trust institutions than verify the honesty of many individuals.[7]

B. THE BARRIERS TO ABUSE OF TRUST AND DISHONESTY

1. The Barriers

Three barriers to dishonesty are moral behavior, self-protection, and the law. Moral behavior refers to trusted persons' self-control over temptations. Self-protection refers to trusting persons' market sanctions against abuse of trust. While moral behavior relates to "trust" in "trust but verify," and self-protection relates to "verify," the law can relate to either; i.e., it can put barriers to trusted persons' temptations or require that trusting persons receive information.

5. *Id.* at 50.
6. *Id.* at 50-52 (summarized; footnotes omitted; citations to authority omitted).
7. *Id.* at 55 (summarized).

These barriers involve costs (i.e., morality costs the trusted persons, self-protection costs the trusting persons, and law costs society as a whole). None has been effective individually but they support and draw on each other and their relative effectiveness and cost changes with circumstances.[8]

2. Morality

"For the purpose of this book, people are moral people if they control their temptations to do the wrong thing, and are inclined to do the right thing."[9] This includes the following principles: (1) not abusing the trust of others, (2) not misleading others for their own benefit, (3) not taking others' property without the owners' permission, and (4) not doing the above even when not likely to be caught.

Moral people follow the rules voluntarily without coercion. Under one view, such people receive the reward of self-control, e.g., the power to control their weaknesses, and rewards and punishments do not empower but submit people who need coercion to others' control. Therefore, trusting people trust those who follow the rules voluntarily more than they trust others.[10]

a. Educating People to be Moral, and the "Selfish Gene" Children are taught to be moral (e.g., not to lie or steal), and, significantly, to be moral when there is no one to police them. This morality is not necessarily "self-sacrifice" but is "self-limitation."

Are people born good or evil, or do they become so because of their environment? Researchers believe that people have a selfish tendency, aimed at survival (the "selfish gene"); however, it is compatible with morality; people need a society to survive, and a society will not survive if members take from society without contributing.[11]

"[L]eadership and moral pressure can determine moral behavior."[12] In Zimbardo's Stanford Prison Experiment, 22 men were assigned the roles of prisoners or guards. Some guards were cruel and abusive to the prisoners and even took pleasure from their role. The guards saw not being tough on the prisoners as a sign of weakness and even the guards that were not abusive did not interfere.[13]

8. *Id.* at 105-06 (summarized).
9. *Id.* at 106.
10. *Id.* at 106-07 (summarized).
11. *Id.* at 107 (summarized; citation to authority omitted).
12. Tamar Frankel, Fiduciary Law 309 (2006).
13. *Id.* at 308-09 (citing Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad 198 (2006); Philip G. Zimbardo, *A Situationist Perspective on the Psychology of Evil: Understanding How Good People Are Transformed into Perpetrators* 14 (2003), http: //www.zimbardo.com/zimbardo.html (last visited Aug. 17, 2007); Craig Haney, Curtis Banks, & Philip Zimbardo, *A Study of Prisoners and Guards in a Simulated Prison* (1973), http://www.zimbardo.com/zimbardo.html (last visited Aug. 17, 2007)).

The role of the law in preventing dishonest behavior may be greater than assumed. Checking the brain activities of subjects during the experiments researchers have recently concluded that "honest moral decisions depend more on the absence of temptation than on the active resistance of temptation. Individuals who behaved honestly showed no sign of engaging additional controlled cognitive processes when choosing to behave honestly. These individuals exhibited no additional neural activity of any kind when they chose to forgo opportunities for dishonest gain, as compared with control trials in which there was no such opportunity. . . . Dishonest behavior was associated with neural activity in brain regions associated with cognitive control. . . . Moreover, patterns of activity in these control-related regions were correlated with individual differences in the frequency of dishonest behavior. . . . However, in contrast to prior studies, we find that control network activity is most robustly associated, not with lying per se, but with the limited honesty of individuals who are willing to lie in the present context."[14] If these conclusions are correct, and because temptations facing fiduciaries are very strong, deterring dishonesty must be stronger than in cases which do not pose temptations for the actors. Not surprisingly, fiduciary law plays a crucial role in keeping fiduciaries honest (willingly or less willingly).

3. Law and Culture

Law is based on voluntary compliance and is ineffective unless most people obey, as seen with Prohibition in the 1930s. People obey the law even though the chances of detection and punishment are small.

Voluntary compliance cannot be coerced. Neither morality nor law alone can change a culture. Morality cannot coerce, but may support a change in culture, and law cannot coerce an entire culture.

Corporations and institutions in effect have law, in the form of internal policies, backed by rewards and sanctions. Their culture is largely determined by top

14. Joshua D. Greene & Joseph M. Paxton· *Patterns of Neural Activity Associated with Honest and Dishonest Moral Decisions,* 106 PROCEEDINGS OF THE NAT'L ACADEMY OF SCIENCES 12,506, 12, 509 (2009); Letter of Marc S. Dreier (July 7, 2009), *reprinted at* Ashby Jones, *Sentencing Looming, Dreier Asks for No More than 12½ Years,* WSJ.COM, July 8, 2009, http://blogs.wsj.com/law/2009/07/08/sentencing-looming-dreier-asks-for-no-more-than-12-12-years/tab/article/(in a letter to a judge by a lawyer who used clients' money to pay his debts in a classic Ponzi scheme, the lawyer wrote: "As I sit here today, I can't remember or imagine why I didn't stop myself. . . . I recall only that I was desperate for some measure of the success that I felt had eluded me. . . . It is hard to explain how my crimes in 2002 reached the level that they did in 2008. . . . I took the first money thinking that I could and would repay it shortly. . . . I don't know what gives some men the strength of character to lead virtuous lives for all of their lives, and what causes others, such as myself, to lose their way.").

management. For instance, if top management is extravagant or frugal, this may be a signal to other employees to obey the law or not.[15]

a. Why Do Most People Obey the Law? People obey the law for a number of reasons. One suggested reason is fear of punishment. Under this view, strong laws, detection, and punishment lead to a culture of obedience.

Under a different view, people obey the law out of reciprocity, e.g., out of a belief that others follow the law. Similarly, they may obey because of signals from their peers that the peers obey the law. In addition, if members of a group follow the law, violators will be stigmatized; if they do not, violators will not be shunned.

Lawmakers and corporate leaders adopt and spread their own culture. They may also influence society's obedience to law by their own attitude toward the law; if they criticize or disparage the law they may undermine obedience. Indeed, people may not obey the law if they suspect that government enforcers have improper motivations, e.g., that they are controlled by "corporate criminals."[16]

b. How Does the Law Change? The law may change either through enforcement of laws not currently enforced or rules society follows that are not on the books. Public opinion may create social pressures on power holders, such as private fiduciaries (e.g., corporate management) and public power holders (e.g., the legislative, executive, and judicial branches).

There are many dead-letter laws on the books. As society's culture changes, these laws are not erased, but are merely not enforced. There are rules that people follow even though these rules are not on the law books. Public opinion can create sufficient pressures for their enforcement.

The years 2008 and those that follow are likely to see changes in the law and its enforcement. During the thirty preceding years enforcement of fiduciary law has weakened, especially the rules against powerful private fiduciaries. Even after the discovery of corporate scandals and fraud had erupted in the beginning of the year 2000 the trend continued. Powerful fiduciaries, holding billions of the public's money, did not alter their way of thinking and behavior. As the companies they led went bankrupt, managements of large enterprises (though not all) vigorously tended to their personal benefits.[17] Even after the crash of 2008 these powerful fiduciaries have not changed their way of life and attitudes. But something has changed in the political power and public opinion. This has caused

15. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 190–92 (2006) (summarized; footnotes omitted).

16. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 192–95 (2006) (summarized; footnotes omitted; citations to authorities omitted).

17. *See*, e.g., John Gittelsohn. *Payback Time for Execs?*, ORANGE COUNTY REGISTER, Jan. 30, 2009, LEXIS, News Library, Curnws File ("former chief executive of Merrill Lynch . . . paid $4 billion in bonuses to executives for 2008, a year the company lost $15 billion").

private sector fiduciaries to slowly react. Thus, the top management of the investment bank of Goldman Sachs has waived their bonuses for the year 2009, even though the investment bank made a fortune.[18] In a settlement by Caterpillar Company and its employees regarding the employees' 401(k) fees, the company promised to avoid benefitting from the employees' savings in a number of ways.[19] The battle (perhaps war) is not over. The Chamber of Commerce is gearing for a fight in Congress.[20] Concentrated private power is supported by arguments that "based on what we now know about AIG, it's unclear 'too big to fail' institutions are in fact too big to fail."[21] A compensation czar appointed by the administration is preparing to limit executive compensation.[22] Large shareholders may have the power to appoint some directors to the board, and perhaps have a say on management's compensation.[23] There are similar pressures on private sector health insurers.[24] Strong public opinion has arrived on the scene first, expressed through the Internet and publications. Law by legislation is likely to follow and courts might slowly change their focus as well.

C. THE DEBATE

There are a number of ways to view trust. The first view of trust is the psychological approach: why and how people come to believe or disbelieve others. The second

18. Susanne Craig, *Goldman Blinks on Bonuses*, WALL ST. J., Dec. 11, 2009, at A1, LEXIS, News Library, Wsj File.

19. Emily Lambert, *Caterpillar Suit Could Lower 401(k) Fees*, FORBES.COM, Nov. 11, 2009, http://www.forbes.com/2009/11/11/caterpillar-pension-lawsuit-personal-finance-retirement-plan.html.

20. U.S. Chamber of Commerce, Letter on H.R. 3269, the "Corporate and Financial Institution Compensation Fairness Act of 2009" (July 27, 2009), http://www.uschamber.com/issues/letters/2009/090727_hr3269.htm (stating opposition to proposed legislation regulating executive compensation).

21. *See*, e.g., Hal S. Scott, *Do We Really Need a Systemic Regulator?*, WALL ST. J., Dec. 11, 2009, at A21, LEXIS, News Library, Wsj File.

22. Louise Story & Stephen Labaton, *Overseer of Big Pay Is Seasoned Arbitrator*, N.Y. TIMES, June 11, 2009, at B1, LEXIS, News Library, Curnws File (noting appointment of "compensation czar" as "compensation official for companies on federal assistance").

23. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, §§ 2001–2004, 111th Cong. (introduced Dec. 2, 2009) (providing for shareholder vote on executive compensation, compensation committee independence, and enhanced compensation reporting).

24. *Democratic Members of the Senate Hold a News Conference on Health Care*, FIN. MARKETS REGULATORY WIRE, Dec. 4, 2009, LEXIS, News Library, Curnws File (noting proposed amendment to health care legislation that would limit tax deduction for an executive's compensation to $400,000 for health insurers with at least 25 percent of their premiums in federal program).

view of trust is through the lens of cost and benefit of verifying truth and reliability. The third view of trust is through the lens of society's interests. If we believe that the self-interest of individuals (whether aggregated or separate) represents the best interests of society as a whole, then the aggregate interest of individuals will suffice to represent society. But if we believe that society's interests do not always coincide with the individual or aggregate self-interest of all individuals then we must examine society's interests separately and weigh its interests against those of the individuals.

The issue of trust becomes even more complicated because all three views—as well as others—interact. The desirable level of trustworthiness and its enforcement may be achieved by psychological, economic, or social means. And the interaction among these components changes with time. Besides, law might induce trustworthy behavior but also increase mistrust as fiduciaries might be acting correctly not because they are trustworthy but because they fear legal sanctions.[25] The combined trust and mistrust has been recognised. Yet it is difficult to visualise conflicting trends without at least marking a line between them. Jennifer Halpern[26] hypothesized that there are "structures or scripts" that underlie human interrelationships; for example the interaction with friends or strangers, or transactions among partners. These include understandings about the future relationships, "'liking' associated with the relationship" and achieving "equality, mutual self-disclosure, and future interaction."[27] Thus, when people bargain with friends, they are expected not to bargain as hard as with strangers,[28] or pay more when they buy from friends and sell for less to friends.[29] Therefore, the desire to maintain friendship and trust is likely to bring commercial transactions to fruition more often.

Larry Ribstein wrote:[30] "Trust is a kind of social glue that allows people to interact at low transaction costs. Trusting people cooperate because it is in their nature or because they have been socialized to do it, not because some costly structure has been set up to ensure reliability. This implies that trust increases social wealth by permitting more investment in production. It is logical,

25. Frank B. Cross, *Law and Trust*, 93 GEO. L. J. 1457, 1463–64, 1466, 1483, 1490, 1508–09, 1539 (2005); "[M]onitoring associated with cognitive trust, which is integral to use of the law, may "poison" the preexisting affective trust. . . . [yet law] might help build affective trust over the long run, in addition to directly enhancing cognitive trust. . . . If this is true, legal structures that enhance cognitive trust will, over time, also enhance affective trust. . . . Affective trust or bonding social capital, without law, thus tends to racist, sexist, and generally xenophobic results.").

26. Jennifer J. Halpern, *The Effect of Friendship on Personal Business Transactions*, 38 J. CONFLICT RESOL. 647, 648–49 (1994).

27. *Id.* at 649.

28. *Id.* at 650.

29. *Id.* at 651.

30. Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 553–55 (2001).

therefore, to consider whether legal rules can contribute to trust." "[But] trust does not provide a distinct justification for mandatory legal rules [to] supersede contract." Even when regulation might lead to reliance among parties, it does not produce the welfare-increasing trust that reduces costly constraints. Mandatory rules designed to increase trust, in any form, may have precisely the opposite effect.[31]

Ribstein's conclusion implies that society and its members would be better off by contractual relationships, guided by an economic approach. This approach assumes that human behavior is led by and should be led by individual costs and benefits. The debate on whether and to what extent law can enhance trust and trusting relationships is not likely to end. What is clear, however, is that trust is important to society; and that it will continue to be abused. The materials in this Book suggest that fiduciary law has a role in limiting the temptation of entrusted persons to abuse. Therefore, law has a role in protecting, or even enhancing, a culture of trustworthiness.

31. *Id.*

EPILOGUE

Fiduciary law deals with entrusted property and power for the benefit of the entrustors and society. Fiduciaries are individuals and organizations in the private sector. However, this Book should not be closed without highlighting a parallel, related legal area that deals with similar entrusted property and power for the benefit of entrustors and society. This area of the law covers the public sector government power: the United States Constitution and the laws derived from it. The United States Constitution is the fiduciary law of public power, just as fiduciary law is the constitution of private power.

Private sector fiduciaries and government officials have much in common. While their functions and entrustment may differ, the laws governing fiduciaries and public officials address similar problems, and the guiding principles in both legal systems are similar: prevent misappropriation of entrustment and ensure a diligent and expert performance of services. Moreover, these two areas of law have been drawing on each other. The structures of institutions in the private sector, such as corporations, reflect the model of local governments. The authors of the Constitution were familiar with, and drew on, private fiduciary law.

In both private and public entrustment cases the laws aim at avoiding abuse of entrustment. In the political area the United States democracy has adopted separation of powers as a major structural controlling characteristic, sometimes at the expense of efficiency,[1] driven mainly by the fear of absolute power.[2] The following quote from the Declaration of Independence says it all:

"We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness.—That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed,—That whenever any Form of Government becomes destructive of these ends, it is the Right of the People to alter or to abolish it, and

1. Susan Rose-Ackerman, Corruption and Government: Causes, Consequences, and Reform, 143 (1999) ("Limits on the power of politicians and political institutions combined with independent monitoring and enforcement can be potent anti-corruption strategies. In a democracy, these limits include the separation of powers between the legislative and executive branches. An independent judicial and prosecutorial systems and a federal structure can limit the power of political leaders. But the fragmentation of political power is not necessarily effective.").

2. *Id.* Note that in some countries, such as England, legislative and executive powers are combined.

to institute new Government, laying its foundation on such principles and organizing its powers in such form, as to them shall seem most likely to effect their Safety and Happiness."[3] This statement describes fiduciary relationships and the law that controls the use of entrusted power.

Professor Robert G. Natelson has argued forcefully that the "Constitution was conceived of as a fiduciary instrument, instituting, to the extent practicable, fiduciary standards. . . . One such purpose, and a very important one, was to adopt for America a federal government whose conduct would mimic that of the private-law fiduciary."[4] All of the following cites to original documents have been derived from Professor Natelson's impressive work.

The idea that government holds its power in trust for the people goes back to Aristotle, Cicero,[5] **and Plato's Republic.**[6] "According to Plato, the purpose of the state was to promote the interest of the entire society,"[7] and the society's guardian should subordinate his interest to society's interest.[8] John Locke noted that "citizens conveyed to government certain powers (alienable rights) so those citizens could enjoy more fully the powers retained (inalienable rights), and that the government had a fiduciary obligation to manage properly what had been entrusted to it."[9]

3. THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776).

4. Robert G. Natelson, *Judicial Review of Special Interest Spending: The General Welfare Clause and the Fiduciary Law of the Founders,* 11 TEX. REV. L. & POL. 239, 281 (2007). *See generally* Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1178 (2004) (comparing Founding Era texts and concluding that "one of [the] general purposes [of the Constitution] was to erect a government in which public officials would be bound by fiduciary duties. . . ."). *See, e.g.,* U.S. CONST. art. I, § 10, cl. 1 (prohibiting the states from passing bills of attainder or ex post facto laws); *id.* amend. XIV, §1 (forbidding states from depriving any person of equal protection of the laws); Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1164, 1178 (comparing Founding Era texts).

5. Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 10, 95–98 (2004) (tracing public trust theory from the founding generation's classical canon through the debates over and provisions of the Constitution).

6. Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1097 (2004), *citing* ALEXANDER HAMILTON ET AL., THE FEDERALIST No. 49 at 283 (George W. Carey & James McClellan eds., Liberty Fund 2001) (1788).

7. Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1097 (2004) (citing PLATO, THE REPUBLIC 164 (H.D.P. Lee trans., 1961) (1955)).

8. Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1097 (2004) (citing PLATO, THE REPUBLIC 71 (H.D.P. Lee trans., 1961) (1955)). *See also* Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1108–23 (2004); Robert G. Natelson, *The Government as Fiduciary: A Practical Demonstration from the Reign of Trajan,* 35 U. RICH. L. REV. 191 (2001).

9. Robert J. Natelson, *Judicial Review of Special Interest Spending: The General Welfare Clause and the Fiduciary Law of the Founders,* 11 TEX. REV. LAW 239, 245 (2007) (citing JOHN LOCKE, THE SECOND TREATISE OF CIVIL GOVERNMENT: AN ESSAY CONCERNING THE TRUE ORIGINAL, EXTENT, AND END OF CIVIL GOVERNMENT, *in* TWO TREATISES OF GOVERNMENT § 136, at 190 (Thomas I. Cook ed., Hafner Publ'g Co. 1947) (1690) (SECOND TREATISE OF CIVIL GOVERNMENT)); SECOND TREATISE OF CIVIL GOVERNMENT § 156, at 200, *quoted in* Robert J. Natelson, *Judicial Review of Special Interest Spending: The General Welfare Clause and the Fiduciary Law of the Founders,* 11 TEX. REV. L. & P. 239, 245 n.22 (2007) ("The power of assembling and dismissing the legislative, placed in the executive, gives not the executive a superiority over it, but is a fiduciary trust placed in him for the safety of the people . . . "); Robert H. Natelson. *The Government as Fiduciary: A Practical Demonstration from the Reign of Trajan,* 35 U. RICH. L. REV. 191 (2001).

The idea of public trust was "transported to America. In 1662, King Charles II granted a royal charter to the 'Governor and Company of the English colony of Connecticut in New-England, in America'"[10] "'upon Trust' for the benefit of the settlers in those colonies. After adoption of the Declaration of Independence, the drafters of most of the state constitutions similarly resorted to the public trust doctrine. . . . [S]everal constitutions employed the terms 'trust' or 'public trust' merely as synonyms for public office."[11] "The governor and company were to serve as trustees not only of their current associates, but also for the colony's future free inhabitants.[12] The charter issued the next year for Rhode Island also featured public trust language,[13] as did the 1732 charter for Georgia."[14]

The Founders were acquainted with the standards of fiduciary law "both in the private and public sectors." Under these rules, private and public fiduciaries could act only "within the scope of their authority." They had "to exercise their authority

10. Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1112 (2004), *quoting* Charter of Connecticut (1662), *available at* http://www.nhinet.org/ccs/docs/conn1662.htm (last visited Dec. 10, 2004).

11. Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1134 (2004) (footnote omitted) (quoting Charter of Connecticut (1662), *available at* http://www.nhinet.org/ccs/docs/conn1662.htm (last visited Dec. 10, 2004)).

12. *See* Charter of Connecticut (1662), available at http://www.nhinet. org/ccs/docs/conn1662.htm (last visited Dec. 10, 2004). "The earlier charters of Virginia and Massachusetts contain no such trust language." Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1112 n.143 (2004) (citing First Charter of Virginia (Apr. 6, 1606), *available at* http://www.nhinet.org/ccs/docs/va-1.htm; Second Charter of Virginia (May 23, 1609), *available at* http://www.nhi-net. org/ccs/docs/va-2.htm; Third Charter of Virginia (Mar. 12, 1612), *available at* http://www.nhinet.org/ccs/docs/va-3.htm; First Charter of Massachusetts (Mar. 4, 1629), *available at* http://www.nhinet.org/ccs/docs/mass-1.htm (all sites last visited Dec. 10, 2004)).

13. Charter of Rhode Island and Providence Plantations (1663), *available at* http://www.yale.edu/lawweb/avalon/states/ri04.htm (last visited Dec. 10, 2004) ("Into the sayd Governour and Companv, and their successours, forever, vpon trust, for the vse and benefit of themselves and their associates, ffreemen of the sayd Collony").

14. Ga. Charter, *passim* (1732), *available at* http://www.yale.edu/lawweb/avalon/states/ga01.htm (last visited Dec. 10, 2004); Robert G. Natelson, *The Constitution and the Public Trust,* 52 BUFF. L. REV. 1077, 1112 (2004).

personally in absence of a prescription to the contrary; and to serve loyally, carefully, and impartially. Authority could be implied as well as express, but grants of authority were narrowly construed. The courts remedied breaches of duty through various remedies, including invalidation of acts in breach of trust."[15]

Further, "the underlying standard—that government agents have an obligation of impartiality to those they serve—was part of a fiduciary ideal of government service that was omnipresent years earlier, when the Constitution was drafted, debated, and ratified."[16] "When the federal constitutional convention met in 1787, most of the state constitutions already contained fiduciary language.... The same was true at the state conventions that met to ratify or reject the Constitution."[17] "The Virginia convention narrowly approved the Constitution, but with a recommendation that a 'declaration or bill of rights' be added, including the proclamation, 'That all power is naturally invested in, and consequently derived from, the people; that magistrates therefore are their trustees and agents, at all times amenable to them.'"[18] "The federal Constitution itself referred in several places to '"public Trust'[19] and to public offices being 'of Trust.'"[20]

15. Robert J. Natelson, *Judicial Review of Special Interest Spending: The General Welfare Clause and the Fiduciary Law of the Founders*, 11 TEX. REV. LAW & P. 239, 281 (2007).

16. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1083 (2004) (citing, *e.g.*, ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 526 (1997)).

17. Fisher Ames, Massachusetts Convention (Jan. 11, 1788), *in* 2 JONATHAN ELLIOT, THE DEBATES IN THE SEVERAL STATE CONVENTIONS ON THE ADOPTION OF THE FEDERAL CONSTITUTION 8–9 (2d ed., J.B. Lippincott 1941) ("by their servants [the people] govern ... they delegate that power, which they cannot use themselves, to their trustees."); Fisher Ames (Jan. 19, 1788), *in id.* at 46; William Symmes (Jan. 22, 1788), *in id.* at 71; Rev. Shute (Jan. 30, 1788), *in id.* at 119; Robert R. Livingston, New York Convention (June 23, 1788), *in* 2 JONATHAN ELLIOT, THE DEBATES IN THE SEVERAL STATE CONVENTIONS ON THE ADOPTION OF THE FEDERAL CONSTITUTION 293 (2d ed., J.B. Lippincott 1941); Alexander Hamilton, *in id.* at 388, 398; Thomas Tredwell (July 2, 1788), *in id.* at 404–05; James Wilson, *Pennsylvania Convention* (Dec. 1, 4, 1787), *in* 2 JONATHAN ELLIOT, THE DEBATES IN THE SEVERAL STATE CONVENTIONS ON THE ADOPTION OF THE FEDERAL CONSTITUTION at 293, 443–4, 459, 480 (2d ed., J.B. Lippincott 1941); Thomas M'Kean (Dec. 11, 1787), *in id.* at 530; *id.* at 533; Charles Pinckney, *South Carolina Legislature* (June 16, 1788), *in* 4 JONATHAN ELLIOT, THE DEBATES IN THE SEVERAL STATE CONVENTIONS ON THE ADOPTION OF THE FEDERAL CONSTITUTION at 256 (2d ed., J.B. Lippincott 1941); John Julius Pringle, *in id.* at 270; Edward Rutledge, *in id.* at 276; General Pinckney (June 17, 1788), *in id.* at 281; Governor Edmund Randolph, *Virginia Convention* (June 10, 1788), *in* 3 *id.* at 204; John Marshall, *in id.* at 225, 657.

18. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1086 (2004) (citing Virginia Convention (June 27, 1788), *in* 13 THE DOCUMENTARY HISTORY OF THE RATIFICATION OF THE CONSTITUTION at 657 (Merrill Jensen et al. eds., 1976)).

19. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1086 (2004) (citing U.S. CONST. art. vi, cl. 3).

20. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1086 (2004) (citing U.S. CONST. art. I, 3, cl. 7 ("Office of ... Trust"); *id.*, art. I, 9, cl. 8; *id.*, art. II, 1, cl. 2 ("Office of Trust")).

The Founders "believed that government should receive sufficient powers to execute its trust.[21] However, care should be taken not to give government too much authority. The *Pennsylvania Herald* opined that 'all power is a delegation from the people for their own advantage [and] no greater portion of it should be any where entrusted than is necessary to accomplish the end proposed.'[22] Both federalists and anti-federalists agreed that an official exceeding the scope of his limited powers thereby breached the public trust."[23]

In addition, all agreed that "public officials had a duty of care."[24] The officials had to have "sufficient knowledge to execute their functions,"[25] and be limited in their "indiscretions."[26] Executives have a duty to select "competent agents."[27]

21. ALEXANDER HAMILTON, JAMES MADISON & JOHN JAY, THE FEDERALIST No. 23 at 113 (Alexander Hamilton) (George W. Carey & James McClellan eds., Liberty Fund 2001) (1788) ("government ought to be clothed with all the powers requisite to complete execution of its trust"); JONATHAN ELLIOT, THE DEBATES IN THE SEVERAL STATE CONVENTIONS ON THE ADOPTION OF THE FEDERAL CONSTITUTION: John Marshall, Virginia Convention (June 10, 1788), at 225 (2d ed., J.B. Lippincott 1941) (similar).

22. *Editorial*, PA. HERALD, June 9, 1787, *reprinted in* 13 THE DOCUMENTARY HISTORY OF THE RATIFICATION OF THE CONSTITUTION 131 (Merrill Jensen et al. eds., 1976).

23. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1138–39 (2004) (citing, *e.g.*, Alexander Contee Hanson, Remarks on the Proposed Plan of a Federal Government, Addressed to the Citizens of the United States of America, And Particularly to the People of Maryland (1788), *reprinted in* 15 THE DOCUMENTARY HISTORY OF THE RATIFICATION OF THE CONSTITUTION 536 (Merrill Jensen et al. eds., 1976)).

24. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1142 (2004) (citing PLATO, THE REPUBLIC 249–50 (H.D.P. Lee trans., 1961) (1955), HUGONIS GROTII, DE JURE BELLI ET PACIS LIBRI TRES 324 (William Whewell D.D. trans., Cambridge University Press 1853) (1625); ALGERNON SIDNEY, DISCOURSES CONCERNING GOVERNMENT 179 (Thomas G. West ed., 1996) ("Cato" on diligence); 2 Henry St. John Bolingbroke, *A Dissertation Upon Parties*, *in* 2 THE WORKS OF LORD BOLINGBROKE 100–01, 158 (Frank Cass & Co. 1967) (1844)).

25. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1142 (2004) (citing James Madison, Journal (June 21, 1787), *reprinted in* 1 THE RECORDS OF THE FEDERAL CONVENTION OF 1787 361 (Max Farrand ed., 1937)); *see also* ALEXANDER HAMILTON, JAMES MADISON & JOHN JAY, THE FEDERALIST No. 57 at 295 (James Madison) (George W. Carey & James McClellan eds., Liberty Fund 2001) (1788) ("The aim of every political constitution is, or ought to be, first to obtain for rulers men who possess most wisdom to discern, and most virtue to pursue, the common good of the society.").

26. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1142 (2004) (citing James Madison, Journal (June 7, 1787), *reprinted in* 1 THE RECORDS OF THE FEDERAL CONVENTION OF 1787 151–52 (Max Farrand ed., 1937); James Madison, Journal (July 20, 1787), *reprinted in* 2 *id.* at 65).

27. Nathaniel Gorham, Journal (July 18, 1787), *reprinted in* 2 THE RECORDS OF THE FEDERAL CONVENTION OF 1787 42 (Max Farrand ed., 1937).

And their functions call "for a higher standard of care than that applicable to the private sector."[28]

"The proposed Constitution contained various provisions designed to render federal officials loyal to the public, with as few conflicting interests as possible.[29] Moreover, Senators and Representatives were not to serve in the executive branch nor accept, even on resignation, newly-created or newly-enhanced executive offices.[30] Correspondingly, to prevent congressional corruption of the President, the legislature could not vary his compensation during his term.[31] To reduce the chances of foreign corruption of the President, only natural-born citizens could be elected to that office."[32] Age and residency limits were imposed on Senators.[33] "To reduce the likelihood of factional corruption, the President was to be selected in the most impartial manner the drafters could design."[34]

THE DEBATE

Since the publication of Robert G. Natelson's *The Constitution and the Public Trust*, at least one contemporaneous commentator who in part disagreed with the fiduciary model has been discovered.[35] In addition, in a later article, Natelson

28. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1142–43 (2004).

29. Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1147–48 (2004) (citing Robert G. Natelson, *A Reminder: The Constitutional Values of Sympathy and Independence*, 91 KY. L.J. 353, 390–405 (2003)).

30. U.S. CONST. art. I, 6, cl. 2; *see also* ALEXANDER HAMILTON, JAMES MADISON & JOHN JAY, THE FEDERALIST No. 76 at 395 (Alexander Hamilton) (George W. Carey & James McClellan eds., Liberty Fund 2001) (1788); JONATHAN ELLIOT, 2 THE DEBATES IN THE SEVERAL STATE CONVENTIONS ON THE ADOPTION OF THE FEDERAL CONSTITUTION, John Williams, New York Convention (June 21, 1788) 241 (2d ed., J.B. Lippincott 1941); FRIENDS OF THE CONSTITUTION: WRITINGS OF THE "OTHER" FEDERALISTS 1787–1788: Tench Coxe, *An American Citizen III*, PHILA. INDEP. GAZETTEER, Sept. 29, 1788, at 467 (Colleen A. Sheehan & Gary L. McDowell eds., 1998); Hugh Williamson, Remarks on the New Plan of Government (Feb. 1788), *reprinted in id.* at 277.

31. U.S. CONST. art. II., 1, cl. 7; see also ALEXANDER HAMILTON, JAMES MADISON & JOHN JAY, THE FEDERALIST No. 73 at 379–80 (Alexander Hamilton).

32. U.S. CONST. art. II, 1, cl. 5.

33. U.S. CONST. art. I, 3, cl. 3; ALEXANDER HAMILTON, JAMES MADISON & JOHN JAY, THE FEDERALIST No. 62 at 319 (James Madison) (George W. Carey & James McClellan eds., Liberty Fund 2001) (1788).

34. John Dickinson, *Fabius II*, PA. MERCURY, Apr. 15, 1787, *reprinted in* 17 THE DOCUMENTARY HISTORY OF THE RATIFICATION OF THE CONSTITUTION 124–25 (Merrill Jensen et al. eds., 1976); Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1147–49 (2004).

35. The commentator was Noah Webster, the "outspoken Federalist and future lexicographer." Robert G. Natelson, *Judicial Review of Special Interest Spending: The General Welfare Clause and the Fiduciary Law of the Founders*, 11 TEX. REV. LAW & POL. 239, 245 n.18 (2007) (citing Giles Hickory, N.Y. AM. MAG. (Feb. 1, 1788), *in* 20 THE DOCUMENTARY HISTORY OF THE RATIFICATION OF THE CONSTITUTION 738, 741, 743 (John P. Kaminski & Gaspare J. Saladino eds., 1976–2006)).

set out the standard for the fiduciary's exercise of discretion: "The Founders' fiduciary law was that if the instrument creating the fiduciary's powers granted discretion, then that discretion had to be exercised in accordance within any guidelines specified in the instrument.[36] When no grounds were specified—as when the instrument authorized the fiduciary to act 'as he or she shall see fit'—then he or she still had to show good cause for any significant deviations from the principle of equality."[37] Thus, in this view whatever was not specified in the Constitution was left to the discretion of the actors, except that the actors had to justify their actions by showing that their actions followed or implemented the Constitution's general principles. The movement to contract has appeared in the political public arena as well. Significantly, when the Republican Party came to power, the Party announced a "Contract with America." Thereafter, President Clinton of the Democratic party announced a "Covenant with America." Both announcements were inappropriate. A promise to obey the will of the people would have been more in line. Hopefully, this is what the two declarations meant.

The similarities between private fiduciaries and government fiduciaries are striking. The two power holders balance each other. As private power becomes stronger, it might overcome government power. But if private power does not regulate itself, resulting in excesses that harm the economy and the financial system, the government tends to raise its controls. During the Great Depression, President Franklin Roosevelt introduced, and Congress enacted, a number of statutes that protected employees and other entrustors in the financial system and constrained private fiduciaries.[38] As the statutes that reined in fiduciaries were slowly watered down during the past thirty years, the voters' reaction was to

36. *See, e.g.*, Burrell v. Burrell, Amb. 660, 660, 27 Eng. Rep. 428, 428 (Ch. 1768).

37. 1 Vern. 66, 23 Eng. Rep. 315, 316 (Ch. 1682). *See* Robert G. Natelson, *Judicial Review of Special Interest Spending: The General Welfare Clause and the Fiduciary Law of the Founders*, 11 TEX. REV. LAW & POL. 239, 273–74 (2007).

38. Fair Labor Standards Act of 1936, ch. 676, 52 Stat. 1060 (current version at 29 U.S.C. §§ 201–219 (2006)); National Labor Relations Act (Wagner Act), ch. 372, 49 Stat. 449 (1935) (current version at 29 U.S.C. §§ 151–169 (2006)); Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-bbbb (2006)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-nn (2006)); Public Utility Holding Company Act of 1935, ch. 687, 49 Stat. 838 (codified as amended at 15 U.S.C. §§ 79 to 79z-6 (2000)) (repealed 2005); Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa-bbbb (2006)); Investment Company Act of 1940, ch. 686, §§ 1–53, 54 Stat. 789, 789–847 (codified as amended at 15 U.S.C. §§ 80a-1 to -64 (2006)); Investment Advisers Act of 1940, ch. 686, §§ 201–221, 54 Stat. 789, 847–57 (codified as amended at 15 U.S.C. §§ 80b-1 to -21 (2006)).

choose a very different President, and stricter regulations and accountability are being imposed on private sector fiduciaries.[39]

The prosperity of this country depends on entrustment to government and to private fiduciaries. The freedom and well-being of this country's people depend on the accountability of both species of fiduciaries and on preventing them from misappropriating their entrusted property and power. In fact, both government and private sectors, each in its own sphere of activities, are grappling with similar issues involving global trades.[40]

The different views concerning the fiduciary laws, both private and governmental, relate to where the lines should be drawn rather than to the principles to be followed. What kind of entrustment and how much entrustment should trigger legal constraints? Are there alternative constraints by public pressures and values that would be more effective than law? What kinds of structural constraints are desirable to cool fiduciaries' temptations and feelings of entitlement? What kinds of protection should law provide entrustors, and when should entrustors fend for themselves? How should accountability differ in the exercise of private power as compared to accountability in the exercise of public government power? And how should freedom for innovation be retained and encouraged in balancing legal intrusion? When is entrusted power (private or government) too big? When and how should it be reined in? Because these questions are eternal in any society, we can ponder upon them, learn from history, and compare past lessons to the current environment.

In general, the answers may depend on the extent and nature of the entrustment, the dangers of abuse of entrustment, the mechanisms of controls over private and public power holders. In the public area we have a longer tradition and experience on how to create accountability. In the area of private power we have less understanding and a shorter experience. The one barrier to unlimited private power is the law. A few private sector mechanisms have arisen, but their effect is not sufficiently strong to match overwhelming temptations and ambitions. The balance of power that reflects the government structure was established in the 1930s, such as the Glass-Steagall Act of 1933, and the antitrust laws, both of which were designed, among other things, to rein in large private organizations that would lead to unlimited and uncontrollable power. But these structures have been dismantled slowly since the 1980s. In light of the history of the years 2008 and 2009 it is not likely that private power will be viewed as the weak power of individuals. It is not likely that mammoth concentration of entrusted assets and power will be viewed as needing protection against government.

39. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (introduced Dec. 2, 2009).

40. Import Safety: Regulatory Governance in the Global Economy (Cary Coglianese et al. eds., 2009).

The beginning of the year 2010 may witness a fierce clash between government and private power holders. If the private sector does not create its own separation of powers and strong barriers to abuse of entrustment, then fiduciary law will be one of the most prevalent and actively used areas of the law, to take its place beside Constitutional law. Each area is likely to adopt some of the other's rules, and perhaps some of the other's structures. Even if the rules in the two areas remain different, their respective images might change and strengthen the picture of power given in trust. As metaphoric and imprecise as this prediction sounds, one might look to the underlying principles and perhaps some of the mechanisms of the United States Constitution for the future development of fiduciary law.

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TABLE OF CASES

A

A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 586 (Del.) (1953) 123, 159
Action Marine. Inc. v. Continental Carbon Inc., 481 F.3d 1302 (11th Cir.2007) 259
Adair v. Unisys Corp. 579 F.3d 220, 236–37 (3d Cir. 2009) 249
Adams v. Catrambone, 359 F.3d 858 (7th Cir. 2004) 21
Anti-Monopoly, Inc. v. General Mills Fun Group, 611 F.2d 296 (9th Cir. 1979) 18
April Enters,Inc. v. KTTV, 147 Cal. App. 3d 805, 819 (1983) 69
Ark. Valley Agric. Soc'y v. Eichholtz, 25 P. 613, 613 (Kan. 1891) 97
Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) 172
Arst v. Stifel, Nicolaus & Co., 86 F.3d 973 (10th Cir. 1996) 2, 8, 190
Aspen Wilderness Workshop, Inc. v. Colo. Water Conservation Bd., 901 P.2d 1251 (Colo. 1995) 127
Associated Indem. Corp. v. CAT Contracting, 964 S.W.2d 276, 288 (Tex. 1988) 12, 57
Attorney Grievance Comm'n v. Hess,722 A.2d 905 (Md. 1999) 112
Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) 261
Australian Sec. & Inv. Comm'n v Citigroup Global Mkts. Australia Pty. Ltd., [2007]FCA 963 (June 28, 2007) 3, 117

B

Baker v. Battershell, No. 5, 1986 Tenn. App. LEXIS 3124 (Ct. App. July 9, 1986) 250
Bal Harbor Club, Inc. v. AVA Dev., Inc. (*In re* Bal Harbor Club, Inc.), 316 F.3d 1192 (11th Cir. 2003) 245
Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176 (1955) 266
Banca Cremi S.A. v. Alex, Brown & Sons, Inc., 132 F.3d 1017,1028 (4th Cir. 1997) 172
Banco Espanol deCredito v. Security Pac. Nat'l Bank, 973 F.2d 51, 53 (2d Cir. 1992) 72
Bank Line, Ltd. v. United States, 163 F.2d 133, 139 (2d Cir. 1947) 263
Bank of Am. v. City & County of S.F., 309 F.3d 551, 562 n.6 (9th Cir. 2002) 115
Bank of Calif. v. Connolly, 111 Cal. Rptr. 468 (Ct. App. 1973) 54
Baptist Health v. Murphy, 365 Ark. 115, 125 (2006) 3
Barker v. First Nat'l Bank, 20 F. Supp. 185, 188–89 (N.D. Ala. 1937) 174
Barth v. Barth, 659 N.E.2d 559 (Ind. 1995) 21

Bates v. State Bar of Arizona, 433 U.S. 350 (1977) 133
Beatty v. Guggenheim Exploration Co., 122 N.E. 378, 380 (N.Y. 1919) 252, 254
Beck v. Pace Int' Union, 427 F.3d 668, 671 (9th Cir. 2005) 222
Bereslavsky v. Caffey, 161 F.2d 499, 500 (2d Cir. 1947) 263
Berg & Berg Enters., LLC v. Boyle, 100 Cal. Rptr. 3d 875 (Ct. App. 2009) 40
Bevel v. Higginbottom, No. CIV-98-474-X, 2001 U.S. Dist. LEXIS 17977 (E.D. Okla. Oct. 4, 2001) 178
Blackmon v. Hale, 463 P.2d 418 (Cal. 1970) 164
Bloor v. Dansker (In re Investors Funding Corp. of N.Y. Sec. Lit.), 523 F. Supp. 533 (S.D.N.Y. 1980) 88
Bodnar v. John Hancock Funds, No. 2:06-CV-87 PS, (2008) 64
Bonner v. Dist. Court, 206 P.2d 166, 169 (Mont. 1949) 13, 23
Boss v. La Salle Bank, N.A., 84 F.Supp. 2d 947, 950 (N.D. Ill. 1999) 46
Bostic v. Goodnight, 443 F.3d 1044, 1046, 1049 (8th Cir. 2006) 256
Branson Sch. Dist. RE-82 v. Romer, 161 F.3d 619, 633 (10th Cir. 1998) 5, 235
Breen v. Williams (1996) 186 CLR 71, 106 71
Brehm v. Eisner, 746 A.2d 244, 261–62 (Del. 2000) 118
Brooks v. Wright, 971 P.2d 1025 (Alaska 1999) 124
Brooks v. Valley Nat'l Bank, 539 P.2d 958 (Ct. App. Ariz. 1975) 9
Brophy v. Cities Serv. Co ., 70 A.2d 5, 7 (Del. Ch. 1949) 9, 109, 255
Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1032 (2d Cir. 1993) 172
Brumm v. McDonald & Co. Sec., 603 N.E.2d 1141 (Ohio Ct. App. 1992) 191
Buford v. H&R Block, Inc., 168 F.R.D. 340, 351 (S.D. Ga. 1996) 129
Buran Equip. Co. v. Superior Court, 190 Cal. App. 3d 1662, 1666 (Cal. App. 6th Dist. 1987) 164
Burg v. Horn, 380 F.2d 897 (2d Cir. 1967) 197
Burrell v. Burrell, Amb. 660, 660, 27 Eng. Rep. 428, 428 (Ch. 1768) 285
Burrow v. Arce: *The Current State of Attorney Fee Forfeiture,* 40 St. Mary's L.J. 967 (2009) 255
Bush v. Canfield, 2 Conn. 485, 488 (1818) 257

C

Cal. Dental Ass'n v. Am. Dental Ass'n, 152 Cal. Rptr. 546, 550 (Cal. 1979) 245
Carpenter v. United States, 484 U.S. 19, 26 (1987) 22
Carramerica Realty Corp. v. NVIDIA Corp., No. C 05-00428 JW, (2006) 39
Cavic v. Grand Bahama Dev. Co., Ltd, 701 F.2d 879 (7th Cir. 1983) 93
CenTra, Inc. v. Estrin, 538 F.3d 402, 415 (6th Cir. 2008) 204
Century Indem. Co. v. Congoleum Corp. *(In re* Congoleum Corp.), 426 F.3d 675, 690 (3d Cir. 2005) 204
Charles Hughes & Co., Inc., v. SEC, 139 F.2d 434 (2d Cir. 1943) 48
Chase Nat'l Bank v. Sayles, 30 F.2d 178 (D.R.I. 1927) 265
Chipser v. Kohlmeyer & Co., 600 F.2d 1061, 1066–67 (5th Cir. 1979) 47

Chou v. Univ. of Chi., 254 F.3d 1347, 1362 (Fed. Cir. 2001) 137
City of Hope v. Genentech, Inc., 181 P.3d 142 (Cal. 2008) 22, 26, 60, 114, 221
City of Newport v. Fact Concerts, Inc., 453 U.S. 247 (1981) 259
Coca-Cola Co. v. Dixi-ColaLab., Inc., 155 F.2d 59, 63 (4th Cir. 1946) 264
Coffee Break Café, Inc. v. Mattison, No. 31358-VA, 2001 Va. Cir. LEXIS 502 (Va. Cir. Ct.May 10, 2001) 41
Commodity Futures Trading Comm'n v. Heritage Capital Advisory Servs, Ltd., 823 F.2d 171, 173 (7th Cir. 1987) 47
Connick v. Myers, 461 U.S. 138, 148 (1983) 128
Conway v. Bonner, 100 F.2d 786 (5th Cir. 1939) 40
Corestates Bank, N.A. v. Signet Bank, No. 96-3199, (1996) 72
Corradino v. Corradino, 48 N.Y.2d 894, 895 (N.Y. 1979) 114
Cotton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 699 F. Supp. 251 (N.D.Okla. 1988) 182
County of Oneida v. Oneida Indian Nation, 470 U.S. 226, 245 (1985) 265
Credit Lyonnais Bank Nederland, N.V. v. Pathe Communs. Corp., No. 12150, (1991) 37
Cresswell v. Sullivan & Cromwell, 922 F.2d 60 (2d Cir. 1990) 264
Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 594 (Tex. 1992) 12, 57
Crossman v. Keister, 79 N.E. 58 (Ill. 1906) 254

D

Dairy Queen, Inc. v. Wood, 369 U.S. 469 (1962) 264, 265
Delta Pride Catfish, Inc., v. Marine Midland Bus. Loans, 767 F. Supp 951 (E.D. Ark. 1991) 109
Denison State Bank v. Madera, 640 P.2d 1235, 1241 (Kan. 1982) 2
Denver Nat'l Bank v. Von Brecht, 322 P.2d 667 (Colo. 1958) 8, 10
Dependahl v. Falstaff Brewing Co., 653 F.2d 1208, 1216–17 (8th Cir.), *cert. denied,* 454 U.S.968 (1981) 259
DeRance, Inc. v. PaineWebber, Inc., 872 F.2d 1312, 1321 (1989) 47
Diduck v. Kaszycki & Sons Contractors, Inc., 974 F.2d 270 (2d Cir. 1992) 19
Disney v. Walt Disney Co., 2005 Del. Ch. LEXIS 94 (Del. Ch. June 20, 2005) . . 201
DK Prods.,Inc. v. Miller, Case No. CA2008-05-060, 2009 WL 243089 (Ohio Ct. App. 12 Dist. Feb. 2, 2009) 250
Dodge v. Ford Motor Co ., 170 N.W. 668 (Mi. 1919) 157
Dresser Indus., Inc. v. Digges, No. JH-89-485, (1989) 112
Dunkin v. Dunkin, 986 P.2d 706, 849 (Or. Ct. App. 1999) 54

E

E.I. Du Pont de Nemours Powder Co. v. Masland, 244 U.S. 100 (1917) 250
Elmore v. Cone Mills Corp., No. 6:88-3258-17, 1990 U.S. Dist. LEXIS 15347, at * 26–31(D.S.C. Aug. 13, 1990) 250

Emle Indus., Inc. v. Patentex, Inc., 478 F.2d 562, 574 (2d Cir. 1973) 199
Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938) 264
Essex Trust Co. v. Enwright, 102 N.E. 441 (Mass. 1913) 254
Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962) 47
Estate of Hann v. Hann, 614 N.E.2d 973, 978 (Ind. App. 1993) 268
Ewert v. Bluejacket, 259 U.S. 129, 138 (1922) 265

F

Falcone v. Middlesex County Med. Soc'y, 34 N.J. 582, 597 (1961)........ 157, 247
FDIC v. Fuller, 994 F.2d 223, 224 (5th Cir. 1993)....................... 264
Finegan v. Theisen, 52 N.W. 619 (Mich. 1892) 8
First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A., 919 F.2d 510 (9th Cir. 1990) 72
First Sec. Bank of Utah v. Banberry Dev. Corp, 786 P.2d 1326, 1333 (Utah 1989) 2
Fleetwood Enters. Inc. v. Gaskamp, 280 F.3d 1069, 1076 (5th Cir. 2002) 236
Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976); DEL. CODE ANN. tit. 8, § 144 (2009) 192
Floyd v. Hefner, No. H-03-5693, 2006 U.S. Dist. LEXIS 70922 (S.D. Tex. Sept. 29, 2006) 40
Fox v. Encounters Int'l, Nos. 05-1139, 05-1404, 2006 U.S. App. LEXIS 9269 (4th Cir. Apr. 13, 2006) 46

G

Gagnon v. Coombs, 654 N.E.2d 54, 63 (Mass. App. 1995) 253
Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 822–23 (8th Cir. 2009)................................ 23, 131, 244
Gardner v. Surnamer, 608 F. Supp. 1385, 1391 (E.D. Pa. 1985) 138
Gartenberg v. Merrill Lynch Asset Mgmt, Inc., 740 F.2d 190 (2d Cir. 1984)................................ 30, 146
Gatliff Coal Co. v. Cox, 142 F.2d 876 (6th Cir. 1944) 266
Gaver v. Early, 215 P. 394 (Cal. 1923) 131
Gould v. Greylock Reservation Comm'n, 215 N.E.2d 114, 126 (Mass. 1966)... 127
Gozenbach v. Eberwein, 655 S.W.2d 794, 796 (Mo. Ct. App. 1983) 204
Grace Line, Inc. v. Todd Shipyards Corp., 500 F.2d 361 (9th Cir. 1974)...... 5, 91
Green v. Nuveen Advisory Corp., 295 F.3d 738, 743–45 (7th Cir. 2002)....... 154
Greisman v. Newcomb Hosp., 192 A.2d 817 (N.J. 1963) 36, 156, 246
Griffin v. U.S., 588 F.2d 521, 528 (5th Cir. 1979)......................... 91
Grimes v. Kennedy Krieger Inst, Inc., 782 A.2d 807, 823–25 (Md. 2001)....................... 159, 209, 248
Gulfstream Aerospace Corp. v. Mayacamas Corp., 485 U.S. 271 (1988) 263
Guth v. Grace Co., 5 A.2d 503 (Del. 1939) 20

H

Hamilton v. Mercantile Bank, 621 N.W.2d 401 (Iowa 2001).................. 8
Harris Trust & Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250 (2000).. 267
Hart v. Geysel, 294 P.2d 570 (Wash. 1930) 198
Hecker v. Deere & Co., 556 F.3d 575 (7th Cir. 2009)...................... 42
Helm Fin. Corp. v. MNVA R.R., 212 F.3d 1076, 1081 (8th Cir. 2000)....... 40, 41
Henderson v. Axiam, Inc., No. 96-2572-D, 1999 Mass. Super. LEXIS 580 (Mass.Super. Ct. June 22, 1999) 254
Hodgkinson v. Simms, 117 D.L.R. 4th 161 (1994) 152
Hoke v. Henderson, 15 N.C. (4 Dev.) 1 (1833)............................ 22
Holmes v. Lerner, 74 Cal. App. 4th 442 (Ct. App. 1999) 57
Holy Cross Parish v. Huether, 308 N.W.2d 575, 577 (S.D. 1981) 27
Honda Fin. Corp. v. Francis, No. 92-0085-B, (1993) 41
Hoover v. Wagner, 47 F.3d 845, 850 (7th Cir. 1995) 263
Hudson v. Craft, 204 P.2d 1 (Cal. 1949)............................... 198
Hunt v. Miller, 908 F.2d 1210 (4th Cir. 1990)............................ 38
Hyman v. Jewish Chronic Disease Hosp., 206 N.E.2d 338 (N.Y. 1965) 158

I

In re American Printer & Lithographs, Inc., 148 B.R. 862, 866 (Bankr. N.D. Ill. 1992)....................................... 148
In re Caremark Int'l, Inc. Deriv. Litig., 698 A. 2d 959 (Del. Ch. 1996) 175, 176
In re Cendant Corp. Litig. 182 FRD 144, 147–49 (1998), 264 F.3d 201 (3d Cir. 2001).. 155
In re Citygroup, Inc. S'holders Derivitive Litig. 964 A. 2d 106 (Del. Ch. 2009) 144
In re Cooperman, 83 N.Y. 2d 465 (1994) 182
In re Cox Communic'ions, Inc. S'holder Litig. 879 A. 2d 604, 643 (Del. Ct.Ch. 2005) 43
In re County Green Ltd. P'ship., 438 F. Supp. 701, 707, W.D. Va. 1977........ 41
In re Estate of London, 171 N.Y.S. 981, 983–84 (Sur. Ct. 1918) 159
In re Estate of Prankard, 723 N.Y.S. 2d 515, 326 (Sur. Ct. 2000)............ 115
In re Estate of Rothko, 379 N.Y.S. 2d 923, 935 (Sur. Ct. 1975) 131, 255
In re Gehl's Estate, 92 N.W. 2d 372 (Wis. 1958) 205
In re Investor's Funding Corp. of New York Secs. Litig., 523 F. Supp. 533, 542 n. 4 (S.D.N.Y. 1980) 113
In re Kemp & Beatley, Inc., 473 N.E. 2d 1173 (N.Y. 1984).................. 260
In re Marriage of Brewer & Federici, 93 Cal. A.P.P. 4th 1334 (2001) 54
In re Martin, 817 F. 2d 175, 181 (1st Cir. 1987)......................... 148
In re NCS Healthcare, Inc. 2003 Del. Ch. LEXIS 56 (Del. 26 May 28, 2003) 246

In re Patterson, 53 B.R. 366, 374 (Banker. D. Neb. 1985) 207
In re Prudential Insurance Co. of Am. In Sales Practices Litig.
975 F. Supp. 584 (D.N.J. 1997) 172
In re SmarTalk Teleservices Inc. Secs. Litig., 487 F. Supp. 2d 298
(S.D. Ohio 2007) 117
In re Tsikouris 340 B.R. 604 (Bankr. N.D. Ind. 2006) 222
Industrial Loan & Inv. Co. v. Superior Ct., 209 P. 360 (Cal. 1922) 204
Ins.Co. of N. Am. v. Morris, 981 S.W.2d 667, 674 (Tex. 1998). 62

J

Johnson v. Brewer & Pritchard, P.C., 73 S.W.3d 193, 199 (Tex. 2002) 62
Johnson v. Schmitz, 119 F. Supp. 2d 90, 98 (D. Conn. 2000) 137
Jones v. Harris Assocs. L.P., 527 F.3d 627
(7th Cir. 2008) 23, 30, 33, 131, 132, 145, 220, 244
Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 444–52 (7th Cir. 1987) 230
Jostens, Inc. v. Kauffman, 842 F. Supp. 352, 354 (C.D. Ill. 1994). 28

K

Kahn v. Icahn, No. 15916, 1998 Del. Ch. LEXIS 223 (Del. Ch. Nov. 12,
1998) 198
Kalmanash v. Smith, 51 N.E.2d 681, 688 (N.Y. 1943) 169
Kazanjian v. Rancho Estates, 235 Cal. App. 3d 1621, 1625
(Cal. App. 1991). 164
Kirschner v. West Co., 300 F.2d 133 (3rd Cir. 1962) 266
Kohn v. Am. Metal Climax, Inc., 458 F.2d 255, 270 (3d Cir. 1972) 211
Kotis v. Nowlin Jewelry, Inc., 844 S.W.2d 920, 923 (Tex. App. 1992). 236

L

Lacy v. Ticor Title Ins. Co., 794 S.W.2d 781, 787 (Tex. App. 1990) 62
Laird v. Integrated Res., 897 F.2d 826 (5th Cir. 1990) 48
Lange v. Schropp (*In re* Brook Valley VII), 496 F.3d 892, 900
(8th Cir. 2007) 10, 52, 175, 177
Lash v. Cheshire County Sav. Bank, Inc., 474 A.2d 980 (N.H. 1984) 8, 10, 62
Lautenberg Foundation v. Madoff, No. 09-816 (SRC), 2009 U.S. Dist. LEXIS
82084 (D.N.J. Sept. 9, 2009) 170
Lewis v. Scott (*In re* Lewis) No. 94-15516, 97 F.3d 1182
(9th Cir. 1996) 104, 238
Liberty Oil Co. v. Condon Nat'l Bank, 260 U.S. 235 (1922). 265
Lift-a-Loft Corp. v. Rodes-Roper-Love Ins. Agency, Inc., 975 F.2d 1305,
1311–12 (7th Cir. 1992). 264
Lincoln Benefit Life Co. v. Edwards, 966 F. Supp. 911 (D. Neb. 1997). 235
Linden Place v. Stanley Bank, 167 P.3d 374, 375 (Kan. Ct. App. 2007) 1
Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940) 222

Locati v. Johnson, 980 P.2d 173 (Or.Ct. App. 1999). 17
Long v. Ostroff, 63 Pa. D. & C. 4th 444, 446 (Ct. Com. Pl. 2003). 110
Lopez v. Medford Cmty. Ctr., Inc., 424 N.E.2d 229, 233 (Mass.1981). 120
Lopez v. TDI Servs., 631 So. 2d 679, 684 (La. App. 1994) 40
Love v. Clayton, 134 A. 422, 424 (Pa. 1926) 41
Lowe v. SEC, 472 U.S. 181 (1985) 9
Lucas v. S.C. Coastal Council, 505 U.S. 100, 1029–31 (1992) 126
Lynch v. Patterson, 701 P.2d 1126 (Wyo. 1985). 17
Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243–44 (Del. 2009) 251

M

MacDonald v. Clinger, 84 A.D.2d 482, 487 (1982). 222
Maksym v. Loesch, 937 F.2d 1237, 1243 (7th Cir. 1991) 264
Manassas Travel, Inc. v. Worldspan, L.P., No. 2:07-CV-701-TC, (2008) 2
Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 593
(Sup. Ct. 1999). 119, 122
Maritrans GP Inc. v. Pepper, Hamilton & Scheetz, 602 A.2d 1277, 1283
(Pa. 1992). 103
Marshall v. Farmers' & Mechs.' Sav. Bank, 8 S.E. 586, 589 (Va. 1889) 97
Martin Marietta Corp. v. International Telecom. Satellite Org., 763 F. Supp.
1327, 1331–33 (D. Md. 1991) 206
Martin v. Camp. 219 N.Y. 170, 172–74 (1916) 182
Martin v. Peyton, 158 N.E. 77 (N.Y. 1927) 69
Martinelli v. Bridgeport Roman Catholic Diocesan Corp., 10 F. Supp. 2d 138,
156 (1998) 3, 64, 72, 221
McVey v. Va. Highlands Airport Comm'n, No. 01-2466, (2002). 128
Meadows v. Bierschwale, 516 S.W.2d 125 (Tex. 1974); Crossman v. Keister,
79 N.E.58 (Ill. 1906) 254
Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) 20, 52, 144
Middlesex Ins. Co. v. Mann, 124 Cal. App. 3d 558, 573
(Cal. App. 1981). 164
Moore v. Regents of Univ. of Cal., 793 P.2d 479 (Cal. 1990) 16, 18, 25, 109
Morgantown v. Royal Ins. Co., 337 U.S. 254 (1949) 262
Morice v. Bishop of Durham, 32 Eng. Rep. 947, 947 (1805) 199
Moses v. Moses, 53 A.2d 805, 807 (N.J. 1947) 268, 269
Myzel v. Fields, 386 F.2d 718, 741–42 (8th Cir. 1967) 264

N

Nash v. Schock, No. 14721, 1997 Del Ch. LEXIS 174 (Del. Ch. Dec. 3,
1997) 252
Nat'l Audubon Soc'y v. Superior Court, 658 P.2d 709, 721 (Cal. 1983). 125
Nat'l Med. Enters. v. Godbey, 924 S.W.2d 123, 147 (Tex.1996) 62
Nelson v. Hodowal, 512 F.3d 347 (7th Cir. 2008) 154

Nelson v. Serwold, 687 F.2d 278, 282 (9th Cir. 1982) 5, 91
Neubauer v. Goldfarb, 133 Cal. Rptr. 2d 218 (Ct. App. 2003) 22
NLRB v. Americana Healthcare Ctr., 782 F.2d 941, 946 (11th Cir. 1986) ... 91, 263
NLRB v. United Brotherhood of Carpenters, 531 F.2d 424 (9th Cir. 1976) 5
Novak v. Andersen Corp., 962 F.2d 757, 760 (9th Cir. 1992) 249

O
O'Malley v. Boris, No. 15735-NC, 2002 Del. Ch. LEXIS 33 (Del. Ch. Mar. 18, 2002) 202
Oakland Raiders v. Nat'l Football League, 32 Cal. Rptr. 3d 266 (Ct. App. 2005) 245
Oberly v. Kirby, 592 A.2d 445 (Del. 1991) 192
Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003) 246
OnePoint Solutions, LLC v. Borchert, 486 F.3d 342 (8th Cir. 2007) 260
Ostrander v. Gardner, 474 F.3d 4, 6 (1st Cir. 2007) 264

P
Palmer v. Brown, 273 P.2d 306, 315–16 (Cal. App. 1954) 27
People v. Walker, 90 P.2d 854, 855 (Cal.Ct. App. 1939) 16
Pepper v. Litton, 308 U.S. 295, 307 (1939) 17
PFS Distribution Co. v. Raduechel, 2009 WL 2225812 (8th Cir., July 28, 2009) 251
Piambino v. Bailey, 757 F.2d 1112, 1144 (11th Cir. 1985) 129
Pinsker v. Pac. Coast Soc'y of Orthodontists, 526 P.2d 253 (Cal. 1974) 157
Police & Fire Ret. Sys. of Detroit v. Bernal, No. 4663-CC, 2009 WL 1873144, at 3 (Del. Ch. June 26, 2009) 251
Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1289–90 (S.D.Ohio 1996) 191
Prosise v. Foster, 544 S.E.2d 331 (Va. 2001) 17, 37

R
Raycon Corp. v. Ceramtech, Inc., No. 20-9332, 2000 Mich. App. LEXIS 2511, at 2 (Ct. App. Mar. 28, 2000) 20
Reading v. Attorney-General, 1 All E.R. 617 (House of Lords Mar. 1, 1951) 23
Reginald Martin Agency, Inc. v. Conseco Medical Ins. Co., No. 1:03-CV-3810-RWS, (2005) 235
Ripley v. Int'l Rys. of Cent. Am., 171 N.E.2d 443 (N.Y. 1960) 257
Rippey v. Denver United States Nat'l Bank, 273 F. Supp. 718, 723 (D. Colo. 1967) 181
Roberts v. Sears, Roebuck & Co., 573 F.2d 976 (7th Cir. 1978) 12, 64
Robins Island Preservation Fund v. Southold Dev. Corp., 959 F.2d 409, 423–35 (2d Cir. 1992) 264

Rockwell Graphic Sys. v. DEV Indus., Inc., 91 F.3d 914, 917–18 (7th Cir. 1996) 250
Ross v. Bernhard, 396 U.S. 531 (1970) 266
Ross v. Conway, 28 P. 785 (Cal. 1892) 8
Ross v. Patrusky, Mintz & Semel, No. 90 Civ. 1356 (SWK), (1997) 113
Ross v. Wilson, 127 N.E.2d 697 (N.Y. 1955) 166
Ruiz v. Cont'l Cas. Co., 400 F.3d 986, 990 (7th Cir. 2005) 64
Russell v. Mass. Mutual Life Ins., 722 F.2d 482, 490–92 (9th Cir. 1982) 259
Russell v. Russell, 427 S.W.2d 471, 476 (Mo. 1968) 206

S
S. Atl. Ltd. P'ship of Tenn. v. Riese, 284 F.3d 518 (4th Cir. 2002) 10
S. Cretney, The Rationale of Keech v. Sandford (1969) 148
Sanford v. Nat'l Ass'n for the Self-Employed, Inc., No. 09-22-P-H, (2009) 222
Santulli v. Englert, Reilly & McHugh, P.C., 586 N.E.2d 1014, 1016 (N.Y. 1992) 174
Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171, 176 (Tex. 1997) 12, 57
Schock v. Nash, 732 A.2d 217 (Del. 1999) 105
SEC v. Bank of Am., No. 09CV6829, (S.D.N.Y Aug. 3, 2009) xii
SEC v. Blavin, 760 F.2d 706 (6th Cir. 1985) 48
SEC v. Bolla, 401 F. Supp. 2d. 43 (D.D.C. 2003) 103
SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) 46, 203
SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1942) 2
SEC v. Cuban, 634 F. Supp. 2d (D.C. Tex. 2009) 261
SEC v. Goldinger, No. CV-91-3445 JMI (GHKx),1995 U.S. Dist. LEXIS 22168 (C.D. Cal. May 12, 1995) 250
SEC v. Gruttadauria, No. 1:02CV324,Litigation Release No. 17,369 (N.D. Ohio filed Feb. 21, 2002) 142
SEC v. Lyon, 605 F. Supp. 2d 531 (S.D.N.Y. 2009) 104
SEC v. McGuire, No. 07-CV-4779-JMR/FLN, Litigation Release No. 20,387 (D.Minn. filed Dec. 6, 2007) 142
SEC v. Omnigene Devs., 105 F. Supp. 2d 1316 (S.D. Fla. 2000) 48
SEC v. Shanahan, No. 4:07CV270 JCH, 2008 U.S. Dist. LEXIS 100640 (D. Mo. Dec. 12,2008) 142
SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) 260
Securities Investor Protection Corp. v. Stratton Oakmont, Inc., 234 B.R. 293, 329 (Bankr.S.D.N.Y. 1999) 46
Selectica, Inc. v.Versata Enters., Inc., No. 4241-VCN, 2010 Del. Ch. LEXIS 39 (Del. Ch. Feb. 26, 2010) 245
Seminole Tribe v. Florida, 11 F.3d 1016 (11th Cir. 1994) 266
Sequoia Vacuum Sys. v. Stransky, 40 Cal. Rptr. 203 (Ct. App. 1964) 250
Serv. Corp. Int'l v. H.M. Patterson & Son, 263 Ga. 412 (1993) 183

Seventh Elect Church in Israel v. First Seattle Dexter Horton Nat'l Bank, 299 P. 359, 360 (Wash. 1931) 252
Sharp Electronics Corp. v. Metropolitan Life Ins. Co., 578 F.3d 505 (7th Cir. 2009) 165
Simon v. Socony-Vacuum Oil Co., 38 N.Y.S.2d 270 (Sup. Ct. 1942) 166
Simonds v. Simonds, 380 N.E.2d 189 (N.Y. 1978) 253
Smith v. Biggs Boiler Works Co., 91 A.2d 193, 197 (Del. Ch. 1952) 76
Smith v. Richard, 205 Cal. App. 3d 1354; 254 Cal. Rptr. 633; 1988 Cal. App. LEXIS 1070 (1988) 174
Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) 172, 207
Snepp v. United States, 444 U.S. 507 (1980) 20, 253
Solem v. Stumes, 465 U.S. 638, 642 (1984) 228
Sommers v. Apalachicola Northern Railroad Co., 78 So.25 (Fla. 1918) 254
State *ex rel.* Bonner v. District Court, 206 P.2d 166, 169 (Mont. 1949) 13, 23
Stevens v. Marco, 305 P.2d 669 (Cal Dist. Ct. App. 1957) 17, 60
Stewart v. Lehigh Valley R.R. Co., 38 Court of Errors & Appeals 505, 523 (N.J. 1875) 203
Stockman v. Heartland Indus. Partners, L.P., Civ. Nos. 4227-VCS, 4427-VCS, (2009) 183
Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006) 177
Stone v. Ritter, 911 A.2d 362, 364–65 (Del. 2006) 175, 177
Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 768–69 (2008) 163
Storetrax.com, Inc. v. Gurland, 915 A.2d 991, 1001 (Md. 2007) 41
Strauss Veal Feeds, Inc. v. Mead & Hunt, Inc., 538 N.E.2d 299, 303 (Ind. App.1989) 27
Subaru of Am., Inc. v. David McDavid Nissan, Inc., 84 S.W.3d 212, 225–26 (Tex. 2002) 12
Sun Oil Co. v. Wortman, 486 U.S. 717, 726–29 (1998) 265
Sun Oil v. Fleming, 469 F.2d 211, 213–14 (10th Cir. 1972) 265
Sutherland v. Sutherland, No. 2399-VCL, 2009 Del. Ch. LEXIS 46 (Del. Ch.Mar. 23, 2009) 193
Synergetics, Inc. v. Hurst, 477 F.3d 949, 961 (8th Cir. 2007) 20

T

Things Remembered v. Petrarca, 516 U.S. 124 (1995) 263
Tongass Sport Fishing Ass'n v. State, 866 P.2d 1314, 1316–18 (Alaska 1994) 128
Transamerica Mortg. Advisors ("TAMA") v. Lewis, 44 U.S. 11 (1979) 48
Travis v. Kurron Shares of Am. Inc., 272 F. Supp. 2d 816, 821 (D. Minn. 2003) 40, 41
Tull v. United States, 481 U.S. 412 (1987) 265
Tynes v. Bankers Life Co., 730 P.2d 1115, 1123–25 (Mont. 1986) 198

U

U.S. v. Fontana, 528 F. Supp. 137, 143 (S.D.N.Y. 1981) 251
Unicure, Inc. v. Thurman, 599 P.2d 925, 928 (Colo. Ct. App. 1979) 253
United States v. Bolden, 325 F.3d 471, 504–05 (4th Cir. 2003) 126
United States v. Deutsch, 451 F.2d 98 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019 (1972) 36
United States v. Ferranti, 928 F. Supp. 206, 220 (E.D.N.Y. 1996) 82
United States v. Fredericks, 787 F. Supp. 79, 83 (D.N.J. 1992) 129
United States v. Hall, 434 F.3d 42, 59 (1st Cir. 2006) 261
United States v. Iannone, 184 F.3d 214 (3d Cir. 1999) 104, 238
United States v. Loving, 321 Fed. Appx. 246; 2008 U.S. App. LEXIS 25957 (4th Cir.2008) 126
United States v. Murphy, 323 F.3d 102, 104–05 (3d Cir. 2002) 3
United States v. Myerson, 18 F.3d 153 (2d Cir. 1994) 112
United States v. O'Hagan, 521 U.S. 642 (1997) 260
United States v. Robilotto, 828 F.2d 940, 948–49 (2d Cir. 1987) 261
United States v. Scherping, 187 F.3d 796 (8th Cir. 1999) 77
United States v. Skelly, 442 F.3d 94, (2d Cir. 2006) 46
United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006) 183
United States v. York, 112 F.3d 1218 (D.C. Cir. 1997) 39, 221
United States v. Bestfoods, 524 U.S. 51 (1998) 77
Upton v. Tribilcock, 91 U.S. 45, 47–48 (1875) 50
United Mine workers v. Gibbs 262

V

Vai v. Bank of Am., 364 P.2d 247 (Cal. 1961) 54
Vikell Investors Pacific,Inc. v. Kip Hampden, Ltd., 946 P.2d 589, 597 (Colo. App. 1997) 27

W

Warsofsky v. Sherman, 93 N.E.2d 612 (Mass. 1950) 222
Washington Steel Corp. v. TW Corp., 602 F.2d 594, 601 (3d Cir. 1979) 22, 114, 223
Watson v. Button, 235 F.2d 235, 237 (9th Cir. 1956) 256
Watts v. Des Moines Register & Trib., 525 F. Supp. 1311 (S.D. Iowa 1981) 76
Whiteston REIT v. Hartman, 252 F. App'x 631, 633 (5th Cir. 2007) 222
Williams v. Cox Enters., Inc. 283 S.E.2d 367 (Ga. Ct. App. 1981) 198
Winsted Land Dev. v. Design Collaborative Architects, P.C., No. CV 960071571, (1999) 27
Wolf v. Superior Court, 107 Cal. App. 4th 25 (Ct. App. 2003) 17, 60, 66, 69, 221
Wolfle v. United States, 291 U.S. 7, 14 (1934) 182
Wotton v. Wotton, 151 F.2d 147 (10th Cir. 1945) 109

Wsol v. Fiduciary Mgmt Associates, 266 F.3d 654 (7th Cir. 2001) 231
Wyatt v. Union Mortg. Co., 598 P.2d 45, 50 (Cal. 1979) 58

Y
Yamins v. Zeitz, 76 N.E.2d 769 (Mass. 1948). 254
York v. Jones, 717 F. Supp. 421, 425 (E.D. Va. 1989) 236

Z
Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947). 178
Zannoth v. Booth Radio Stations, Inc., 52 N.W.2d 678, 684 (Mich. 1952) 27

INDEX

A

Accountants
  as professionals, 134
  conflict of interest, 87–88, 111–13
Accounting
  for entrusted money, 254–56
  for profits, remedy of, 254–56
  and restitution damages, 256
Adler, Robert S., 201
Administrative Dispute Resolution Act (ADRA), 56
Administrative law
  coherence, 227
"Ad opus," 95*n*102
Advisers Act, 45–46, 49, 184
Advisory letter, 207
Affiliates, 36
Agency, 4
  entrustment of property or power, 5–6, 8–10
  in High Middle Ages, 92–93
  in Jewish Law, 86–87
  in Laws of Hammurabi, 80
  in Roman law, 90–91
  in Sharia Islamic law, 84–85
Agents
  brokers as, 47
American Bar Association
  Model Rules of Professional Conduct, 197, 199, 205
Assets
  right to use, 13–14
Auditors, 112–13
Australia
  Federal Court of Appeals, 3
Authority, signals of, 23–24

B

Bailee, 80–81, 236*n*91
Bailment
  Laws of Eshnunna, 81–82
  Laws of Hammurabi, 80–82
Bankruptcy Code, 207
Bank trust departments
  conflict of interest, 114–17
Bebchuk, Lucian Arye, 208
  and Jesse Fried, 32, 140–42
Best interest test, 150
Bogle, John C., 45*n*177
Breach of contract, 39, 248. *See also* Contract
  remedy for, 252–53
Breach of fiduciary duties
  crime of embezzlement and, 261
  remedies for, 249, 252–53
Brennan, Justice William J., Jr., 2–3
Bribery, 88–89, 165, 167–68, 261
Bribery Act, 3*n*12
Brokers
  as advisers, 48
  as agents, 45
  as bailees, 45
  business sales-and-purchase, 45
  as dealers and in other capacities, 45–50
  as fiduciaries, 47
  marriage, 45, 46
  mortgage, 45, 57–58
  real estate, 45
  securities, 45, 46–47
  stockbrokers, 45
Burden of proof, 82
Business environment
  business judgment rule, 68, 125, 192, 245
  role in judicial categorizing, 223
Business organizations
  in Jewish Law, 86–87
  in Roman law, 92
Business sales-and-purchase brokers, 45. *See also* Brokers

C

Care, duty of
  care standards, 171–74
  corporate directors, 174–77
  debtors, 177
  nature of, 121
  principles, 169–71
Charitable organizations
  duty of loyalty, 119–21
Check-cashing institutions, 58–59
Chodus, Rafael, 134
Citigroup, 117
Civil Justice Reform Act (CJRA), 55
Civil wrongs and fiduciary relationships, similarities between, 240–41
Coherence, 223–28
  administrative law, 227
  contract law, 225–27
  health law, 227
  procedures, 227
  tort law, 227
Commercial developers of inventions, 59–62
Common law, 262–67
  assert corporate rights by corporate directors, 266
  interlocutory review, 266–67
  period of limitation v. laches in equity, 264
  right to a trial by jury, 265–66
Comptroller of the Currency, 115–16, 150
Conflicts-of-interest, 199, 199*n*19, 202–3
  examples, 109–17
  transaction, information about, 202–3
Consent
  nature of, 207–12
  silence as, 209–12
Constructive trust. *See also* Trust
  attached to entrusted property, 253–54
  as remedy, 251–53
Contract, 98
  approach, 147, 226
  bailment, 80
  breach of, 39, 248, 252–53
  construction, 27
  duties, 235-36
  freedom of, 89–90, 196
  model, 131, 213, 230, 233
  as a promise, 233–35
  terms, subject to disclosure, 214
Contract law
  and conflicts of interest, 148, 226, 278
  and culture, 79, 98
  and default rules, comparison, 212–14
  entrustment of property under, 234
  and fiduciary law, difference between, 230, 235–39
  and fiduciary law, similarities between, 235
  fiduciary rules, arguments for classifying as contract rules, 251
  injunction against breach of a contract duty, 251
  tortification of, 61
Contractors, independent, 45
Control
  beneficiary's, 68
  full, 8, 67
  majority, 109
  principal's, 5, 68
  sale of, transaction, 251
  shared, 35
Corporate directors, 68. *See also* Directors
  as consenters, 211
  assert corporate rights by, 266
  and corporation's creditors, relationship between, 39–41
  distinguished from trustees, 50
Corporate law, 96–97
Corporate social responsibility, 124–25
Corporation
  dissolution of, 260
  law, 123, 159–60, 172–73, 177, 193
  management, 124, 160
  as "nexus of contracts," 232–33
  non-profit, 119–21, 122
  public, 52, 210
Corruption, 88–90, 167–69, 279
Costs of regulation, 149
Court(s)
  conflict of interest, 113–14
  as consenters, 212
  regulation of fiduciaries, 243–48
  regulation of procedures, 262–67
  regulation of remedies, 248–58

Courts recognition, of fiduciary relationships, 62–73
  analogies to the rules, 68–69
  applying similarities to traditional fiduciary relationships, 65–68
  deferring to parties, 69–72
  fairness of extending fiduciary relationships definition, 72–73
  principles, applying, 62–65
Criminal sanctions, 260–62
Culture
  law and, 274–76
Cunningham, Lawrence A., 124, 160

D

Damages, 248
  punitive, 238–39, 258–60
  restitution, 256
Dealers
  brokers as, 45–50
Debtors
  in possession of bankrupt's estate, 52–53
Default rules
  bargaining, 197
  and contract law, comparison, 212–14
  nature and justification for, 195–200
  nature of consent and surrogate consenters, 207–12
  releasing fiduciaries, 200–207
Delaware
  Code, 198, 202, 207–8
  General Corporation Law, 208
Directors, 50–52, 68. *See also* Corporate directors
Disclosure, 202–3, 207–9
Dishonesty
  barriers to abuse, 272–73
  role of law in preventing, 274
Dobris, Joel C., 134
Duties of fiduciaries
  agents, 108
  development, 103–4
  directors, 176
  duties to public. *See* Public interest
  duty of care. *See* Care, duty of
  duty of loyalty. *See* Loyalty, duty of
  entrustors with conflicting interests, 177–82
  fiduciaries' rights and protections from the entrustors' claims, 182–83
  focus of, 107
  historical context, 73–77, 80–97
  human nature and, 101–2
  in legislation, 183–93
  lawyers, 162
  morality, 104
  to prevent harm, 160
  standards/principles and rules, 104–6
  structure and characteristics of, 106–7

E

Embezzlement
  crime of, and breach of fiduciary duties, 34–35, 212, 261
  and criminal forfeiture, 261
Enforcement, 79, 102, 105, 120, 122, 152, 165, 228, 252–53, 277
Emerging fiduciary relationships, 53–62
  check-cashing institutions, 58–59
  commercial developers of inventions, 59–62
  friends, 57
  inventors, 59–62
  law, category, 221, 231, 235
  law, principles, 7
  mediators, 55–57
  mortgage brokers, 57–58
  spouses, 53–55
Employee Retirement Income Security Act of 1974 (ERISA), 184–86, 249
  exemptions, 186–87
  fiduciary relationships, defined, 2
  Section 1104, 184–85
Entrustment, 106
  affected by market forces, 30–35
  boundaries of, 35–42
  controlling directives to fiduciary services, 28
  entrustors' expertise and, 10
  entrustors' trust and, 12
  information, 22, 104, 117, 260
    misappropriation of, 254–55
  importance of, 7–8
  legal constraints to trustworthiness, 38

Entrustment (*Cont.*)
legal relationships and, 10–11
no need for, 35–36
of power, 4–6, 8–10, 20–25
misuse of, 104, 125–26, 215, 267, 269
as prior condition to fiduciary relationships, 26
of property, 4–6, 8–10, 20–25
misappropriation of, 19, 107, 215, 267, 269
of property rights, 18–20
risk to entrustors, 25–35
Entrustor(s), 100
ability to control fiduciaries, 11–12, 19
affected by market forces, 30–35
capability of independent will, 200–201
clear and specific consent to transaction, 203–6
with conflicting interests, 177–82
emanating from entrustment, risk to, 4
expertise of, 10
fiduciaries for, 11
fiduciaries' performance, monitoring, 29–30
impact of fiduciary services on, 37
inability to specify fiduciary activities in advance, 26–28
and information about conflict-of-interest transaction, 202–3
limits to class of, 36–37
prior entrustment to fiduciary services, 26
providing notice for, 200
risk of fiduciary relationships, 25–35
risks by self-protection, limits on, 39–42
trust and entrustment, 12
trust of fiduciaries, 4, 8
Equitable remedies, 256–58. *See also* Remedies
performance of fiduciary services, 258
restitution, 257
Equity, 262–67
assert corporate rights by corporation's directors, 266
interlocutory review, 266–67
laches in equity v. common period of limitation, 264–65
right to jury trial, 265, 265–66
Equity Rules of 1912, 262
Eshnunna's Laws
bailment in, 81–82

F

Face-to-face communication, 207
Fairness, 88, 228–29
burden of proving, 213–14, 214*n*87
Family, 92
Federal Court of Appeals (Australia)
on fiduciary relationships, 3
Fiduciary duties
waiver of, 197, 200–207. *See also* Loyalty, duty of, and Care, duty of
Fiduciary law
and contract law, difference between, 235–39
and contract law, similarities between, 235
Fiduciary law as independent legal category, 217–42
bottom-up process, 218–19
business environment, role of, 223
civil wrongs and fiduciary relationships, similarities between, 240–41
coherence, issue of, 223–28
contract as a promise, 233–35
corporation as "nexus of contracts," 232–33
fairness, 228–29
fiduciary rules as contract rules, arguments for, 229–32
human needs and, 217–19
reasons for, 219–20, 239–40
recognizing new fiduciaries, judicial process of, 220–22
theories of fiduciary law and contractual approach, 233
top-down process, 218
tort law and fiduciary law, differences between, 241
voluntary uncompensated services, 233
Fiduciary relationships
and civil wrongs, similarities between, 240–41
classification of, 184, 199, 217
courts' recognition of, 62–73
defined, 1–4, 1*n*4, 3*n*11, 6, 63
elements of, 4–6, 29, 42–43
emerging, 53–62
entrustment. *See* Entrustment
good and evil effects of, 73–77
mode, transforming, 200–207
nature of, 1
in New Testament, 83–84
public vs. private, 211
traditional, 41–53
undue influence and, 12, 12*n*44
Fiduciary rules as contract rules, arguments for classifying, 229–32
Fiduciary services, 6–7
entrustment as prior condition to, 26
impact on entrustors, 37
Financial intermediaries, fiduciary relationship of, 36–37
Financial managers, 44–45
Foreign Corrupt Practices Act (FCPA), 168–69
"Form ready-made contracts," 195
Friends, 57
Friendship, 57, 277

G

Getzler, Joshua, 4, 19, 29, 218
Gifts, 8, 35, 113, 168, 199, 210, 252*n*48, 257*n*73
Glass-Steagall Act of 1933, 116
Good faith, 54*n*220, 67–68
Goring ox rule, 81, 81*n*11
Government officials
conflict of interest, 113–14
Government regulators
as consenters, 211

H

Hammurabi's Laws
agency in, 80
bailment in, 80–82
remedies in, 82–83
Health law
coherence, 227
High Middle Ages
agency, 92–93
partnership, 93–95
reliable or trusted person, 95
use and trust, 95–96
Historical context, 73–77, 80–97

I

Independent will
entrustors' capability of, 200–201

Information
entrustment of, 20–22
Informed consent, 199*n*19
clarity and specificity in, 203–6
Inheritance, 91
Injunction, 248, 249–51, 258, 262
In personam, 19
In rem, 19
Intellectual property, 17. *See also* Property
Interlocutory review, 266–67
Intermediaries, 7, 45–50
Inventors, 59–62
Investment advisers, 9, 38
Investment Advisers Act of 1940, 42, 47*n*185, 49–50, 104, 202
Investment banks, 22, 34, 117, 133, 276
Investment Company Act of 1940, 23*n*99, 35–36, 44, 122, 146, 187–88, 209, 211
Section 36(b), 145

J

Jewish Law, 90
advisory relationships in, 87–88
agency and business organizations in, 86–87
Judges
conflict of interest, 113–14
Judicial activism and self-limitation, 244–46
Judicial discretion, courts' use of, 243–48
factoring in public interest, 246–48
judicial activism and self-limitation, 244–46
Jurisdiction
virtually limitless, 93

K

Koran, 84, 89–90

L

Law and Equity Act of 1915, 262
Law firms' billings
conflict of interest, 112–13
Lawyers, 43–44
conflict of interest, 111–12
Leadership, 273

Legal relationships
  entrustment and, 10–11
Legal rules, 195
Liability, 91
  of transferee of entrusted property, 267
Locke, John, 14, 280
Loyalty
  definition of, 107–8
Loyalty, duty of
  arm's-length negotiations by entrustors' representatives, 132–33
  aspects of, 108
  compensation of mutual funds' managers, 145–46
  conflict of interest, unconditional prohibition of, 147–49
  conflicts of interest (examples), 109–17
  contract-fiduciary mix, 131–32
  courts' and legislatures' approaches, 146
  curtailing executive compensation, consequences of, 143–45
  debates, 146–56
  duty not to delegate fiduciary duties, 130–31
  duty to account, 130
  duty to act in good faith, 129
  duty to comply with directives, 121–31
  entrustment abuse, and market efficiency, 153–56
  entrustment abuse, self-protection against, 152–53
  fiduciaries' self-limiting mechanisms, 117–19
  fiduciary services as businesses, 133–38
  identifying executives with corporation's owners, identification, 139–43
  market competition and management compensation, 139
  not-for-profit and charitable organizations, 119–21
  preventive rules, 108–9
  "sole interest" and "best interest," 149–52
  trustee's duty of, 82

M

Mandatory rules
  nature and justification for, 195–200
Market forces
  reducing entrustors' risk from fiduciary services, 30–35
Market timing, 20, 229
Marriage, 53
Marriage brokers, 45, 46. *See also* Brokers
Mediation, 55
Mediators, 55–57
Model Rules of Professional Conduct, 103, 108, 111–12, 138, 163, 197, 199, 205
Money managers, conflict of interest by, 188–93
Moore v. Regents of University of California, 109–10
Moral behavior, 272, 273–74
Morality, 101, 273–74
  fiduciary duties, 104
Moral themes
  influence on fiduciary law, 88–89
Mortgage brokers, 45, 57–58. *See also* Brokers
Moses law
  remedies in, 82–83
Multi-disciplinary approach, 102–3

N

Negligence rule, in Hammurabi's Code, 81, 82
New Testament, fiduciary relationships in, 83–84
New York Corporation Law, 193
Not-for-profit organizations
  duty of loyalty, 119–21

O

Office
  proprietorship of, 214–15
Officers of organizations, 50–52
Ownership, 91
  of abandoned land, 88

P

Parties
  deferring to, by courts, 69–72
Partnership, 92, 94, 246
  in High Middle Ages, 93–95
  misappropriation of, 198
Pater familias, 92
Pension funds, 155, 184, 186–87
Physicians, 43–44
  conflict of interest, 109–11
Plato, 280, 291
Ponzi scheme, 121
Power, 13–17
  balance of, 240, 286
  entrustment of, 4–6, 8–10
  in negotiation, 201
  property and, 17–18
  property rights and, 13–17
"Power paradox," 201
Private Securities Litigation Reform Act of 2005, 153
Professionals, 43–44
Property, 91, 13*n*46
  entrustment of, 4–6, 8–10
  intellectual, 17
  power and, 17–18
  taking of, 196–97
  in virtual world, 24–25
Property rights, 13–17. *See also* Rights
  entrustment of, 18–20
  social recognition of, 13, 14
Prudent investor rule, 54*n*220
Public good, 246–48
Public interest
  duties of professional fiduciaries to prevent harm by colleagues, 160–64
  employee whistle-blowers, 165–66
  hospitals, 154–59
  and parties' interest, 166–69
  society versus individual's interest, 159–60
  trustees' liability for co-trustees' actions, 164–65
Public office, 22–23
Public trust, 63–64, 125–26
  application of, 126–29
Punitive damages, 213, 258–60. *See also* Damages
  breach-avoiding, 238–39

Q

Quasi-fiduciary, 67

R

Real estate brokers, 45. *See also* Brokers
Reliable person. *See also* Trusted person
  in Salic law, 95
Religion
  influence on fiduciary law, 89–90
Remedies, 248–58
  of accounting for profits, 254–56
  for breach of fiduciary duties, 249
  equitable, 256–58
  Laws of Hammurabi, 82–83
  law of Moses, 82–83
  of restitution, 82–83
  in Sharia Islamic law, 86
Restitution
  equitable remedies, 257
  remedy of, 82–83, 83*n*21
Restitution damages, accounting and, 256
Resulting trust, 267–69. *See also* Trust
Revised Model Nonprofit Corporation Act, 121
Rights, 16
  to exclude, 15, 17
  to jury trial, 265
  property, 13–17
  to a trial by jury, 265–66
Risk, 4–6, 25–32, 34–35, 79, 94–95, 104–7, 191, 211, 212, 234, 248
Roman law, 98
  agency in, 90–91
  business organizations in, 92
  trust in, 91

S

Salic law
  reliable or trusted person relationship under, 95
Sarbanes-Oxley Act, 177
  Section 304, 142
Scalping, 203
Securities and Exchange Commission, 33, 46, 49, 142, 211
  broker-dealers duties in, 48
Securities brokers, 45, 46–47. *See also* Brokers

Securities Exchange Act of 1934, 46*n*183
  criminal sanctions, 260
  judicial injunctive relief against party, 250
  remedy of accounting for profits, 255
  Rule 10b-5, 170
Securities regulation, 261–62
Self-limiting mechanisms, of fiduciaries, 117–19
Self-protection, 272
  limits on entrustors' risks by, 39–42
Service-contracts and compensation, of fiduciaries
  arm's-length negotiations by entrustors' representatives, 132–33
  compensation of mutual funds' managers, 145–46
  contract-fiduciary mix, 131–32
  courts' and legislatures' approaches, 146
  curtailing executive compensation, consequences of, 143–45
  fiduciary services as businesses, 133–38
  identifying executives with corporation's owners, identification, 139–43
  market competition and management compensation, 139
Sharia Islamic law, 89–90, 98
  agency (*wakalat*) in, 84–85
  remedies in, 86
  trust (*waqf*) in, 85–86
Shingle theory, 47*n*184, 48
Silence
  as consent, 207–9
Silverstein, Elliot M., 201
"Social contract," 216
Social responsibility, 124–25
Societas. See Partnership
Societas publicanorum, 92
Special interest doctrine, 120
Spouses, 53–55
State pension funds, 156
Statute of Uses, 73–75
Stockbrokers, 45. *See also* Brokers
Strine, Leo, 43
Surrogate consenters, 209–12
  as fiduciaries, 210
  independent, 210–11

T

Teachers
  conflict of interest, 113–14
Temptation, 30, 53, 67, 97–98, 272, 286
Tort law
  and fiduciary law
    differences between, 241, 226–27
    source of remedies, 248, 259, 269
  coherence, 227
Traditional fiduciary relationships, 41–53
  courts' recognition of, 65–68
  debtors, 52–53
  directors, 50–52
  financial managers, 44–45
  intermediaries, 45–50
  officers of organizations, 50–52
  professionals, 43–44
  trustees, 44
Trusts, 4
  assets, 68, 85, 109, 116
  barriers to abuse, 272–73
  broad-based, 38
  constructive, 251–54
  defined, 271
  documents, 5, 96, 180, 206, 222
  economic view of, 276–77
  entrustment of property or power, 5–6, 8–10
  fiduciary law vs. contract law, 213
  in High Middle Ages, 95–96
  law versus, 272, 274–78
  nature of, 271–72
  property, 109, 121, 164, 181*n*286, 199, 205, 230
  psychological view of, 276
  resulting, 267–69
  role of, 271–72
  in Roman law, 91
  in Sharia Islamic law, 85–86
  social means of, 277
  for tax avoidance, 75, 77
  voting, 75
Trust agreement, 8–9*n*25
Trusted person. *See also* Reliable person
  in Salic law, 95
Trustee(s), 244
  constructive, 251

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  defined, 1*n*3, 44
  distinguished from corporate directors, 50
  duty of loyalty, 82
Trust fund, 50–51, 50*n*203, 50–51*n*204, 51*n*205
Trust Indenture Act of 1939, 42, 285

U

Underwriters, 117, 187
Undue influence
  fiduciary relationship and, 12, 12*n*44
Uniform Codes and Statutes
  fiduciary relationships, defined, 1
Uniform Trust Code
  fiduciary relationships, defined, 1
United States Constitution, 279, 287
U.S. Sentencing Guidelines, 104
Utilitas ecclesiae, 95, 96

V

Virtual world, property in, 24–25
Voluntary uncompensated services, 233
Voting trusts, 76, 257–58*n*78

W

Waivers, 33, 204–7, 212