FIDUCIARY OBLIGATION UNDER INTELLECTUAL SIEGE: CONTEMPORARY CHALLENGES TO THE DUTY TO BE LOYAL

BY DEBORAH A. DEMOTT

This essay argues that fiduciary obligation is a distinctive type of obligation. Its central rationale, nurturing and enforcing commitments to act loyally toward the interests of others, furnishes limits on the reach of fiduciary obligations. Attempts to characterize fiduciary obligation as solely a type of contractual obligation or as a concept best rationalized by the law of torts are unpersuasive, as are attempts to capture fiduciary obligation within definitions of altruistic behaviour. The author elaborates these arguments using examples drawn from partnership and corporate law.

I. INTRODUCTION .................................................. 472
II. THE CLAIMS OF ALTRUISM .................................. 477
III. OF REAL AND HYPOTHETICAL CONTRACTS ................. 482
IV. ENCROACHMENTS FROM TORT ................................. 488
V. JUSTIFICATIONS FOR MANDATORY FIDUCIARY NORMS .......... 491

© Copyright, 1992, Deborah A. DeMott.

* Professor of Law, Duke University School of Law. This essay was the basis for the James L. Lewtas Lecture on Commercial Law, given at Osgoode Hall Law School on 13 November 1991. Earlier versions of this essay were presented to faculty workshops at the University of Arizona and Florida State University Colleges of Law. I am grateful to Professor John McCamus for his editorial comments.
I. INTRODUCTION

What is fiduciary obligation? To what extent is it distinctive? Does it matter how we answer these questions? Fiduciary obligation is noteworthy for the broad range of legal contexts in which it plays a role, for the variable content of the particular duties it imposes, and for the flamboyant judicial rhetoric it attracts. Trustees, corporate directors, agents, guardians, attorneys, partners, commercial lenders, marriage counsellors and spies—only a capacious plot could be inhabited by such a disparate cast of characters, but all have starred prominently in cases imposing a duty, of one sort or another, to be loyal to the interests of another. Not surprisingly to legal theorists, the pervasive reach of fiduciary obligation, coupled with the variable content of the obligation, presents a large challenge.

Recent theoretical writing includes a number of ambitious claims about the nature of the obligation and about its proper categorization within schemes of legal concepts and obligations. The claims are claims about taxonomy. They attempt to answer the question, “What sort of beast is this?” Questions of taxonomy are basic to much legal argumentation, as they are to the work of other intellectual disciplines. Taxonomy is the process of classifying particular types of things into general categories, categories constructed with some purpose or system in mind.

This essay explores the challenge to legal taxonomy posed by fiduciary obligation. After examining the respective claims of altruism and contract to capture fiduciary norms, the essay examines distinctions between conventional fiduciary norms and norms derived from tort law. The essay then explores a few practical implications of decisions about classification. For concrete illustrations, the essay draws on current disputes concerning partnership law and corporate law. The essay concludes by explaining the limited usefulness and persuasiveness in law of a style of argument it describes as taxonomic. In general, the essay argues that fiduciary obligation is a distinctive type of obligation with characteristics and limits derived from its principal rationale. That rationale is nurturing and enforcing commitments to act loyaly toward the interests of others. These commitments frequently follow from the long-settled legal consequences of choosing a particular structure, like a trust or a corporation, for a transaction or relationship.
A few initial points about taxonomy may be helpful. Common though questions of taxonomy are, disciplines differ in their tactics for answering them. Taxonomic decisions in botany and zoology place species (and subspecies within species) into established categories designed to show the potential relationships among dissimilar types of organisms. The starting point in taxonomic biology is the species, organized in turn into larger groups or genera, and still more generally organized by analogous genera to form orders and classes. Likewise, work in molecular biology begins by identifying individual genes and mapping sequences among them. Biologists, in short, begin with the particular, the individual species in botany and zoology, and move upward toward the general. Legal taxonomists, in contrast, appear to begin with judgments about general and abstract starting points, which in turn dictate the placement of particulars.

Moreover, decisions in biological taxonomy begin with descriptions of a species' observable traits. In zoology, for purposes of taxonomy, the basic characteristics of mammals are their teeth and toes, and for birds, their beak shape. Legal taxonomy, as we shall shortly see, often seems to turn much less on the description of observed reality than on a priori classifications. To be sure, the designation of specific characteristics, like teeth and toes, as central for purposes of classification in turn reflects pre-empirical assumptions. Perhaps the relative strength and pervasiveness of pre-empirical assumptions are more precise points of distinction between law and biology.

Legal taxonomy has concrete consequences that further differentiate it from taxonomic work in biology. Whether a particular type of event constitutes a tort as opposed to a contract matters greatly: among other consequences, remedies and limitations periods are apt to differ depending on how the event is classified. In biology, in contrast,

---

1 Pre-empirical assumptions reflect judgments about a discipline's purpose, about its formulation of problems and about its criteria for deciding when those problems have been solved. These assumptions "cannot be demonstrated empirically because they determine the rules for collecting and applying empirical data in the first place." E.L. Rubin, "Beyond Public Choice: Comprehensive Rationality in the Writing and Reading of Statutes" (1991) 66 N.Y.U. L. Rev. 1 at 3.

2 Thoughtful scholars address these questions of classification in carefully nuanced style. Recently, for example, Professors Hansmann and Kraakman advocated the abolition of limited shareholder liability for tort claims but urged its retention for contract claims. See H. Hansmann & R. Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) 100 Yale L.J. 1879. To differentiate tort from contract claims, Hansmann and Kraakman suggest courts should
taxonomic decisions matter, but fewer practical consequences turn on them.

How does it matter whether the giant panda (*Ailuropoda melanoleuca*) is better classified as a bear or as a raccoon? However classified, giant pandas would continue to be rotund beasts with black and white fur and a taste for eating bamboo. To species members in the wild, the classification question seems not to matter at all, unless conservation programs are more intense for beasts classified as bears than for raccoons. For zoo-resident giant pandas, the question may matter more: zookeepers might decide that giant pandas should be housed near their smaller raccoon relatives, amid the smaller mammals, rather than in the bears' domain. Children and nostalgic adults, moreover, may be disappointed to learn that their favourite toy was not a bear after all. Indeed, one reference work resolves these problems by deeming the giant panda an "aberrant bear" of the family *Ursidae*. Other zoologists classify the giant panda as an aberrant raccoon, in colloquial terms a raccoon with an attitude.

Like the giant panda, fiduciary obligation is difficult to classify and, unless one is willing to ignore various observed traits, arguably "aberrant" however or wherever it is situated in a taxonomic scheme. Like a contract, fiduciary obligation usually—but not always—follows a voluntary association, and frequently an express agreement, among parties. Remedies for breach of the fiduciary's duty to be loyal, however, often differ from the remedies available for breach of contract.

---

evaluate "whether the victim was able, prior to the injury, to assess the risks she took in dealing with the firm and to decline to deal if those risks seemed excessive in comparison with the net advantages she otherwise derived from the transaction." Ibid. at 2121. Victims who proceeded into a transaction "in substantial awareness of the risks of injury involved" should be treated as contract claimants. Ibid. See also ibid. n. 107, where the authors write that the question of risk-awareness "should not be generally asked of each individual victim, but rather for categories of victims."


4 *Britannica* acknowledges that the other species called a "panda," the Himalayan panda (*Ailurus fulgens*), is unquestionably a raccoon. See ibid. Other authorities also treat the giant panda as a major taxonomic challenge but resolve the question differently. *The Encyclopedia of Mammals* locates the giant panda within the raccoon family, to which it assigns two subfamilies: *Alurinae* (herbivorous pandas) and *Procyonidae* (the other fifteen omnivorous species of raccoons). Raccoons descended from *Canidae*, the dog family. With the exception of the giant panda, raccoons have ringed tails; all raccoons except coatis and giant pandas are nocturnal. See D. Macdonald, ed., *Encyclopedia of Mammals* (New York: Facts on File, 1984). In contrast, another authority notes the giant panda's superficial resemblance to a bear and suggests that it "may be a true member of the *Ursidae*." See *McGraw-Hill Encyclopedia of Science and Technology*, vol. 13 (New York: McGraw-Hill, 1987) at 74-75.
Indeed, courts acknowledge that in some fiduciary settings remedies have a deterrent purpose which at times justifies the inclusion of a punitive or exemplary component. Fiduciary obligation is often mandatory, a trait discussed later in this essay, which seems at odds with the stereotypic concern of contract law. That is, the content of contractual obligation is, for the most part, chosen by the parties to the contract.

Moreover, if the parties' relationship will carry fiduciary consequences, the legal rules applicable to the parties' negotiations differ from the legal regulation of pre-formation behaviour incident to ordinary commercial contracts. In negotiations leading to an ordinary commercial contract, parties may not lie to each other and may not actively conceal material facts from each other's investigation. But they need not be candid with each other. In contrast, parties negotiating to form a partnership—by virtue of which they will owe each other fiduciary duties—are obliged to be candid with each other during the negotiations; that is, to disclose honestly all facts related to the prospective partnership and its property.5

Further complicating the taxonomist's task, the history of fiduciary language and norms is traceable to the trust and to the inhibitions equity courts imposed on trustees in their dealings with trust property and with the trust's beneficiaries. Not all fiduciaries, however, are under inhibitions and duties identical to those of the trustee. Corporate directors, for example, may self-deal in ways that trustees may not. In any event, the basic taxonomic distinction used to classify the law of private obligations, the distinction between obligations voluntarily assumed and those imposed by law, was developed by jurists and academics who paid little attention to the place and significance of the law of trusts and other creatures of equity. As Professor Patrick Atiyah describes these taxonomists' work, "nobody seems to have troubled overmuch about the place of equitable obligations in the great divide between voluntarily assumed and legally-imposed obligations."6

---

5 As a corollary, protecting pre-contractual disclosure of proprietary information does not present the problems between prospective partners that it does in the context of the ordinary commercial contract. See G.R. Shell, "Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Tort Cause of Action" (1991) 44 Vand. L. Rev. 221 at 236-39.

Beyond these basic taxonomic problems, fiduciary obligation is paradoxical in some respects. Major sectors of significant economic activity in the United States feature decision makers governed by fiduciary norms, however construed. Trustees of private employers’ employee benefit plans, when making decisions concerning plan assets, are subject to express fiduciary standards set forth in the Employee Retirement Income Security Act of 1974. Indeed, by 1989 (the most recent year of availability for this particular statistic), private pension plans held assets worth 1,986.3 billion dollars. Additionally, corporate directors have long been characterized as occupying a fiduciary position, which, unsurprisingly, has generated an enormous volume of case-law defining the particular significance in various contexts of fiduciary inhibitions on directors. In other respects as well, case-law continues to develop and interpret fiduciary norms with vigour. In current litigation between lenders and borrowers, some courts have been willing to hold the lender to a fiduciary standard in evaluating its decisions that are adverse to the borrower’s interests, especially when the lender has been a source of pervasive advice concerning the borrower’s business or has effectively monopolized the borrower’s access to credit markets.

For some observers, however, fiduciary obligation seems an anachronism, a dusty relic of an earlier era, evoking more the world of Bleak House than that of The Bonfire of the Vanities. Fiduciary roles and values seem embodied in Mr. Jarndyce, the troubled but exemplary guardian in Bleak House, but not in Sherman McCoy, the Master of the Universe in The Bonfire of the Vanities.

The language of fiduciary obligation itself is paradoxical, combining to an unusual degree perceived power with apparent

---

12 Supra, note 10.
13 Supra, note 11.
imprecision. The defendant in litigation over fiduciary issues stands accused, in effect, of betraying others' trust. Courts writing opinions enthusiastically respond to the rhetorical stakes exemplified by Judge Cardozo in *Meinhard v. Salmon*\textsuperscript{14} to hold fiduciaries to "a punctilio of an honour the most sensitive."\textsuperscript{15} Particularized into rules, fiduciary norms are, in contrast, elusive and apparently variable. Indeed, fiduciary norms mean different things in different contexts. As applied to a trustee, the duty to be loyal substantially limits the trustee's ability to purchase trust property. The trustee's purchase without the beneficiary's informed consent is a breach of the trustee's duty. Even if the beneficiary consents, and his or her consent is fully informed, the beneficiary is bound to the bargain with the trustee only if its terms are "fair and reasonable."\textsuperscript{16} Corporate directors, in contrast, enjoy much wider latitude in dealings with the corporation and its property. Directors who are not themselves parties to the transaction may, if appropriately informed, approve the transaction and bind the corporation to it.\textsuperscript{17}

II. THE CLAIMS OF ALTRUISM

Whatever fiduciary obligation may mean in particular settings, in general, a person subject to the obligation must act to serve the interests of another person, the beneficiary of the obligation, within the scope of their relationship. Thus, the obligation requires the person subject to it to sacrifice the immediate pursuit of self-interest, especially when that pursuit conflicts with the beneficiary's interests.

As some legal theorists define altruism, fiduciary obligation requires those subject to it to act altruistically. Professor Duncan Kennedy defines altruism broadly:

> The essence of altruism is the belief that one ought not to indulge a sharp preference for one's own interest over those of others. Altruism enjoins us to make sacrifices, to share, and to be merciful ... Sacrifice is the dynamic notion of taking action that will change an

\textsuperscript{14} 249 N.Y. 458 (1928).

\textsuperscript{15} Ibid. at 464.

\textsuperscript{16} *RESTATEMENT (SECOND) OF TRUSTS* § 216 (1959).

\textsuperscript{17} See, e.g., *REVISED MODEL BUSINESS CORP. ACT* § 8.61 & § 8.62 (1989).
ongoing course of events, at some expense to oneself, to minimize another's loss or maximize his gain.\textsuperscript{18}

By definition, then, a person acting to further another's interests is acting altruistically.

As applied to fiduciary obligation, the breadth of Professor Kennedy's definition of altruism seems highly non-descriptive of many phenomena which it includes. Suppose the relationship in question is one between commercially sophisticated and wary parties—perhaps a partnership formed for the purpose of commercial real estate development. Such parties are likely to be animated in their business dealings by the pursuit of self-interest, a motivation likely to pervade the formation of their partnership. Indeed, it would be surprising if these parties failed to pursue self-interest in negotiating the terms of their partnership agreement. Likewise, after the partnership is formed, self-interest is likely to animate partners' proposals to modify their agreement and partners' bargaining to obtain fellow partners' assent to self-favouring modification proposals.\textsuperscript{19} Although partnership law in defined ways constrains self-interested acts through the fiduciary rubric, partners in commercial real estate projects tend not to exhibit either the motivation or behaviour typically thought to be altruistic. Indeed, some partnerships may be composed of members who realize that their self-interest in the long run will be furthered by co-operative behaviour in the short run. That realization, however, is not an impulse toward altruism.

Moreover, the broad definition of altruism ignores the point that the duty to act loyally is one imposed by the law in particular relationships (almost always relationships voluntarily entered into by the person subject to the obligation).\textsuperscript{20} In contrast, in its conventional sense, altruistic action is self-willed, not compelled by law, as illustrated by the absence of a legal duty to undertake the rescue of other persons who are

\textsuperscript{18} D. Kennedy, “Form and Substance in Private Law Adjudication” (1976) 89 Harv. L. Rev. 1685 at 1717.


\textsuperscript{20} A constructive trust, especially if it is viewed as a remedial device rather than the product of a prior undertaking by the defendant, is a counter-example. See \textsc{Restatement of Restitution} § 160 (1937).
strangers to the potential rescuer.21 Defining altruism so broadly also
slights the differences between parties’ reasons for entering into a
relationship—which may be self-interested in the extreme—and the
norms thereafter applicable to the relationship—which may be norms of
co-operation or loyalty. The point bears repetition that self-interested
parties may perceive that a relationship requiring co-operation or more,
loyalty, may in the long run be more profitable to its individual
participants.22

Fiduciary obligation also presupposes that the fiduciary’s loyalty
has a defined focus—a beneficiary—to be served.23 Although altruists
ignore self, they do so not necessarily to further the interest of a defined
object or a specific person. Similarly, loyalty to one beneficiary
precludes equally faithful service to another beneficiary with conflicting
interests. In prosaic terms, a fiduciary gets one dog in each fight,
whereas an altruist is not so limited.

The austere exclusivity of fiduciary commitment troubles some
legal theorists. Recently, Professor Lawrence Mitchell advocated the
creation of fiduciary duties to be owed by a corporation’s management
to holders of debt securities issued by the corporation (but not
necessarily to the corporation’s other creditors).24 Professor Mitchell
acknowledges that, under present law, the ultimate beneficiaries of
managers’ fiduciary duties to a corporation are its stockholders. He
objects, instead, to managers’ ability to benefit stockholders through
transactions that disappoint bondholders but do not breach
bondholders’ contractually defined rights.25 But sometimes the interests
of any business’s creditors may conflict with the interests of its equity

---

21 See J.M. Adler, “Relying Upon the Reasonableness of Strangers: Some Observations
About the Current State of Common Law Duties to Aid or Protect Others” (1991) Wis. L. Rev. 867
at 872.

22 See C.P. Gillette, “Commercial Relationships and the Selection of Default Rules for

23 Professor Mitchell, whose analysis emphasizes the fiduciary’s conduct rather than the
beneficiary’s interest, also recognizes that “[o]bviously the reason that the fiduciary principle exists
is to protect the interests of the beneficiary.” See L.E. Mitchell, “A Theoretical and Practical

1165 at 1166 n. 3. This article declines to address whether its analysis applies to privately negotiated
debt.

25 Ibid. at 1214.
owners. Whether to expand the business, to engage in risky business transactions and to distribute, rather than retain earnings are often questions on which creditors’ preferences may diverge from those of owners.26 How can the same managers have a fiduciary level of devotion to both creditor and owner interests? Outside insolvency, present law may well require directors to be less than generous with debtholders if that treatment advances shareholders’ interests.27 Once the business approaches insolvency, creditors’ and shareholders’ interests are likely to diverge even more sharply. Prior to the point of actual insolvency, once the business enters “the vicinity of insolvency,” the Delaware Court of Chancery recently held that directors owe their duties to “the corporate enterprise,” not only or merely the corporation’s shareholders.28 To say that under exigent circumstances directors owe duties to an entity, however, is far different from saying directors have a fiduciary duty—let alone an enforceable one—to the enterprise’s creditors.

Most theorists, to be sure, recognize the paramount nature of common shareholders’ interests—at least in the long term—over the


27 In evaluating the primacy of shareholders’ interests, it is important to keep in mind the breadth and strength of the American business judgment rule, which broadly shields the decisions of disinterested directors from judicial scrutiny of the decisions’ merits and shields the directors themselves from personal liability. In John Hancock Capital Growth Management, Inc. v. Aris Corp., 1990 Fed. Sec. L. Rep. (CCH) ¶ 95,461 (Del. Ch. Aug. 24, 1990), Texstylene Corporation’s directors rejected an inexpensive bond repurchase—at a 25% discount—in favour of a more expensive restructuring of the debt to facilitate a sale of Texstylene’s assets to another corporation. The Court held that since a majority of Texstylene’s directors did not have a selfish interest in rejecting the inexpensive bond repurchase, the business judgment rule applied to the directors’ decision.

The business judgment rule, however, applies only to directors who make an informed judgment. See Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). The corporation statute in Delaware, as in many other states, permits a corporation to include in its certificate of incorporation a provision exculpating directors from liability for money damages for acts of gross negligence. See Del. Code Ann. tit. 8, § 102(b)(7) (1991).

Shareholder interests are entitled to primacy when the corporation’s directors abandon its future prospect of continued existence. If directors initiate an active bidding process to sell the company or a reorganization entailing a break up of its assets, shareholders’ intents must be paramount. See Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1988). Shareholders’ interests also must trump those of other constituencies when directors respond to a hostile takeover with a defensive strategy involving a break up of the corporation. See Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989).

interests of the other claimants.\textsuperscript{29} Other claimants' interests, unlike equity shareholders' residual interests, are more amenable to protection through other devices, like express agreements. Indeed, courts tend to resolve conflicts between the rights of preferred stockholders and those of common stockholders by limiting preferred stockholders' fiduciary claims to rights created expressly or impliedly by the instrument under which the preferred stock was issued.\textsuperscript{30} The issuer's directors are free to treat redeemable preferred stock as a loan to be repaid or refunded, and to make the redemption decision to further the interests of common stockholders.\textsuperscript{31} In contrast, common stockholders are residual claimants whose interests resist advance specification.\textsuperscript{32}

Somewhat at odds with the tradition of common shareholders' primacy, several states recently enacted statutes permitting, and in some instances requiring, directors to consider the interests of non-shareholder constituencies, including employees, creditors, consumers and local communities in which the corporation operates its business. Although support for these statutes is traceable to concerns about hostile Takeovers, not all of the statutes are limited to the decisions of directors of a target corporation confronted with an unwanted bid.\textsuperscript{33} The practical effect of these statutes is open to question because for the most

\textsuperscript{29} See, e.g., \textit{Principles of Corporate Governance} § 2.01 (Proposed Final Draft 1992), which provide that a corporation's objective should be to conduct business activities "with a view to enhancing corporate profit and shareholder gain"; but see M. Lipton & S.A. Rosenblum, "A New System of Corporate Governance: The Quinquennial Election of Directors" (1991) 58 U. Chi. L. Rev. 187 at 204-05. Here, Lipton and Rosenblum contend that there is no intrinsic reason that "conformity to the wishes of the stockholders must be the central goal of the corporation." In Canada, these lines of demarcation seem to be drawn with a duller instrument. The scope of interests protected by statutory oppression remedies—including creditors' interests—is one basis for the contrast. See, generally, D.A. DeMott, "Oppressed But Not Betrayed: A Comparative Assessment of Canadian Remedies for Minority Shareholders and Other Corporate Constituents" (forthcoming, Autumn 1992) 35 Law & Contemp. Probs.

\textsuperscript{30} See Hurst & McGuinness, supra, note 26 at 205.

\textsuperscript{31} See R.M. Dodd, Jr., "Purchase and Redemption by a Corporation of Its Own Shares" (1941) 89 U. Pa. L. Rev. 697 at 724-25.

\textsuperscript{32} See R.B. Thompson, "The Law's Limits on Contracts in a Corporation" (1990) 15 J. Corp. L. 377 at 407. Thompson describes the risks associated with drafting fully contingent contracts where these contracts must cover the risks of managerial misconduct that arise from breaches of fiduciary duties of care and loyalty. The imposition of mandatory legal rules turns on "the relative strength of alternative constraints on management conduct."

part they do not enable non-shareholders to sue. At most, the constituency consideration statutes provide a defence—of a weight yet to be determined by litigation—to directors sued by shareholders.

The larger question raised by constituency statutes is, in weaker form, the same question raised by proposals to create additional fiduciary obligations to be owed by directors to non-shareholder interests. Is duty diffused likely to become duty denied? Having inconsistent focal points for one’s loyalty inexorably undermines one’s accountability to any set of interests other than one’s own.

III. OF REAL AND HYPOTHETICAL CONTRACTS

Broad definitions of contract—capturing fiduciary obligation and virtually all institutions of private law—also abound in recent scholarship. Professors Alan Bromberg and Larry Ribstein write in their treatise on partnership law:

Fiduciary duties are essentially part of the standard form contract that governs partnership in the absence of contrary agreement. Because the parties cannot anticipate all problems that may arise during the course of their relationship, and because dealing with all these problems contractually would be quite costly, the law supplies general terms to fill in the interstices.

In short, fiduciary norms are default rules whose interstitial character justifies their imposition when the parties’ express agreement is incomplete. According to Professors Bromberg and Ribstein, the law’s choice of a default rule should replicate “what the partners would have been likely to agree to in the absence of transactions costs, in light of


35 See J. Biancalana, “Defining the Proper Corporate Constituency: Asking the Wrong Question” (1990) 59 U. Cin. L. Rev. 425 at 441-42. Here, Biancalana notes that managerialism—which places managers in central roles and authorizes them to consider the interests of all groups—uses language of trusteeship but imposes no enforceable duties on anyone. See also M.A. O’Connor, “Restructuring the Corporation’s Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers” (1991) 69 N.C.L. Rev. 1189 at 1233. The author argues that constituency statutes create risks that “directors may hide behind vague duties to conflicting groups to serve their own interests.”

practical considerations and the other elements of the partnership relationship."\textsuperscript{37}

As a criterion for specifying the contents of default rules, what-the-parties-would-have-agreed-to has an initial and obvious appeal. The standard defers to the parties' own wishes, or, more precisely, their wishes had they addressed the issue resolved by the rule. Implementing the would-have-agreed-to criterion is difficult however. Is the criterion addressed to the agreement to be reached, hypothetically, between particular parties? If so, the content of the agreement will reflect the outcomes of the parties' bargaining. A party's skill in bargaining and the intensity with which she or he wishes to conclude a deal are likely to affect the outcome. Indeed, nothing in the agreement the parties would actually reach, if they bargained over the point, might resemble fiduciary obligation. Perhaps the criterion instead looks to the agreement that reasonable parties would reach, and makes no assumptions about their relative bargaining strength or the relative intensity of their desires to close a deal. If so, the content of the default rule seems simply to be a mandatory legal rule detached in content from the results of party bargaining.

The most plausible interpretation of the would-have-agreed-to criterion is that it means the contract terms which would be insisted upon by a reasonable person who recognizes himself or herself to be vulnerable to the other party in the relationship. The reasonable person who is self-aware of his or her own vulnerability might indeed bargain for fiduciary-like constraints on the other party.\textsuperscript{38} And a reasonable person, self-aware of his or her own vulnerability, might bargain for the chief practical consequence of fiduciary protection, which is to trigger an opportunity for judicial review of the other party's actual behaviour and of the advantages gained through it. \textit{Ex ante}, in short, this sort of reasonable person might well bargain for \textit{ex post} review of the relationship's subsequent history. Just \textit{how much} the reasonable person understands about his own vulnerability is an intriguing and open question. Suppose the reasonable person considers making an

\textsuperscript{37} Ibid. at 6:69.

\textsuperscript{38} Similarly, in describing the rules they believe should apply to lawyers, lay persons frequently picture themselves as clients and wish their lawyer to be their uncritical hired gun, bound by a norm of absolute confidentiality to clients. See T. Schneyer, "Some Sympathy for the Hired Gun" (1991) 4 J. Legal Educ. 11 at 13 n. 11.
investment as a minority shareholder in a corporation. Is the reasonable person aware that the controlling shareholders, who will be in operational control of the corporation, are likely to possess an inevitable superiority of insight into the company’s future?39

Ironically, some theorists use the contract classification so broadly that the consequences resemble the diffusion of loyalty favoured by altruism’s advocates. Professors Schleifer and Summers argue that non-shareholder constituents have entered into “implicit contracts,” based on trust, that supplement or supersede the constraints imposed by any express contracts between the corporation and the particular constituent. Thus, the corporation’s implicit contract with its employees limits its right to terminate them because employees invest effort in learning about their particular employer and its business on the faith that their employment will continue.40 Of course, not all implicit contracts, as defined, appear to be efficient; “implicit contract” seems like a handy justification for any perquisite. Even determining the terms of an “implicit contract” in a fashion satisfactory to a lawyer is difficult. Do implicit contracts contain conditions? May they be modified? Are they subject to a parol evidence rule?

The mandatory components of fiduciary rules also challenge the descriptive accuracy of characterizing them as interstitial default rules. By definition, a default rule is inapplicable to the extent the parties agree otherwise. To be sure, contract law itself includes mandatory rules not subject to being trumped or ousted by the parties’ agreement otherwise. Contract law does not enforce promises made without consideration, at least in the absence of detrimental reliance on the promise, even if the promisor expressly acknowledged the absence of any anticipated benefit. Formal requirements, such as the Statute of Frauds,41 likewise are mandatory, as is the substantive doctrine of unconscionability. Articles One and Two of the Uniform Commercial

39 The majority’s informational advantage does not presuppose that it manipulates, withholds, or misstates material information. See Cede & Co. v. Technicolour, Inc., 582 A.2d 1182, 1187 n. 8 (Del. 1988). Here, the Court stated that “the majority may have insight into their company’s future based primarily on bits and pieces of nonmaterial information that have value as a totality” (emphasis in original).


41 Restatement (Second) of Contracts § 110 (1981).
CODE contain additional illustrations of mandatory rules. Under Article One, the duties of good faith imposed by the U.C.C. may not be eliminated through the parties' agreement, although those duties may be defined by standards in agreements if the standards are not "manifestly unreasonable." Moreover, while Article Two permits parties considerable flexibility in designing and specifying their own choices of remedies, it requires that, in all instances, there be "some minimum remedy for breach."

The degree to which particular fiduciary rules are mandatory varies enormously. On the heavily mandatory end of the spectrum are rules requiring candour. Consider again the partnership rule treating partners as fiduciaries. Under section 20 of the UNIFORM PARTNERSHIP ACT, each partner has a duty to account to the partnership for profits derived without fellow partners' consent "from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property." Courts interpret section 20 to require candid disclosure of dealings and interests related to the business of the prospective partnership. Professors Bromberg and Ribstein explain that, prior to executing a partnership agreement, a rule of candour is justified because "it will be difficult for the parties to build a relationship based on trust if they must deal with each other skeptically at the outset." Is a duty to be candid intelligible if it is characterized as a default rule? If a party negotiating to form a partnership expressly waives his right to know material information that is in his prospective partner's possession, would the waiver be effective? The person who executed the waiver, without knowing the information possessed by the other person, would be unable to evaluate the magnitude and significance of the information. True, he might arguably be proceeding in full knowledge of his ignorance, but that realization does not provide

42 UNIFORM COMMERCIAL CODE (1989) [hereinafter U.C.C.].
43 Ibid. § 1-102(3).
44 Ibid. § 2-719, Official Comment 1.
46 Ibid. § 21(1).
47 See, for example, Libby v. L.J. Corp., 247 F.2d 78 (D.C. Cir. 1957).
48 Bromberg & Ribstein, supra, note 36 at 6:63.
a concrete basis on which to assess the risks of proceeding further with the other party.

In contrast, fiduciary rules that regulate behaviour seem more like default rules. Partners are free to consent in the partnership agreement to a partner's right to purchase partnership property, thereby ousting the default rule requiring consent specific to the transaction from each partner. The purchasing partner, however, must disclose all material information to fellow partners and, according to the leading case, must pay the property's fair value to the partnership. Even if the partnership agreement expressly provides that the terms of the purchase shall be determined "in the sole discretion" of the purchasing partner, the purchasing partner must pay fair value. Thus, partnership law appears also to embody a strong mandatory norm against expropriation of partnership property.

A recent amendment to Delaware's version of the Revised Uniform Limited Partnership Act creates a number of difficult questions about the force of the anti-expropriation norm. In 1990, Delaware amended its version of the R.U.L.P.A. to provide that

[1] to the extent that, at law or equity, a partner has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner, (1) any such partner acting under a partnership agreement shall not be liable to the limited partnership or to any such other partner for the partner's good faith reliance on the provisions of such partnership agreement, and (2) the partner's duties and liabilities may be expanded or restricted by provisions in a partnership agreement.

As written, the Delaware addition to the R.U.L.P.A. permits the limited partnership agreement to specify exclusively the general partner's duties to the partnership and to its limited partners. It also permits exculpatory

49 See Jerman v. O'Leary, 701 P.2d 1205 (Ariz. Ct. App. 1985) [hereinafter O'Leary]. In the absence of such a provision, a partner wishing to purchase partnership property must, at a minimum, inform his fellow partner of that fact, even when the property is sold at an open auction. See Marsh v. Gentry, 642 S.W.2d 574 (Ky. 1982). This case involved an auction sale of a thoroughbred horse owned by the partnership.

50 O'Leary, ibid. at 1210.

51 Ibid. at 1209. See also Labovitz v. Dolan, 545 N.E.2d 304 (Ill. App. Ct. 1989), appeal denied, 550 N.E.2d 557 (Ill. 1990), which held that a general partner's right to use "sole discretion" in making distributions to limited partners does not immunize its decisions from judicial scrutiny under a fiduciary standard.


53 Ibid. § 17-1101(d).
provisions to be operative in limited partnership agreements well beyond the effective scope of exculpation for corporate directors under Delaware law.\textsuperscript{54} The Delaware corporation statute permits only the elimination or reduction of directors' liability for money damages for breaches of the duty of care they owe to the corporation.\textsuperscript{55} In contrast, Delaware's addition to the R.U.L.P.A., on its face, permits restrictions on a partner's duties of loyalty.

It is not clear how the Delaware statute would affect common provisions in limited partnership agreements, and how it would resolve common disputes among partners. If the limited partnership agreement permits the general partner to purchase partnership property on such terms as it determines in its sole discretion, is the general partner free to pay less than fair market value? Does the statute exclude challenges to the general partner's use of its discretion that are based on unconscionability? Is the general partner relying \textit{in good faith} on the agreement's sole discretion provision if it pays nothing? Or next to nothing? And in litigation brought by limited partners against a purchasing general partner, who has the burden on the question of good faith reliance?

Less mandatory, it seems, is the fiduciary norm forbidding a partner’s competition with the partnership. Ordinarily partners may not compete with the partnership, even while it is in the process of dissolving.\textsuperscript{56} One court upheld a clause in the partnership agreement of an oil production group providing that each partner “shall be free to enter into business and other transactions for his or her own separate individual account, even though such business or other transaction may be in conflict with and/or competition with the business of this partnership.”\textsuperscript{57} The scope of activity that is privileged by a free to compete clause is not limitless, however. A free to compete clause, for

\textsuperscript{54} Whether such flexibility is tolerable in the limited partnership setting is open to dispute. Compare Thompson, supra, note 32 at 409-10, which observes that possibilities for abuse are limited by the tax-driven nature of investment in many limited partnerships; and D.S. Reynolds, “Loyalty and the Limited Partnership” (1985) 34 U. Kan. L. Rev. 1 at 32-33. Reynolds suggests that a lack of intimacy between limited partners and a general partner makes it hard to argue that limited partners’ assent to general exculpatory language constitutes assent to general partners’ specific self-dealing transactions.

\textsuperscript{55} Delaware General Corporation Law, DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

\textsuperscript{56} See Monin v. Monin, 785 S.W.2d 499 (Ky. Ct. App. 1990).

example, does not permit a partner to use confidential information acquired from the partnership to advantage the partner over the partnership in competing for the same business opportunity.\(^{58}\) Indeed, if the free to compete clause expressly encompassed and allowed the use of confidential information in ways detrimental to the partnership, the partner using the information would be under an obligation to compensate the partnership for the value of the information, which is partnership property.

IV. ENCROACHMENTS FROM TORT

The mandatory nature of some fiduciary norms raises the question whether fiduciary doctrines might best be regarded as a specialized province of tort law, which, in general, is the private law domain of legally imposed duties. This taxonomic decision would carry significant consequences. In particular, standards for liability derived from tort often turn on the defendant’s motivation, at least in the case of intentional torts. Fiduciary standards, in contrast, conventionally operated independently of the defendant’s subjective motivation even when the defendant’s account of that motivation was credible. Fiduciaries who created a conflict between their self-interest and their beneficiary’s interest breached the duty of loyalty to the beneficiary, however well-motivated the fiduciary’s conduct might have been. Indeed, as in Boardman v. Phipps,\(^{59}\) liability attached to fiduciaries who acted, in the circumstances, in ways many people would consider to be reasonable.

Additionally, the basic rationale of tort law is to compensate people for injuries inflicted upon them and for losses they have suffered. In contrast, a fiduciary’s liability is often to account for profit realized by the fiduciary when the fiduciary’s conduct has not inflicted an injury on anyone. Many instances of fiduciary liability are geared to produce restitution of a benefit obtained by the fiduciary, not compensation for a


loss suffered by the beneficiary, if the beneficiary chooses to pursue the
restitutionary remedy. Compensation as a remedy for breach of fiduciary obligation is, however, well established as an alternative remedy. Demarcating the outer limits of the fiduciary’s liability to compensate for loss requires at least a presumptive theory of fiduciary obligation, a rationale for its imposition.

To be sure, if the plaintiff elects to seek compensation, difficult issues may arise given sufficiently remarkable sequences of facts. Suppose a fiduciary breaches a duty of loyalty to his or her beneficiaries, a breach unknown to beneficiaries until they have proceeded into a transaction and suffered substantial loss. The loss, in turn, would not have been suffered by the beneficiaries had they known of the fiduciary’s disloyalty because they would not have proceeded with the transaction. The actor directly causing the substantial loss, however, is not the fiduciary but a negligent third party. Should the fiduciary’s liability to compensate extend to losses traceable to the actions of the negligent third party? One limiting principle is that a fiduciary undertakes to be loyal within the scope of the relationship but not to be an insurer as to all consequences that ultimately befall the beneficiary. This analysis, in turn, presupposes that the fiduciary’s commitment to be loyal is the central and distinctive rationale for imposing the obligation.

---

60 See, e.g., RESTATEMENT (SECOND) OF TORTS § 874 (1979), which provides that a person standing in a fiduciary relationship with another is subject to liability to the other for harm resulting from a breach of the duty imposed by the relationship; and RESTATEMENT (SECOND) OF TRUSTS § 205(a) (1959), which provides that a trustee who commits a breach of trust is chargeable with any loss or depreciation in value of trust estates resulting from the breach.

61 See Canson Enterprises Ltd. v. Boughton & Co., [1991] 3 S.C.R. 534, 85 D.L.R. (4th) 129, which limited a defendant’s liability to loss arising before intervention by negligent third parties. Here, a solicitor failed to disclose to a client that property purchased by the client had passed through an intermediate transaction. The client suffered enormous loss due to the negligence of a soil engineer and a pile driver. This led to damage to a building constructed on property purchased by the solicitor’s client.


63 R. Cooter & B.J. Freedman, “The Fiduciary Relationship: Its Economic Character and Legal Consequences” (1991) 66 N.Y.U. L. Rev. 1045 at 1074. Here, the authors argue that the mechanisms of enforcing a fiduciary obligation demonstrate a centrality of loyalty as a rationale for obligation. Focusing on the centrality of loyalty has other consequences as well. If the beneficiary’s behaviour could be characterized as contributory negligence in a tort law framework, that fact is irrelevant to assessing whether the fiduciary acted disloyally. See Gummow, supra, note 62 at 86-87.
Given the basic rationale for imposing fiduciary obligation, it is regrettable that many recent corporation statutes, in defining directors' duties to the corporation, avoid using words like fiduciary and loyalty, instead casting directors' obligations in the language of good faith. What is the precise meaning of good faith in this context? The statutes do not define it. Is a director who has a personal interest—whether pecuniary or nonpecuniary—in a transaction acting in good faith if he or she participates as a director in making a decision about the transaction? Is the director acting in good faith if he or she fails to disclose this interest to fellow directors? Suppose the self-interested director fails to disclose his or her interest but sincerely (and correctly) believes that the transaction will prove beneficial to the corporation? Is the director liable to account for any profit realized?

Along the same lines, at least one court has premised fiduciary liability on its assessment of whether the defendant acted opportunistically. In Jordan v. Duff and Phelps, Inc., the plaintiff, an employee-at-will, bought shares in his employer subject to a condition obliging him to sell the shares back at book value if his employment terminated for any reason. After the plaintiff announced that he wished to leave voluntarily for family reasons, officers of his employer did not tell him that negotiations were under way which, if successful, would

---

64 See, e.g., Revised Model Business Corp. Act, supra, note 17, § 8.30(a), which provides that a director must discharge duties as a director: 1) in good faith, 2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and 3) in a manner he or she reasonably believes to be in the corporation's best interests. To similar effect is the Business Corporations Act, R.S.O. 1990, c. B-16, s. 134(1).

Indeed, the drafters of this revised model Act appear intimidated by the very words fiduciary and loyalty, and cast directors' obligations in the language of good faith on the stated ground that courts otherwise might mistakenly unleash the "unique attributes and obligations ... imposed by the law of trusts." See the Revised Model Business Corp. Act, supra, § 8.30 & official comment. Similarly, drafters working on the Revised Uniform Partnership Act appreciate the power of fiduciary language and continue to dispute whether partners should be designated as fiduciaries in the new statute. See D.J. Weidner, "Three Policy Decisions Animate Revision of Uniform Partnership Act" (1991) 46 Bus. Law. 427 at 456-59.

65 The revised model Act ultimately relegates the answer to this question to an inquiry into whether the transaction was "fair to the corporation" at the time of its commitment to the transaction. See the Revised Model Business Corp. Act, supra, note 17, § 8.61(b)(3), which the official comment treats as encompassing "the behaviour of the director having the conflict" as well as the "market fairness" of the price and the likelihood that the corporation would benefit from the transaction.

lead to the merger of their company with another at a very favourable price, one well above book value. The Court held that the officers' failure to disclose the ongoing negotiations breached a fiduciary duty owed to the plaintiff as a stockholder. Even though the plaintiff's status as an employee-at-will would enable his employer to fire him for any reason, the Court reasoned that the employer may not act opportunistically to take advantage of the plaintiff. As a standard, though, opportunism suggests that the defendant's motive or intention is dispositive.

Perhaps these developments reflect discomfort with the austere and uncompromised nature of fiduciary norms, comparable to the evident discomfort with the exclusivity of fiduciary commitment discussed earlier in this essay. Perhaps, as Professor Grant Gilmore once predicted of contract law, fiduciary norms are being encroached upon, if not yet overtaken by, tort law-driven standards that are sensitive to questions of intent and motive. In retrospect, of course, Professor Gilmore's prediction of the death of contract as a distinctive grouping of legal doctrines was mistaken or, at best, premature. Fiduciary norms, similarly, may prove to be resilient.

V. JUSTIFICATIONS FOR MANDATORY FIDUCIARY NORMS

Even if fiduciary norms are distinctive, what justifies the mandatory imposition of any fiduciary rule? First, mandatory rules supply standardized content for the legal consequences of relationships. Enabling people to develop standardized expectations, in carefully defined settings, can be efficient. The law of property defining estates in land, for example, defines sets of highly standardized expectations that enable transactions to proceed much more simply than would be the case otherwise. A seller's warranty that the interest one is purchasing is a fee simple does not eliminate all of a buyer's worries, but it furnishes a standardized set, or a package, of expectations that reduces the buyer's need to investigate, and the seller's need to describe, the precise rights that the seller is, in fact, able to convey.

Mandatory fiduciary rules likewise reduce the need for highly particularized investigations. In the absence of mandatory rules

---

requiring candour and forbidding expropriation, a prospective partner would need carefully to explore the propensities for deceit and self-aggrandizement of each prospective fellow partner. Much of the information needed to draft an agreement to protect oneself is likely to be in the other person’s possession. Only rarely do people wishing to enter into long-term relationships with other people volunteer that their true intentions are opportunistic and exploitative. Only on television (and in some types of literature) do villains readily identify themselves early in the plot. In this respect, life does not imitate art.

Outside the partnership context, consider for a moment the utility of mandatory fiduciary norms in agency law. In their absence, prospective principals, assuming they are cautious and prudent, would want much information before engaging any particular agent to act on their behalf. The legal consequences of agency explain this caution. An agent has power to bind a principal to contracts made within the scope of the agency relationship. If the agent appears to a third party to be authorized, the principal may be bound even in the absence of actual authority. Moreover, the principal may be vicariously liable for torts committed by the agent acting within the scope of the relationship. Agents who are free to profit from the relationship, with no duty to account to the principal, may develop tastes for risky behaviour. At the same time, the cautious prospective principal may be reluctant to demonstrate potential vulnerability by bargaining too vigorously for a high standard for the agent’s conduct.\textsuperscript{58} Wouldn’t the potentially rapacious agent interpret the prospective principal’s concern as a clue that this principal will be especially ripe for exploitation? In the absence of mandatory fiduciary norms, bargaining to define a relationship with, for example, a real estate agent or a stockbroker, would be strategically complex. Indeed, agents who are in fact honest and honourable might welcome mandatory fiduciary rules due to the practical difficulties otherwise of distinguishing themselves from their less trustworthy (but subtle) competitors.

Mandatory fiduciary norms may also typify situations in which ultimate beneficiaries of fiduciary protections are not likely to be in a position to bargain with persons who manage property on their behalf.

\textsuperscript{58} For an analysis of strategic considerations in pre-contractual negotiations as they affect incentives to disclose information, see J.S. Johnston, “Strategic Bargaining and the Economic Theory of Contract Default Rules” (1990) 100 Yale L.J. 615.
Consider three settings in which Congress has, through federal legislation, imposed mandatory fiduciary duties and defined their content. E.R.I.S.A.\textsuperscript{69} imposes five affirmative fiduciary duties on persons who control employee benefit plans, all of which are mandatory and not subject to modification through provisions in the instrument creating the plan.\textsuperscript{70} The Trust Indenture Act of 1939, as amended in 1990, likewise characterizes an indenture trustee as a fiduciary and defines the content of the duties the trustee owes to holders of debt securities issued under the indenture.\textsuperscript{71} Finally, the Investment Company Act of 1940 imposes a fiduciary duty on a mutual fund’s investment advisor with respect to payments the advisor receives for its services to the fund.\textsuperscript{72}

Why are legislatively defined fiduciary norms mandatory in these three diverse settings? In all three, the persons whose interests are protected by the presence of fiduciary standards are not in a position, for one reason or another, to bargain with the person to whom the fiduciary standard applies. Participants in E.R.I.S.A.-governed plans may not even be eligible employees when the plan’s instruments are drawn. Likewise, holders of debt securities are, by definition, not holders when the issuer’s management, the securities’ underwriter, and the indenture trustee negotiate the terms of the indenture. True, people who hold investments in debt securities and mutual funds frequently—but not always—acquire them voluntarily.\textsuperscript{73} That legislation makes the fiduciary norms mandatory, however, demonstrates that acquiring an interest with already defined rights (already defined by an instrument, that is) does not always have the same significance as participating in bargaining over those rights.

The ability to bargain to define the terms of a relationship, however, leaves much unexplained. Even in settings in which parties seem to have crafted provisions that foreseeably have predictable effects if specific contingencies occur, some courts stress the need to evaluate on a case-by-case basis whether parties’ behaviour breached fiduciary

\textsuperscript{69} Supra, note 7.

\textsuperscript{70} See ibid. § 1110CA. See, generally, B. Krikorian, Fiduciary Standards in Pension and Trust Fund Management (Stoneham: Butterworth, 1989).


\textsuperscript{73} People who acquire securities through inheritance do not make a voluntary investment choice, unless one is willing to give that effect to a decision not to disaffirm an inheritance.
norms. In *Smith v. Atlantic Properties*, for example, the four shareholders in a closely-held corporation adopted articles and by-laws giving each shareholder a veto over all directors' decisions and over all proposed share transfers. When his fellow shareholders vetoed one shareholder's proposed transfer of shares to a foundation, he avenged himself by vetoing all dividend distributions. The Court held the vengeful director liable for the accumulated earnings penalty imposed on the corporation by the Internal Revenue Service, finding that the vengeful director "recklessly" ran "risks which were inconsistent with any reasonable interpretation of a duty of utmost good faith and loyalty." Even though the vengeful use of the veto seems to have been a foreseeable contingency, the Court expressly declined to endorse a general relaxation of the "utmost good faith and loyalty" standard when the parties themselves created the device that led to their predicament. Retaining judicial prerogative to review parties' actual behaviour on a case-by-case basis may be paternalistic, but it may also be a realistic acknowledgement of people's ability to be caught by surprise when the contingency they ignored, or they recognized but discounted, finally materializes. Judicial paternalism may be something for which the self-aware vulnerable party might bargain. The question raised by *Smith*, is how best to define behaviour that suffices to bargain away fiduciary protection?

To be sure, in some settings in which bargaining is unlikely, some fiduciary norms are effectively treated as default rules. As discussed above, many states' corporation statutes permit exculpatory provisions in corporations' charters that reduce or eliminate directors' liability for money damages for breaches of their duty of care. One explanation

---


77 These exculpatory clauses do not, of course, represent a complete opting out from the duty of care; rather, they relieve directors of specified consequences—liability for money damages—if they breach the duty. Thus, a third party who knowingly benefitted from the directors' breach could be liable. An exculpatory clause, however, does not eradicate the duty itself. Such a clause would not enable directors to contract away their duty to shareholders through express provisions in a merger agreement that relieve directors of their duty to advise shareholders of the existence of a higher offer for their stock. Compare *Conagra, Inc. v. Cargill, Inc.*, 382 N.W.2d 576 (Neb. 1986). Here, the Court granted summary judgment against a party to a negotiated merger agreement. The plaintiff sued the directors of a merger partner who had cancelled a shareholders' meeting
for this permissiveness is that other constraints—other than legal enforcement of fiduciary norms—seem to work more effectively.\textsuperscript{78} In particular, product markets and labour markets in many cases take their own revenge on inept managers. Moreover, judicial enforcement of the duty of care inevitably is inhibited by judges' reluctance to probe the merits of business decisions.\textsuperscript{79} Each of the examples of legislatively mandated fiduciary norms, moreover, is a statutory response to reports of extensive abuses that occurred in the absence of mandatory fiduciary norms.

Moreover, parties' relative ability to bargain does not seem to explain the \textit{intensity} with which courts articulate or apply fiduciary norms. Courts especially stress the severity of fiduciary standards in partnerships and closely-held corporations in which actual bargaining over the terms of the parties' relationship is likely to occur, but not in publicly-held corporations in which such bargaining is least likely. Judge Cardozo emphasized that the fiduciary standard is one of a "punctilio of an honour the most sensitive" in \textit{Meinhard v. Salmon},\textsuperscript{80} involving a two-person joint venture in real estate. Thus, the parties' initial ability to define their relationship through bargaining is not the sole explanatory factor. If it were, courts would use the "punctilio" standard in evaluating the stewardship of directors of publicly-held corporations, not the actions of partners. In closely-held small ventures (whether organized as partnerships or corporations), minority investors often lack realistic opportunities to exit: the sole market for their investment interests is likely to be the majority or controlling investor. Small closely-held ventures also have dramatically different arrangements for internal governance than do publicly-held corporations. In particular, small ventures are unlikely to have independent directors accountable to the interests of all investors. In short, despite their opportunity to bargain initially, minority investors in small enterprises are more vulnerable to

\textsuperscript{78} See Thompson, supra, note 32 at 407. Professor David Charney used a similar argument to explain when nonlegal commitments should lead to legal liability: to the extent transacting parties in a particular context would rely on non-legal sanctions to enforce the commitment, it should not be treated as an enforceable contract term. See D. Charney, "Nonlegal Sanctions in Commercial Relationships" (1990) 104 Harv. L. Rev. 375 at 456-63.

\textsuperscript{79} See Thompson, ibid. at 408.

\textsuperscript{80} Supra, note 14.
subsequent overreaching by the majority. And overreaching behaviour in a small venture seems to betray a more personalized relationship than does the identical behaviour when a director of a publicly-held corporation indulges in it.

Finally, to the extent fiduciary rules are characterized as default rules, difficult questions arise concerning the evidence of agreement that would suffice to vary the default norm. How much specificity should be required (the question posed by Smith81)? Should a restraint like the parol evidence rule apply? That is, should we almost always prefer the written manifestation of an agreement over otherwise compelling evidence that the parties reached a bargain-in-fact? In the absence of a provision in a written instrument establishing an alternative to the default rule, what evidence of agreement should suffice? Tolerance of prior breaches of the default rule?82 Diffuse oral assurances ("Don't worry about it. Trust me.")? Should the parties' sophistication be relevant? Is it relevant whether the parties used legal counsel?

Resolving these difficult questions requires an expenditure of resources not required by mandatory rules.83 Whether, on balance, the expenditure is justified is a question that is not answered by taxonomic arguments. We need to ask whether mandatory rules at present inhibit transactions and relationships that would be beneficial to the participants, perhaps not to each of them individually in each instance, but to broad classes of participants over time. Argument-by-classification is not responsive. Like argument-by-labelling the author,84 it bypasses engagement with the merits of the issues at stake.

To be sure, taxonomy is useful. It is useful to have basic divisions among legal categories, and analysis surely proceeds more expeditiously

81 Supra, note 74.

82 See, e.g., Re E.F. Hutton & Co., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (S.E.C. July 6, 1988). Here, a sophisticated customer, who complained of the firm's earlier failure to execute his limit orders, was entitled to disclosure of the firm's practice of giving priority to proprietary trades when the firm accepted a particular limit order from the customer.

83 Compare Laniak v. Advisory Comm. of the Brainerd Mfg. Co. Pension Plan, 935 F.2d 1360 (2d Cir. 1991). This Court remanded for trial of factual issues requisite to a careful examination of whether a 57-year-old employee knowingly and voluntarily waived participation in his new employer's pension plan.

as a result of categorization. The examples of argument-by-taxonomy explored in this essay illustrate taxonomy’s chief weakness, its artificiality. Used to resolve difficult questions, argument-by-taxonomy seems an example of legal formalism at its worst. That is, taxonomic arguments are mechanistic, in that the result follows inexorably from the initial classification, follows as inexorably as the ticking of a mechanical clock that is wound at regular intervals. Taxonomic argument presupposes, additionally, a closed system of argument that forecloses reference to any factors external to the scheme of categorization. In short, it treats “as definitionally inexorable that which involves nondefinitional, substantive choices.” Taxonomy furnishes starting points but not answers. The evaluation of fiduciary norms requires much more than simple taxonomy can provide.

In turn, identifying the central or distinctive justification for fiduciary norms is often crucial to constructing and applying them in particular contexts. Otherwise the norms—context-variable in any event—seem vague and ill-defined, and sometimes over-stretched. Fiduciary norms can best be justified as components of the legal infrastructure that specifically support obligations of loyalty to persons or entities other than oneself. It is not surprising that doctrines protective of commitments to act loyally have evolved in a noticeably context-and-fact specific manner; their nature invites and justifies close judicial attention to the facts of particular controversies. Similarly, fiduciary norms lose their bite when they are imposed on behalf of beneficiaries whose interests systemically conflict. If fiduciary norms are overextended, that vitiates their force and their undergirding of commitments to act loyally, leaving a residue of empty, albeit emphatic, rhetoric.

---

85 See A.J. Hirsh, “The Problem of the Insolvent Heir” (1989) 74 Cornell L. Rev. 587 at 654. Hirsh writes that “[m]uch like the process of speciation in biology, the process of categorization in law can generate analytical (as opposed to adaptive) efficiencies whose benefits outweigh their costs.”
