The Critical Resource Theory of Fiduciary Duty

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INTRODUCTION

Fiduciary law is messy. Courts routinely impose fiduciary duties in myriad relationships, including trustee-beneficiary, employee-employer, director-shareholder, attorney-client, and physician-patient. In each of these relationships, courts require fiduciaries to adhere to a general obligation of loyalty, but countless variations on that theme tailor the general obligation to the specific context. In addition, courts regularly impose fiduciary obligations ad hoc in relationships where one person trusts another and becomes vulnerable to harm as a result. Surveying this landscape, one of the leading commentators on the law of fiduciary obligation concluded that it is "atomistic," and despite attempts to articulate a principled description of fiduciary relationships, the prevailing view remains that fiduciary law is "elusive." The purpose of this Article is to craft a unified theory of fiduciary duty.

1. On the nature of fiduciary duty as a duty of loyalty, see infra Part I.
2. See infra Part II.
4. See infra Part III.
5. For a sampling of recent academic commentary, see Karen E. Boxx, The Durable Power of Attorney's Place in the Family of Fiduciary Relationships, 36 GA. L. REV. 1, 15 (2001) ("A clear characterization of fiduciary obligation is elusive and its exact nature is much debated."); Peter J. Hammer, Pegram v. Herdrich: On Peritonitis, Preemption, and the Elusive Goal of Managed Care Accountability, 26 J. HEALTH POL'Y & L. 767, 771 n.6 (2001) ("The term fiduciary is a slippery concept."); Andrew D. Shaffer, Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About, 8 AM. BANKR. INST. L. REV. 479, 482 (2000) ("Despite its long history, the exact contours of the concept have remained elusive.").
The unified theory of fiduciary duty offered here advances two primary goals: (1) It articulates the principles that distinguish fiduciary from nonfiduciary relationships, and (2) it rationalizes the content of fiduciary obligations. This account of fiduciary duty is offered as a descriptive theory in the spirit of James Gordley's call to "give a systematic and sensible account of our law." Moreover, both of the primary goals serve the aspiration of equality, which is often expressed as the desire to treat like cases alike.

6. It is often said that fiduciary duty has developed more by metaphor than principle. See, e.g., DeMott, supra note 3, at 879 ("Applicable in a variety of contexts, and apparently developed through a jurisprudence of analogy rather than principle, the fiduciary constraint on a party's discretion to pursue self-interest resists tidy categorization."). As described in some detail below, see infra Part II, courts approach fiduciary claims by asking first whether they arise in the context of an established fiduciary relationship, such as trustee-beneficiary. One function of a unified theory is to ensure that the identification of "fiduciary relationships" proceeds in a principled manner. See infra Parts IV and V.

7. The nature of "fiduciary" duty is examined in Part I below, and the intensity of the fiduciary obligation is explored in Part VI below. While the fiduciary principle—the principle of loyalty—remains constant among the various fiduciary relationships, the intensity of fiduciary duties varies. A unified theory of fiduciary duty explains and justifies that variation. See infra Part VI.

8. James Gordley, The Common Law in the Twentieth Century: Some Unfinished Business, 88 CAL. L. REV. 1815, 1820 (2000). According to Gordley, such an account requires something other than articulating a general principle and then "show[ing] how the principle explains as many of the decided cases as possible." Id. at 1871. Commenting on the task of rationalizing the law of restitution, Gordley expressed his fear that courts and scholars will "manipulate the case law to fit the principle, or formulate an unconvincing principle to fit the case law, or both, and then present the end result as the common law." Id.

9. Of course, achieving that aspiration requires some judgments about which attributes "count" when deciding whether cases are alike. See Frederick Schauer, Precedent, 39 STAN. L. REV. 571, 596 (1987) (observing that the statement "like cases should be decided alike" is "so broad as to be almost meaningless," and that the real issue is "whether we should base our decisionmaking norm on relatively large categories of likeness, or by contrast leave a decisionmaker more or less at liberty to consider any possible way in which this particular array of facts might be unique"). The critical resource theory described here takes cues from the courts on this point. In other words, the theory is descriptive, and no attempt is made to evaluate the normative desirability of imposing fiduciary duties in cases that meet the description of fiduciary relationships offered here.


While the charge to "treat like cases alike" is certainly challenging—and perhaps incoherent—it is also without doubt an important feature of the Western conception of law. See,
The theory proposed here is animated by the view that fiduciary relationships form when one party (the “fiduciary”) acts on behalf of another party (the “beneficiary”) while exercising discretion with respect to a critical resource belonging to the beneficiary. The italicized typeface highlights the three core requirements of a fiduciary relationship. Each requirement plays an important role in distinguishing fiduciary from nonfiduciary relationships. When combined, these requirements show how the duty of loyalty that is the essence of fiduciary duty protects beneficiaries against opportunistic behavior by fiduciaries.¹⁰

The “on behalf of” requirement describes relationships in which one person acts primarily for the benefit of another. Even though a fiduciary may be compensated for her work, she acts on behalf of the beneficiary by considering the interests of the beneficiary and selecting actions that are designed to serve those interests, even when such actions impose costs on the fiduciary. Because the prospect of mutual benefit motivates almost all contractual relationships, however, this requirement cannot easily distinguish fiduciary relationships. It is most useful in circumstances where the other two

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¹⁰ The most commonly cited definition of opportunism is Oliver Williamson’s: Opportunism is “self-interest seeking with guile.” OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47 (1985) [hereinafter WILLIAMSON, ECONOMIC INSTITUTIONS]. This definition is often criticized for being too narrow. See, e.g., George M. Cohen, The Negligence-Opportunism Tradeoff in Contract Law, 20 HOFSTRA L. REV. 941, 957 (1992) (defining opportunism as “any contractual conduct by one party contrary to the other party’s reasonable expectations based on the parties’ agreement, contractual norms, or conventional morality”). Kenneth Davis offers the following definition of opportunism in the fiduciary context: “Opportunism reflects the fiduciary’s departure from the pattern of conduct she would engage in were she alone to bear the full costs and enjoy the full benefits of her actions.” Kenneth B. Davis, Jr., Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives, 80 NW. U. L. REV. 1, 5 (1985).

Opportunism usually conveys moral disapproval, see Deborah A. DeMott, Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions, 19 DEL. J. CORP. L. 65, 71 (1994), but opportunistic actions are not necessarily morally suspect. Timothy J. Muris offers another oft-cited definition of opportunism that does not imply such judgments: “[W]hen a performing party behaves contrary to the other party’s understanding of their contract, but not necessarily contrary to the agreement’s explicit terms, leading to a transfer of wealth from the other party to the performer.” TIMOTHY J. MURIS, OPPORTUNISTIC BEHAVIOR AND THE LAW OF CONTRACTS, 65 MINN. L. REV. 521, 521 (1981).
requirements are satisfied. For example, in landlord-tenant cases, the tenant exercises discretion with respect to a critical resource belonging to the landlord (i.e., the rental property), but does not act primarily for the benefit of the landlord.

The “discretion” requirement implies that the fiduciary makes choices about how to perform her obligations. What distinguishes a fiduciary from many other contracting parties, however, is that a fiduciary exercises discretion with respect to a critical resource belonging to the beneficiary, whereas most contracting parties exercise discretion only with respect to their own performance under the contract. Moreover, to say that a fiduciary exercises discretion implies something more than having mere access to critical resources. This admittedly fine distinction helps to differentiate fiduciaries and service providers, such as electricians or mechanics.

The “critical resource” requirement is the most innovative feature of the new theory. Lawyers have long understood that one who deals with property on behalf of the beneficial owner of the property is subject to fiduciary duties. The quintessential fiduciary relationship—the trust—follows this pattern. Despite the obvious connection between property and fiduciary duty in the trust context, property-based theories of fiduciary duty have not commanded widespread support because so many fiduciary relationships appear to exist without the requisite property. Fiduciary relationships based on confidential information and cases proscribing the use of relationship-specific “opportunities” have been cited as evidence that a property-based theory is too narrowly drawn. In these cases, it is argued, there is no “property” at the core of the relationship.

11. Some commentators even generalize their description of fiduciary duty to standards similar to the one proposed in this Article. See, e.g., Davis, supra note 10, at 4 (“The source of the fiduciary problem is the joinder of the fiduciary's discretionary control over some nontrivial portion of the principal's assets and affairs with the unavoidable fact that the interests of the principal and the fiduciary are not perfectly aligned.”); Larry E. Ribstein, The Revised Uniform Partnership Act: Not Ready for Prime Time, 49 BUS. LAW. 45, 53-54 (1993) (“Courts recognize fiduciary duties only in certain types of agency-like or trust-like contracts where it is appropriate to require a party who controls another's property to act in the other's interests.”).


13. See, e.g., J.C. Shepherd, The Law of Fiduciaries 53-54 (1981) (“The most universal criticism of the property theory is that it requires many things which are not in the traditional sense property to be considered as property in order for the rule to work.”); Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J.L. & ECON. 425, 435 (1993) (describing the property theory as “flat wrong, unless we treat 'property' as silly putty”).
The term "critical resource" is introduced here to avoid the pitfalls associated with relying on the legal concept of "property."\textsuperscript{14} In many instances, a critical resource will be something that is widely recognized as property—for example, money or land that is placed in trust. In other instances, a critical resource will be something valued by the beneficiary but not ordinarily considered property\textsuperscript{15}—for example, the confidential information shared by a client with an attorney. For purposes of articulating a theory of fiduciary duty, an exact definition of the boundaries of the term "critical resource" is not required. The important point is that something lies at the core of the fiduciary relationship and binds the fiduciary to the beneficiary.\textsuperscript{16} If the purported beneficiary of a fiduciary duty offers nothing beyond a vague expectation that another would act loyally, courts should refuse to impose fiduciary duties.

The critical resource theory of fiduciary duty accurately describes established categories of fiduciary relationships and provides a framework for analyzing relationships that fall outside of those categories. Moreover, the critical resource theory reveals that the beneficiary's vulnerability emanates from an inability to protect against opportunism by the fiduciary with respect to the critical resource. This insight suggests that fiduciary law can be justified on the grounds that it deters opportunistic behavior.\textsuperscript{17}

This description of fiduciary relationships bears a strong resemblance to the description of "firms" in the property rights theory pioneered by economists Sanford Grossman, Oliver Hart, and John Moore ("GHM").\textsuperscript{18} The central insight of the property rights theory of

\textsuperscript{14} For a more detailed discussion on the distinction between "critical resources" and "property," see infra Part VI.C.

\textsuperscript{15} Robert Cooter and Bradley Freedman state, "The asset may take various forms, including cash, stock, land, a patent or copyright, valuable information, a business opportunity, or a business enterprise." Robert Cooter & Bradley J. Freedman, The Fiduciary Relationship: Its Economic Character and Legal Consequences, 66 N.Y.U. L. Rev. 1045, 1048 n.6 (1991).

\textsuperscript{16} The ambiguity in such a core concept may strike some readers as a fatal flaw in the theory. But such an objection should have no more force here than the claim that the ill-defined contours of the concept of "property" should lead to the abandonment of property rights. In both instances, courts or legislatures make a determination that public policy warrants legal protection.

\textsuperscript{17} For a debate concerning the policy of deterrence in the fiduciary context, see Hanoch Dagan, The Distributive Foundation of Corrective Justice, 98 Mich. L. Rev. 138, 157-62 (1999) (arguing that "the availability of a profits-based recovery must be a function of the deterrence issue"); Weinrib, supra note 12, at 34 (stating that "the fiduciary's liability to disgorge profits is not an example of a policy of deterrence impacting the relationship from the outside, but is rather the remedial consequence that reflects the nature of the obligation owed by the fiduciary to the beneficiary").

the firm is that an appropriate allocation of ownership rights over the assets of a firm reduces the likelihood that one party will unfairly take advantage of the other participants within the firm. Under this view, the owner of property may deter opportunistic behavior by threatening to withdraw the property from the firm or by threatening to otherwise deprive another participant in the firm of access to the property.

These insights can be generalized to all fiduciary relationships (not just firms) by asserting that the defining attribute of fiduciary relationships is found in the allocation of residual control over critical resources. Just as property owners have the right to define how their assets are used, beneficiaries exert residual control over their critical resources. While such control provides important opportunities for self-help by the beneficiary, the threats associated with residual control may not deter opportunism. For example, the fiduciary may balance the potential benefits from opportunism against the potential costs associated with being terminated and decide to assume the risk of detection.

Even if the beneficiary can bring an action against the fiduciary in tort or contract, the best that the beneficiary can expect in most cases is compensation for actual harm done. If the fiduciary's expected benefits from opportunism exceed the beneficiary's expected harm, compensatory remedies will not deter the opportunistic behavior. In these instances, fiduciary duty improves deterrence by

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20. Cf. Thomas W. Merrill, Property and the Right to Exclude, 77 Neb. L. Rev. 730, 741 (1998) [hereinafter Merrill, Right to Exclude] (“A’s right to exclude with respect to Blackacre leads directly to A’s right to dictate the uses of Blackacre, because no one else will be in a position to interfere with the particular uses designated by A.”).

21. That beneficiaries have residual control over critical resources follows from the definition of “critical resource” employed in this Article. As discussed in more detail in Part IV.C below, a critical resource is anything belonging to the beneficiary that—when subject to the discretion of the fiduciary—provides the fiduciary with the occasion to act opportunistically.

providing *restitution* rather than compensation.\(^\text{23}\) The important lesson is that fiduciary duty performs roughly the same economic function as ownership.

The remainder of the Article proceeds as follows: Part I provides a brief description of the loyalty obligation that comprises fiduciary duty. Part II surveys the judicial landscape and extracts the principles most often used by courts to distinguish fiduciary from nonfiduciary relationships. Particular attention is given to cases involving "confidential relationships," as these are some of the most difficult cases for courts under current standards. Part III describes several unsuccessful attempts to rationalize fiduciary law. These theoretical justifications fail either because they are overinclusive (i.e., they cannot distinguish fiduciary from nonfiduciary relationships) or because they are underinclusive (in that they exclude some fiduciary relationships). Part IV uses the property rights theory of the firm as a conceptual foundation for the critical resource theory of fiduciary duty. Each of the three requirements of fiduciary relationships is then examined in turn. The law of agency illuminates the "on behalf of" requirement; "critical resources" are distinguished from "property," and the "discretion" requirement is explored in the difficult case of service providers. Part V applies the critical resource theory of fiduciary duty to explain easy cases and resolve hard cases. Part VI describes the justification for the content of fiduciary duties that is implied by the critical resource theory. The basis of this notion is that fiduciary law provides protection against opportunistic behavior, and the strength of that protection varies inversely with the potential for self-help on the part of the vulnerable party. Finally, Part VII briefly explores three additional implications of the critical resource theory of fiduciary duty.

I. THE NATURE OF FIDUCIARY DUTY

When the term "fiduciary duty" is used in this Article, it refers to a duty of loyalty. This duty has been described as a duty of

\(^{23}\) Douglas Laycock has summarized the importance of restitutionary remedies as follows: The restitutionary claim matters in three sets of cases: (1) when unjust enrichment is the only source of liability; (2) when plaintiff prefers to measure recovery by defendant's gain, either because it exceeds plaintiff's loss or because it is easier to measure; and (3) when plaintiff prefers specific restitution, either because defendant is insolvent, because the thing plaintiff lost has changed in value, or because plaintiff values the thing he lost for nonmarket reasons.

“unselfishness”24 or an “obligation to behave as if [the fiduciary] has adopted an other-regarding preference function.”25 Each of these formulations has some merit, but for reasons discussed in this section, each is slightly misleading. For present purposes, therefore, “fiduciary duty” connotes an obligation to refrain from self-interested behavior that constitutes a wrong to the beneficiary as a result of the fiduciary exercising discretion with respect to the beneficiary’s critical resources.

Obviously, this description of fiduciary duty requires some unpacking. In particular, the notion of “wrong” may seem opaque to those unfamiliar with the law of restitution.26 Fiduciary duty has often been conceived as an equitable wrong, in contradistinction to tort, which is a legal wrong.27 Breach of contract and breach of statutory duty are also considered legal wrongs.28 The unifying attribute of all wrongs is that “one person misappropriates a protected interest of another.”29 The protected interest in a fiduciary relationship is the beneficiary’s interest in the critical resource.30 As a general matter, a wrong is committed in the fiduciary context when the fiduciary does or has something that is inconsistent with the beneficiary’s interest in the critical resource.

Breach of fiduciary duty is sometimes associated with “unjust enrichment,”31 but this association can be more confusing than

26. If Andrew Kull is right, this could be a very large group. Andrew Kull, Rationalizing Restitution, 83 CAL. L. REV. 1191, 1195 (1995) (“To put it bluntly, American lawyers today (judges and law professors included) do not know what restitution is.”).
28. Birks, supra note 27, at 1779.
29. See Friedmann, supra note 12, at 1879.
30. Whether the critical resources belong to the beneficiary—or, in the words of property law, are “owned” by the beneficiary—is an issue that is exogenous to fiduciary law. Similarly, whether the fiduciary has committed a wrong against the beneficiary as a result of the fiduciary’s discretion with respect to those critical resources is informed by principles outside of fiduciary law.
31. See Gareth Jones, Unjust Enrichment and the Fiduciary’s Duty of Loyalty, 84 L. REV. Q. 472 (1968). As a means of distinguishing fiduciary from nonfiduciary relationships, reference to unjust enrichment is not helpful. The obvious problem with this approach is that whether a person is unjustly enriched may depend on whether the person is a fiduciary. Defining the relationship by reference to unjust enrichment, therefore, is simply tautological. See DeMott, supra note 3, at 913 (“But the principle of unjust enrichment cannot explain as a general matter why some people are under the fiduciary constraint and others are not, and it inevitably requires...
helpful. Taken at face value, the term "unjust enrichment" seems to imply an "open-ended and potentially unprincipled charter of liability." As noted in the recent draft of the Restatement (Third) of Restitution, however, the law relating to unjust enrichment is concerned "with a narrower set of circumstances giving rise to what is more appropriately called unjustified enrichment," which is "enrichment that lacks an adequate legal basis: [I]t results from a transfer that the law treats as ineffective to work a conclusive alteration in ownership rights." Even this narrower conception of unjust enrichment is too broad to capture the essence of fiduciary obligation. The duty that is distinctive of fiduciaries arises out of a concern that the fiduciary will take advantage of the beneficiary. It is not a concern about inadvertent harm, but about self-interested behavior. This nuance is best seen by distinguishing "wrongful enrichment" from "unjust enrichment." While "[e]very wrongful enrichment can be dressed up in the language of unjust enrichment," the key to maintaining the distinction is to determine whether the plaintiff is required to rely on the defendant's wrongful action to sustain a claim. Under this view, culpability is simply not relevant to claims of unjust enrichment, which is limited in the main to cases involving mistakes. Although all commentators seem to agree that breach of fiduciary duty falls within the boundaries of the law of restitution, identifying breaches of fiduciary duty as wrongs rather than cases of unjust enrichment

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32. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. b (Discussion Draft 2000).

33. Id.


35. Birks, supra note 27, at 1783. The Restatement (Third) of Restitution and Unjust Enrichment makes no attempt to distinguish these concepts. See, e.g., § 3 cmt. a ("Any profit realized in consequence of intentional wrongdoing is unjust enrichment because it results from a wrong to the plaintiff.").

36. Birks, supra note 27, at 1788.

37. Birks uses mistakes as the primary examples of his structure. See, e.g., id. at 1779 (analyzing the "receipt of a mistaken payment"); cf. Laycock, supra note 23, at 1284-85 (describing various cases in which unjust enrichment is the only source of liability). For a detailed examination of mistakes, see Hanoch Dagan, Mistakes, 79 Tex. L. Rev. 1795 (2001).
CRITICAL RESOURCE THEORY

highlights an important feature of fiduciary law—namely, its focus on opportunism.\textsuperscript{38}

Obviously, this conception of fiduciary duty is limited to the duty of loyalty, as opposed to the duty of care. References to a "fiduciary duty of care" are common,\textsuperscript{39} and fiduciaries routinely owe a duty of care. Of course, many other people also owe a duty of care. More importantly, while the content of that duty of care may be stated in terms of ordinary negligence or gross negligence, depending on context, the intensity of the duty of care is not dependent on whether the person acting is a fiduciary. In short, the duty of care is "not distinctively fiduciary."\textsuperscript{40}

Unlike the duty of care, the fiduciary duty of loyalty is distinctive. Although fiduciaries are not the only people who owe a duty of loyalty—Part VII.A below argues that the implied obligation of good faith and fair dealing in contract law is a form of loyalty obligation—the content of the duty of loyalty imposed in the fiduciary context is unique. In other words, the requirements imposed by the duty of loyalty change as one moves from contractual relationships to fiduciary relationships. In the fiduciary context, the duty of loyalty requires the fiduciary to adjust her behavior on an ongoing basis to avoid self-interested behavior that wrongs the beneficiary. By contrast, the implied obligation of good faith and fair dealing requires loyalty to the other contracting party only to the extent that the terms of the contractual relationship reasonably contemplate the actions in

\textsuperscript{38} Conflating wrongs and cases of unjust enrichment can also have immediate practical effects. See Edelman, supra note 34, at 1870 (citing differences in choice-of-law rules, statutes of limitation and respose, varying interest rates, and available defenses).


\textsuperscript{40} DeMott, supra note 3, at 915.
question. Stated another way, both contracting parties and fiduciaries may be allowed to engage in self-interested behavior. For this reason, fiduciary duty should not be equated with a duty of selflessness. However, the fiduciary must refrain from self-interested behavior that wrongs the beneficiary, whereas contracting parties may act in a self-interested manner even where the other party is injured, as long as such actions are reasonably contemplated by the contact. In short, fiduciaries are expected to be much more scrupulous about their self-interested behavior than mere contracting parties.

The emphasis here on the fiduciary’s self-interested behavior might, at first blush, seem to be merely the flip side of a requirement that the fiduciary act in the interests of the beneficiary. A failure to act in the interests of the beneficiary, however, may arise in several contexts: when the fiduciary acts in the interests of a third party, when the fiduciary (otherwise) fails to exercise proper care, or when the fiduciary acts in a self-interested manner. While any action that harms the beneficiary might in some sense constitute a breach of loyalty, courts typically reserve the label “loyalty” for self-interested

41. This statement is qualified with the word “usually” to account for those cases in which courts impose “good faith” obligations beyond the reasonable expectations of the contracting parties. As will be discussed below, see infra Part VIII.A, the critical resource theory acknowledges the blurred line that separates fiduciary relationships and contractual relationships. To the extent that loyalty obligations originate from sources outside of the contract, they tend to have a fiduciary character.

42. In recognition of the fact that conflict-of-interest transactions may sometimes work to the advantage of the beneficiary, fiduciary law typically allows the parties to a fiduciary relationship to “contract out” of fiduciary duties. Moreover, in some fiduciary relationships—notably partnerships, where each partner has a fiduciary obligation to the partnership—the fiduciaries simultaneously work on their own behalf when they work on behalf of the beneficiary.

43. To the extent that the rhetoric of Meinhard v. Salmon suggests a duty of selflessness, Judge Cardozo goes too far. See 164 N.E. 545, 548 (N.Y. 1928) (noting that the “thought of self was to be renounced, however hard the abnegation”).

44. See Victor Brudney, Contract and Fiduciary Duty in Corporate Law, 38 B.C. L. REV. 595, 633-34 n.101 (1997) (“[G]ood faith’ requires one party to ‘consider’ the other party’s interest in exercising discretion under their contract and thus seeks limits on the extent to which the party may serve his own interests. But it does not seek (as does the classic fiduciary stricture) to prevent him or her from serving those interests, whether or not at the risk of some harm to the other party.”).

45. DeMott, supra note 3, at 882 (“If a person in a particular relationship with another is subject to a fiduciary obligation, that person (the fiduciary) must be loyal to the interests of the other person (the beneficiary).”). There is some tension between the standard for breach of fiduciary duty and the “on behalf of” requirement discussed below. See infra Part IV.B. All fiduciaries work on behalf of beneficiaries, but loyalty is not measured by the failure to provide the benefits of the relationship. Only when such a failure results from self-interested behavior on the part of the fiduciary are concerns about loyalty raised.
actions. Actions that advantage a third party at the expense of the beneficiary are usually treated as a breach of the duty of care.\footnote{46. The intuition here seems to be that a fiduciary who is not motivated by self-interest would not intentionally serve the interests of a third party ahead of the interests of the beneficiary. Evidence that such action has occurred, therefore, suggests negligence. For discussions of this point in the corporate context, see Lawrence E. Mitchell, \textit{A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes}, 70 TEX. L. REV. 579, 590-96 (1992); D. Gordon Smith, \textit{The Shareholder Primacy Norm}, 23 J. CORP. L. 277, 284-86 (1998).}

Courts emphasize self-interested behavior (rather than other-regarding behavior) for another reason: Whether a fiduciary is engaged in other-regarding behavior is often too difficult to assess because it ultimately depends on either the fiduciary's motives or the effect of the fiduciary's actions on the beneficiary, neither of which may be transparent. As noted in the prior paragraph, there may be competing explanations for an action that is contrary to the interests of the beneficiary, some of which do not involve a breach of the duty of loyalty. In these circumstances, whether the actions of the fiduciary were other-regarding cannot be determined merely by observing the effect of the actions (e.g., harm to the beneficiary). Moreover, fiduciary claims do not require proof of actual loss to the beneficiary. The “harm” caused by a breach of fiduciary duty may be nothing more than an infringement of the beneficiary's right to control the fiduciary. Finally, even where a fiduciary's actions do not seem reasonably contemplated to serve the interests of the beneficiary, judges must guard against the risks associated with hindsight bias.\footnote{47. See Gregory S. Alexander, \textit{A Cognitive Theory of Fiduciary Relationships}, 85 CORNELL L. REV. 767, 782-85 (2000).}

\section*{II. Current Judicial Approaches to Fiduciary Duty}

Justice Frankfurter wrote, “To say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?”\footnote{48. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).} As it turns out, identifying someone as a fiduciary is no simple undertaking. Courts frequently consider whether fiduciary duties
apply to a given relationship but have been extremely vague in articulating the standards for making this determination.

Many courts sensibly divide the universe of fiduciary relationships into two parts: “formal” fiduciary relationships and “informal” fiduciary relationships. Formal fiduciary relationships are those well-settled cases—such as trustee-beneficiary, guardian-ward, partner-partner, director-shareholder, and attorney-client—where fiduciary duties apply as a matter of course. Informal fiduciary relationships—often referred to as “confidential relationships”—are

49. Fiduciary duties do not arise only in contractual relationships. See, e.g., Stone v. Davis, 419 N.E.2d 1094, 1098 (Ohio 1981) (“A fiduciary relationship need not be created by contract; it may arise out of an informal relationship where both parties understand that a special trust or confidence has been reposed.”). Indeed, it is often said that agency relationships are consensual—not contractual—and fiduciary duties are an important feature of agency relationships. See, e.g., Ins. Co. of N. Am. v. Miller, 765 A.2d 587, 593 (Md. 2001).

50. See, e.g., United Fire & Cas. Co. v. Nissan Motor Corp. in U.S., 433 P.2d 769, 771 (Colo. 1967) (stating that a fiduciary relationship is one that “might have impelled or induced [one of the parties] to relax the care and vigilance it would and should have ordinarily exercised in dealing with a stranger”); Dunn v. Dunn, 786 So. 2d 1045, 1053 (Miss. 2001) (“In determining whether a fiduciary relationship exists, we have to look to see if one person depends upon another.”); Memphis Hardwood Flooring Co. v. Daniel, 771 So. 2d 924, 930 (Miss. 2000) (“A fiduciary relationship may arise between parties to a contract where the parties share a mutual interest in obtaining the results called for in the contract.”).


52. At times courts refer to these relationships as “legal” fiduciary relationships or fiduciary relationships “as a matter of law.” See, e.g., Davion v. Williams, 352 So. 2d 804, 807 (Miss. 1977); Cacciatorc v. Mobil Oil Corp., 2000 WL 1029168, at *6 (N.D. Ill. 2000). Confusingly, courts also refer to informal fiduciary relationships as “implied in law.” See, e.g., Reebles, Inc. v. Bank of Am., N.A., 25 P.3d 871, 874 (Kan. Ct. App. 2001) (describing relationships “implied in law due to the factual situation surrounding the involved transactions and the relationship of the parties to each other and to the questioned transactions”).

53. “Confidential relationships” and “fiduciary relationships” are not congruent, but the overlap between the two concepts is substantial. See Restatement (Third) of Restitution and Unjust Enrichment (Discussion Draft 2000) § 15 cmt. b (stating that undue influence might arise in fiduciary relationships or in other confidential relationships); Tamar Frankel, Fiduciary Law, 71 CAL. L. REV. 795, 825 n.100 (1983). Ray Madoff has stated, “Confidential relationships can be understood as both a form and an extension of fiduciary relationships.” Ray D. Madoff, Unmasking Undue Influence, 81 MINN. L. REV. 571, 583 (1997). The primary difference between the two relationships seems to lie in the burden of proof imposed on the plaintiff:

If one person is in a confidential, but not a fiduciary, relation to another, a transaction between them will not be set aside at the instance of one of them unless in fact he reposed confidence in the other, and the other, by fraud or undue influence or otherwise, abused the confidence placed in him.... The existence of a confidential relation is simply one of the elements to be considered in determining whether there is fraud or undue influence or overreaching.
those in which the court imposes fiduciary duties based on a qualitative evaluation of the relationship.

Courts typically do not attempt to explain why fiduciary duties are imposed in formal fiduciary relationships. Many of these relationships have been considered fiduciary in nature for centuries, and any attempt to explain that status seems unnecessary. By contrast, courts are incessantly attempting to rationalize the law governing informal fiduciary relationships. Claims under this heading are common and involve diverse factual settings. The search for common principles is inevitable.

While courts use various formulations to describe informal fiduciary relationships, the common elements are quite simple: (1) "trust" or "confidence" reposed by one person in another;\(^5\) and (2) the resulting "domination,"\(^5\) "superiority,"\(^6\) or "undue influence"\(^7\) of the

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A corollary to the foregoing is that fiduciary duty is only one mechanism for controlling breaches of confidence. See Susan M. Gilles, Promises Betrayed: Breach of Confidence as a Remedy for Invasions of Privacy, 43 BUFF. L. REV. 1, 2-3 (1995) (observing that American courts "have used three theories of recovery—contract, fiduciary duty and tort—to remedy breaches of confidence").

54. This requirement appears again and again in the cases. See, e.g., Ins. Co. of N. Am. v. Morris, 981 S.W.2d 667, 674 (Tex. 1998) (stating that "confidential relationships may arise when the parties have dealt with each other in such a manner for a long period of time that one party is justified in expecting the other to act in its best interest"); Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171, 176-77 (Tex. 1997) ("An informal relationship may give rise to a fiduciary duty where one person trusts in and relies on another, whether the relation is a moral, social, domestic, or purely personal one . . . . But not every relationship involving a high degree of trust and confidence rises to the stature of a fiduciary relationship."); H-B Ltd. P'ship v. Wimmer, 257 S.E.2d 770, 773 (Va. 1979) ("A fiduciary relationship exists in all cases when special confidence has been reposed in one who in equity and good conscience is bound to act in good faith and with due regard for the interests of the one reposing the confidence.").

55. See, e.g., Wilson v. IBP, Inc., 558 N.W.2d 132, 139 (Iowa 1996) ("Although domination and control are significant factors, neither [is] determinative by [itself]."); Union State Bank v. Woell, 434 N.W.2d 712, 721 (N.D. 1989) (stating that the "party reposing the confidence must be in a position of inequality, dependence, weakness, or lack of knowledge"); Lowrance v. Patton, 710 P.2d 108, 111 (Okla. 1985) (concluding that a fiduciary relationship exists where "there is confidence reposed on one side and resulting domination and influence on the other").

56. The nature of superiority required here is elusive. Just because one party to the relationship has greater skill or expertise does not result in the formation of a fiduciary relationship. See, e.g., Hi-Ho Tower, Inc. v. Com-Tronics, Inc., 761 A.2d 1268, 1280 (Conn. 2000) ("Superior skill and knowledge alone do not create a fiduciary duty among parties involved in a business transaction."); High Plains Genetics Research, Inc. v. JK Mill-Iron Ranch, 535 N.W.2d 839, 842 (S.D. 1995) (observing that one party "may have had superior knowledge and technical skills," but the other "was not in a dependent position, lacking in mental acuity, business intelligence or knowledge of the basic principles involved").

With regard to the claim that "[f]iduciary duties redress the inequality of information or power between the parties to a contract," Easterbrook and Fischel respond, "Nice try, but it is
other. Trust alone is not enough, though courts often speak loosely in ways that suggest otherwise—nor is vulnerability. Only in the aggregate do these factors give rise to a fiduciary relationship.

57. See, e.g., Young v. Kaye, 279 A.2d 759, 763 (Pa. 1971) (stating that a confidential relationship "exist[s] whenever the relative position[s] of the parties is such that one has power and means to take advantage of or exercise undue influence over the other").

58. A Missouri appellate court summarized the usual requirements concisely and completely as follows:

From the foregoing authority, certain basic elements necessary to the establishment of a fiduciary relationship arise. In summary, these are: (1) as between the parties, one must be subservient to the dominant mind and will of the other as a result of age, state of health, illiteracy, mental disability, or ignorance; (2) things of value such as land, monies, a business, or other things of value which are the property of the subservient person must be possessed or managed by the dominant party; (3) there must be a surrender of independence by the subservient party to the dominant party; (4) there must be an automatic or habitual manipulation of the actions of the subservient party by the dominant party; and (5) there must be a showing that the subservient party places a trust and confidence in the dominant party.

Chmielecki v. City Prod. Corp., 660 S.W.2d 275, 294 (Mo. Ct. App. 1983). This summary suggests much more precision than actually exists in most of the cases.

59. See, e.g., Parello v. Maio, 494 S.E.2d 331, 333 (Ga. 1998) (stating that "the mere circumstance that two people have come to repose a certain amount of trust and confidence in each other as the result of business dealings is not, in and of itself, sufficient to find the existence of a confidential relationship"); Smith v. Walden, 549 S.E.2d 750, 751 (Ga. Ct. App. 2001) (noting that "mere friendship and close fellowship, without more, do not create a fiduciary relationship"); Kienel v. Lanier, 378 S.E.2d 359, 361 (Ga. Ct. App. 1989) (maintaining that "the mere fact that two persons have transacted business in the past based on oral commitments or understandings and that they have come to repose trust and confidence in each other as the result of such dealings is not sufficient, in and of itself, to warrant a finding that a confidential relationship exists between them"); Daktronics, Inc. v. McAfee, 599 N.W.2d 358, 363 (S.D. 1999) ("One party cannot transform a business relationship into one which is fiduciary in nature merely by placing trust and confidence in the other party."); (quoting Ainsworth v. First Bank of S.D., 472 N.W.2d 768, 7888 (S.D. 1991)); Semenov v. Hill, 982 P.2d 578, 580 (Utah 1999) (finding that "merely depending on another does not create a fiduciary relationship").

60. See, e.g., Mid-Am. Nat'l Bank of Chi. v. First Sav. and Loan Ass'n of South Holland, 515 N.E. 2d 176, 180 (Ill. App. Ct. 1987) ("Where a fiduciary relationship does not exist as a matter of law, such a relationship may nonetheless occur where one party, due to a close relationship, relies very heavily on the judgment of another."); Penato v. George, 383 N.Y.S.2d 900, 904-05 (N.Y. App. Div. 1976) ("Broadly stated, a fiduciary relationship is one founded upon trust or confidence reposed by one person in the integrity and fidelity of another. It is said that the relationship exists in all cases in which influence has been acquired and abused, in which confidence has been reposed and betrayed. The rule embraces both technical fiduciary relations and those informal relations which exist whenever one man trusts in, and relies upon, another.") (emphasis added).


62. An elegant statement of the usual approach was offered by the Pennsylvania Supreme Court in In re Estate of Scott:

The concept of a confidential relationship cannot be reduced to a catalogue of specific circumstances, invariably falling to the left or right of a definitional line... The
These standards are extremely malleable, allowing courts to tailor their decisions to the particular case. The price of such flexibility is that the reporters are filled with cases in which the parties appear to have both an investment of trust and concomitant vulnerability, but which for some other reason do not seem like fiduciary relationships. A recent example of such a case is *Top of Iowa Cooperative v. Schewe*, in which a grain elevator ("Top of Iowa") owed fiduciary duties to a farmer ("Schewe"), who had entered into risky "hedge-to-arrive" ("HTA") contracts.

An HTA requires the farmer to deliver a specified amount of grain at a specified date. In exchange, the farmer agrees to accept a specified price in exchange for the promised grain. If the market ("spot") price of grain declines between the date of the contract and the date of delivery, the buyer must nevertheless pay the contract price.

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63. One set of cases that has been much debated is claims within a family. Family members are not considered fiduciaries simply because of their familial ties, even though family relationships have many of the attributes of traditional fiduciary relationships. See, e.g., Economopoulos v. Kolaitis, 528 S.E.2d 714, 718 (Va. 2000); Bryan R. v. Watchtower Bible & Tract Soc'y of N.Y., Inc., 738 A.2d 839 (Me. 1999). On the other hand, family members are not exempt from fiduciary obligations merely because they are part of the same family. See, e.g., Tex. Bank & Trust Co. v. Moore, 595 S.W.2d 502, 508 (Tex. 1980).

Elizabeth Scott and Robert Scott noted some of the difficulties in applying fiduciary law to parents:

> Given the extensive scope of the relationship, a prescription that parents must systematically subordinate their personal interest to that of the child when the two are in conflict seems unduly burdensome, and ultimately likely to deter prospective parents from taking on the role. Furthermore, enforcement of such an obligation, although theoretically feasible, would require costly and intrusive state supervision of intact families. This effect seems particularly troublesome given the intimacy of the relationship and the presumed importance of privacy to optimal family functioning. Moreover, the substantial costs to children of replacing parents and of severing the filial bond inhibits the imposition of a sanction that is used to discipline fiduciaries in other contexts.

Elizabeth S. Scott & Robert E. Scott, *Parents as Fiduciaries*, 81 VA. L. REV. 2401, 2430 (1995). Despite these obstacles, the authors find much to recommend the conception of parents as fiduciaries.

64. 149 F. Supp. 2d 709 (N.D. Iowa 2001). The existing standards encourage plaintiffs to bring fiduciary claims in many circumstances that are quite remote from the fiduciary framework described by the critical resource theory of fiduciary duty. See, e.g., Comm. on Children's Television, Inc. v. Gen. Foods Corp., 673 P.2d 660, 676 (Cal. 1983) (rejecting a claim that a breakfast cereal manufacturer had a fiduciary relationship with the children who consumed its products); Flynn v. Am. Home Prods. Corp., 627 N.W.2d 342, 350 (Minn. Ct. App. 2001) (rejecting a claim that a drug manufacturer had a fiduciary duty to disclose material safety facts to all consumers).

65. The *Schewe* court did not describe the terms of the HTA in that case. For a description of HTAs, see Glenn L. Norris et al., *Hedge to Arrive Contracts and the Commodity Exchange Act: A Textual Alternative*, 47 DRAKE L. REV. 319, 322-26 (1999).
On the other hand, if the spot price of grain rises between the date of the contract and the date of delivery, the buyer pays only the contract price. The buyer hedges against fluctuations in the spot price by entering into a futures contract that exactly mirrors the HTA. The farmer obtains only the contract price regardless of fluctuation in the spot price. The advantage of such contracts to both parties is that the price is fixed in advance.

The farmer may decide to “roll” the HTA, which means simply that the farmer may delay delivery of the grain to a future period. For example, Schewe had agreed to deliver grain in the fall of 1995, but he decided to roll his HTAs into the spring of 1996—purportedly on the advice and encouragement of Top of Iowa.66 When a farmer elects to roll an HTA, the price of the contract changes to reflect futures prices. If prices are rising, the farmer may be forced to purchase grain at the date of delivery for a spot price in excess of the contract price. In any event, the purpose of rolling a contract is usually speculative.67 Schewe’s timing was bad, as grain prices were rising in the fall of 1995. Top of Iowa sued Schewe for breaching his contract, and Schewe counterclaimed for breach of fiduciary duty. A jury approved both claims.68

In the appeal of the grain elevator’s motion for judgment as a matter of law, the court evaluated the sufficiency of the evidence on Schewe’s fiduciary duty claim. Top of Iowa argued that Schewe was a sophisticated businessman who made his own decisions and that the parties had entered into an arm’s-length commercial relationship.69 Schewe countered by pointing to evidence of “his reliance on and trust in” Top of Iowa’s grain merchandiser, as well as “copious evidence that Top of Iowa had superior knowledge about and experience in the grain industry.”70 The court noted evidence that officers of the grain elevator had extensive experience with hedging transactions and concluded that “the jury could have reasonably inferred that Top of Iowa

66. 149 F. Supp. 2d at 718.
67. See Norris et al., supra note 63, at 324-25:
   In response to the right to roll delivery into farther and farther removed months—and the chance to make money from the fluctuations of the [Chicago Board of Trade] without paying margins and commissions—some farmers entered into a great many HTA contracts. Indeed, many committed a number of bushels to HTA contracts that exceeded their annual grain production by three, four, or more times. And, in many cases, the ratio of HTA bushels to actual bushels did not decrease over time: The right of the producer to roll the HTA contract and sell his crop for cash, combined with favorable cash prices, encouraged farmers to roll the HTA contracts rather than deliver on them.
68. Id.
69. Id. at 714.
70. Id.
possessed superior knowledge and experience with grain transactions involving any sort of 'hedging' or speculation about the future performance of the grain market. 71

This case illustrates the possibility for error in applying concepts like trust and vulnerability to distinguish fiduciary from nonfiduciary relationships. 72 Even if Schewe trusted Top of Iowa and became vulnerable as a result, the relationship did not evidence the potential for opportunism that is characteristic of fiduciary relationships. Indeed, if Top of Iowa was a fiduciary, it is difficult to imagine any principle that would distinguish this relationship from almost any arm's-length contract.

While indeterminacy is a strong objection to the use of "trust" as a standard for sorting fiduciary and nonfiduciary relationships, 73 there is more general criticism of the use of trust to identify fiduciary relationships. In light of recent scholarship, the concept of "trust"

71. Id. at 718. The court observed that "had the court been the trier of fact, the verdict would have been different." Id. at 717.

72. The indeterminacy of traditional common-law standards is illustrated vividly by pairing the following recent cases:

Lender and debtor. In Weltzin v. Cobank, ACB, 633 N.W.2d 290, 293-94 (Iowa 2001), the court rejected a claim of a fiduciary relationship between a bank and shareholders in a cooperative that was a debtor of the bank. According to the court, the bank had no obligation to supervise the management of the cooperative to prevent the cooperative's managers from harming its members. Id. at 295. By way of contrast, the court in Young v. First National Bank of Shreveport, 794 So. 2d 128, 135 (La. Ct. App. 2001) found a fiduciary relationship where a bank officer had "developed a personal friendship with" the debtor and "actively participated in business decision-making." That relationship required the bank officer to disclose conflict-of-interest transactions. Id. at 135-36.

Manufacturer and distributor. In Abernathy-Thomas Engineering Co. v. Pall Corp., 103 F. Supp. 2d 582, 587, 608-10 (E.D.N.Y. 2000), the court held that a manufacturer had fiduciary duties to a distributor where the manufacturer required access to certain confidential customer information. In contrast, the court in United Magazine Co. v. Murdoch Magazines Distribution, Inc., 146 F. Supp. 2d 385, 410-11 (S.D.N.Y. 2001) held that no fiduciary relationship existed absent a contractual requirement to share confidential information.


In each of the foregoing cases, the plaintiffs claimed to have reposed trust in the defendants. In each case, the defendants failed to protect the plaintiffs and the plaintiffs were harmed. And in each case, the court struggled to justify its disposition of the fiduciary duty claims. Using the principles of "trust" and "vulnerability" alone, it would be difficult to distinguish one group of cases from the other. In all of these cases, however, the courts could have easily resolved the issue by using the critical resource theory of fiduciary duty.

simply seems inapt. Although definitions of "trust" vary, the term usually connotes some measure of vulnerability that emanates from the lack of legal or other protection against harm. For example, it is now widely argued that trust is pervasive in commercial relationships and that it plays a crucial role in filling gaps in incomplete contracts. If trust is present in (nearly) every relational contract, then it cannot distinguish purely contractual relationships from fiduciary relationships.

More fundamentally, to the extent that parties rely on legal constraints for protection, they are not trusting at all, but instead relying on the law of fiduciary duty for protection. Such reliance displaces trust. This phenomenon is what Oliver Williamson calls "calculativeness."

One area in which courts have sometimes employed a critical resource theory of fiduciary duty—or, to be precise, a "property rights" theory—is the law of insider trading. In United States v. Chestman, for example, the Second Circuit described a fiduciary's obligation as follows:

A fiduciary relationship involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this

74. In a helpful taxonomy, Jay Barney and Mark Hansen identify three forms of trust: weak form, semi-strong form, and strong form. Jay B. Barney & Mark H. Hansen, Trustworthiness as a Source of Competitive Advantage, 15 STRAT. MGT. J., Winter 1994, at 175. The weak form is hardly worthy of the name "trust," because it contemplates a relationship in which the parties rely on legal constraints to govern conduct. Id. at 177. On the other end of the spectrum, strong-form trust exists when the parties are free to act opportunistically (i.e., there is no legal impediment), but such behavior would "violate values, principles, and standards of behavior that have been internalized by parties to an exchange." Id. at 179. As suggested by the name, semi-strong-form trust falls between the weak and strong forms. It arises where one party is protected by law (as in the weak form), but that protection may fail, leaving the party vulnerable to opportunism (as in the strong form). Id. at 177-78.

75. See Larry E. Ribstein, Law V. Trust, 81 B.U. L. REV. 553, 568-71 (2001) (arguing that law can "crowd out" trust); see also, Lawrence E. Mitchell, The Importance of Being Trusted, 81 B.U. L. REV. 591, 600 (2001) ("[W]hen we deprive people of the experience of being trusted, as fiduciary rules are wont to do, we destroy—at least to the extent we have eliminated that experience—the possibility of trust.").

76. Oliver E. Williamson, Calculativeness, Trust, and Economic Organization, 36 J.L. & ECON. 453, 463 (1993) (It "can be misleading to use the term 'trust' to describe commercial exchange for which cost-effective safeguards have been devised in support of more efficient exchange. Calculative trust is a contradiction in terms."). Williamson has been widely criticized for narrowing the scope of trust too dramatically. See, e.g., Mitchell, supra note 75, at 603 ("The purpose of Williamson's economic analysis is to demonstrate the irrelevance of trust to the study of economic interactions."); Ribstein, supra note 75, at 557-58 n.17 ("This article is generally consistent with Williamson's distinction, except that it admits a broader potential for trust beyond personal relationships.").
property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use.\textsuperscript{77}

The central issue in insider-trading cases is deceptively simple: whether one person must disclose private information to another person (or the market as a whole) prior to trading a security. Under the “classical” theory of insider trading, the insider is a director, officer, or employee of the company whose shares are being traded. Each of these insiders owes a fiduciary duty to the existing shareholders of the company.\textsuperscript{78} According to the Supreme Court in \textit{Chiarella v. United States},\textsuperscript{79} the failure of insiders to disclose material, nonpublic information about the company prior to trading constitutes a breach of the duty of loyalty, which qualifies as deception for purposes of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, promulgated under that statute.

The critical resource theory of fiduciary duty has little to add to this classical theory of insider trading. Material, nonpublic information clearly qualifies as a “critical resource” of the company, and the existence of a fiduciary duty for the insiders is unquestioned. Even when liability is extended to a temporary or constructive insider (such as an attorney, underwriter, accountant, or other agent), the theory remains solid. In the end, this theory of insider trading has implications for the content of the fiduciary obligation—thus triggering federalism concerns\textsuperscript{80}—but the existence of fiduciary relationships is derived from state law and accepted as a given.


\textsuperscript{78} In many instances, the sale of securities involves a counterparty who is not a shareholder of the company prior to the trade. When insiders deal with prospective stockholders, they typically owe fiduciary obligations. In contexts outside of insider trading, however, prospective stockholders do not benefit from fiduciary protection. See, e.g., Montgomery v. Aetna Plywood, Inc., 231 F.3d 399, 407 (7th Cir. 2000) (noting that “prospective stockholders are not owed fiduciary duties” to challenge a restructuring plan); Anadarko Petroleum Corp. v. Panhandle Eastern Corp., 545 A.2d 1171, 1174-77 (Del. 1988) (holding that prospective shareholders in a spin-off of a corporate subsidiary were not entitled to fiduciary protection).

\textsuperscript{79} 445 U.S. 222, 228 (1980) (stating that “one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information ‘that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.’ ”) (alteration in original).

As to the existence of a fiduciary relationship, the first test of the classical theory articulated in *Chiarella* arose in *Dirks v. SEC*, which involved a claim of “tippee” liability. Unlike the insiders and temporary insiders discussed above, a tippee normally owes no preexisting fiduciary duty to the shareholders of the company. The Court resolved the doctrinal tensions by holding that the tippee’s liability was derivative of the inside tipper’s breach of fiduciary duty. Despite the Court’s assertion that “a tippee assumes a fiduciary duty to the shareholders of a corporation,” the tippee is not a fiduciary in any conventional sense and certainly not under the critical resource theory (which requires the exercise of *discretion*—implying some form of authorization—on behalf of the beneficiary). Nevertheless, whether the tippee is treated as a fiduciary or as someone who merely participates in the fiduciary’s wrongful act is of little moment for fiduciary law or the law of insider trading. In either case, the tippee is liable.

The most baffling intersection between fiduciary theory and insider-trading law arises under the “misappropriation” theory of insider trading. The Supreme Court recently embraced the language of property rights in the misappropriation context, though to mixed reviews. As with classical insider trading, misappropriation theory relies on fiduciary duty to establish the existence of a “deceptive device or contrivance” that activates the insider trading prohibitions. In misappropriation cases, however, the duty does not run from an insider to the company’s shareholders, but rather from the trader to the source of the information. As stated by the Supreme Court, “In

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82. The SEC enforcement action that initiated federal enforcement of insider-trading prohibitions under Rule 10b-5 was a tipping case. See *In re Cady, Roberts & Co.*, Exchange Act Release No. 34,668 (Nov. 8, 1961). At the time, however, fiduciary duty was not the foundation of federal insider trading law, and the SEC grounded its opinion on a general duty on the part of people holding material, nonpublic information to either disclose that information before trading or to abstain from trading.
83. *Dirks*, 463 U.S. at 659 (reasoning that “the tippee’s duty to disclose or abstain is derivative from that of the insider’s duty”).
84. *Id.* at 660.
lack of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.\textsuperscript{87}

Reliance on fiduciary concepts to establish the link to securities fraud is completely different in the misappropriation context than in the classical insider trading case. In the classical case, the fiduciary owes an obligation to the counterparty in the trade. The connection between the fiduciary's breach and the counterparty's harm is direct (even if not easily traceable, given that trades occur in impersonal capital markets). In misappropriation cases, on the other hand, the counterparty is not the beneficiary of the fiduciary duty. The bizarre result of the misappropriation theory is that federal insider-trading regulation provides protection to beneficiaries in fiduciary relationships, even though such beneficiaries are not the focus of the regulation.\textsuperscript{88}

Regardless of the merits of insider-trading regulation generally, or of the misappropriation theory in particular, one thing seems clear: "From the standpoint of investors, the role of a fiduciary breach in information acquisition is meaningless."\textsuperscript{89} The connection between fiduciary relationships and securities fraud is complicated by the fact that courts are interpreting statutes and regulations.\textsuperscript{90} The SEC attempted to bring some clarity to the scope of the misappropriation theory in August 2000 by adopting Rule 10b5-2, which provided a nonexclusive definition of the relationships that give rise to a duty of trust or confidence for purposes of insider trading law.\textsuperscript{91} According to that Rule, such relationships are formed

\begin{itemize}
\item \textsuperscript{87} O'Hagan, 521 U.S. at 652.
\item \textsuperscript{88} Robert B. Thompson, Insider Trading, Investor Harm, and Executive Compensation, 50 CASE W. RES. L. REV. 291, 294 (1999) ("[T]he focus necessarily ends up on protecting such relationships—traditionally a concern of state law—much more than protecting the securities transaction and securities trader that is the focus of federal law.").
\item \textsuperscript{89} Krawiec, supra note 86, at 475.
\item \textsuperscript{90} See, e.g., Roberta S. Karmel, Outsider Trading on Confidential Information—A Breach in Search of a Duty, 20 CARDOZO L. REV. 83, 113 (1998) ("The easiest criticism of the property rights theory is that when Congress passed and subsequently amended the Exchange Act, it was concerned about fairness and the protection of investors, not the protection of property rights in information held by issuers and traders."); Saikrishna Prakash, Our Dysfunctional Insider Trading Regime, 99 COLUM. L. REV. 1491, 1527 (1999) (stating that "a contractarian/property rights approach does not undergird Rule 10b-5"); Thompson, supra note 88, at 294 ("Unfortunately for the sake of theoretical consistency, this property rights justification fits uneasily within the structure of a federal statute addressing only securities fraud.").
\end{itemize}
“[w]henever a person agrees to maintain information in confidence,” whenever parties sharing material nonpublic information have a “history, pattern, or practice of sharing confidences” that gives rise to an expectation of nondisclosure, or “[w]henever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling,” unless the person obtaining the information proves that it was not a confidential relationship.

The Rule seems designed to eliminate some of the features of state fiduciary law that are least compatible with the regulation of securities fraud, such as the holding in United States v. Chestman,92 where the Second Circuit Court of Appeals famously concluded that “marriage does not, without more, create a fiduciary relationship.”93 Moreover, extending securities liability to any relationship where “a person agrees to maintain information in confidence” extends the boundaries well beyond fiduciary relationships.94 This effort to override and expand on state fiduciary law suggests that the misappropriation theory is not about fiduciary relationships at all. Instead, it is about regulating information dissemination in securities markets, and the animating principle is one of equal access.95 As a result, the critical resource theory of fiduciary duty has almost nothing to say about the misappropriation theory.

92. 947 F.2d 551 (2d Cir. 1991) (en banc).
93. Id. at 568; cf. id. at 579 (Winter, J., concurring in part and dissenting in part) (“[F]amily members who have benefitted from the family's control of the corporation are under a duty not to disclose confidential corporate information that comes to them in the ordinary course of family affairs.”).
94. Under the critical resource theory, confidential information is a critical resource, but the person who is entrusted with such information must be given discretion with respect to the information before a fiduciary relationship arises.
95. This, of course, hearkens back to the initial developments in insider trading law. See In re Cady, Roberts & Co., Exchange Act Release No. 34,668 (Nov. 8, 1961); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 864 (2d Cir. 1968) (finding that a press release issued by the defendant was “reasonably calculated to affect the market price”). Others have suggested that O'Hagan is based on an equal access rationale. See Bainbridge, Path Dependent, supra note 77, at 1648 (noting that O'Hagan represents an “arguable revival of the long-discredited equal access theory of liability”); Elliot J. Weiss, United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading, 23 J. CORP. L. 395, 437 (1998) (O'Hagan “recharacterizes the holdings of Chiarella and Dirks in terms that suggest that the Court's support of federal prohibitions on insider trading and tipping is rooted in the Court's sense of the need to protect investors from informational disparities that cannot fairly be overcome.”).
While ambiguity has some virtues in the application of fiduciary duty, it does not seem particularly beneficial when deciding whether a fiduciary relationship exists. The need to have a clearer understanding of which relationships are fiduciary and which are not has prompted efforts to rationalize the cases. The numerous attempts to rationalize the law of fiduciary duty provide some insights into the nature of fiduciary obligation, but they share a common failing, namely, the inability to simultaneously identify all fiduciary relationships and distinguish fiduciary relationships from nonfiduciary relationships. This section provides a brief description of the failed search for a theory of fiduciary duty.

Perhaps the most ambitious attempt to uncover a unifying principle of fiduciary obligation was made by Tamar Frankel.


98. The failure to distinguish fiduciary from nonfiduciary relationships generally is one of overinclusiveness. Theories exhibiting this flaw are the most common and are the focus of this section. The scholarship in this area is also occasionally characterized by underinclusiveness. For example, Lawrence Mitchell asserts that "in the typical fiduciary relationship, the dependent will be precluded from exercising any control over that area." Mitchell, supra note 97, at 1685. As noted by Allan Vestal, this requirement would exclude partnerships from the realm of fiduciary relationship. Allan W. Vestal, Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992, 73 B.U. L. Rev. 523, 524-25 n.6 (1993).

Ernest Weinrib also errs by being underinclusive. Weinrib proposes "[t]wo elements [that] form the core of the fiduciary concept and . . . delineate its frontiers. First, the fiduciary must have scope for the exercise of discretion, and, second, this discretion must be capable of affecting the legal position of the principal." Weinrib, supra note 97, at 4. Weinrib relies on both requirements to act as limiting principles. The first would exclude relationships in which one party's functions are completely ministerial. The suggestion, which is also employed in the description of the critical resource theory below, is that a person who is fully protected from harm by contract (or other means) does not need the protection of fiduciary duties. The second requirement excludes from fiduciary treatment those cases in which the fiduciary is unable to affect the beneficiary's legal position. While this may describe some fiduciary relationships, it does not capture physicians, priests, and other counselors who are held to have fiduciary duties of confidentiality. Recognizing that fiduciary duty applies beyond the contexts described, Weinrib articulates an additional principle: fiduciary duty "is part of a pervasive policy of the law to protect the integrity of commercial organizations." Id. at 15. Even with this additional justification, Weinrib is unable to capture all of the contexts in which fiduciary duty routinely applies.
Recognizing the insufficiency of the trust-vulnerability rationale used by most courts, Frankel attempted to formulate an overarching theory of fiduciary duty. She identified "abuse of power" as the central problem inherent in fiduciary relationships. To the extent that "power" refers to the ability of the fiduciary to inflict harm on the beneficiary, it is critical to all accounts of fiduciary duty, including the critical resource theory described in this Article, which uses the notion of "opportunism" as a synonym for "abuse of power." Frankel also asserts that fiduciary duties are necessary only because the "entrustor" is unable to prevent abuse through other legal or social mechanisms. This "gap" in protection also plays a central role in the critical resource theory of fiduciary duty. The intuition here is straightforward: If the beneficiary is fully protected by self-help, contract, regulation, or some other mechanism, fiduciary duty is not

99. Although Frankel distances herself from the traditional analysis of fiduciary obligation, she appeals to the same notions of trust and vulnerability that characterize that approach. For example, she speaks of the two parties to a fiduciary relationship as a "fiduciary" and an "entrustor." Frankel, supra note 53, at 800. She also justifies the imposition of fiduciary duties by reference to the "entrustor's vulnerability." Id. at 810.

100. See id. at 807-08:

A more useful approach to fashioning fiduciary law would begin with the general reason for legal intervention in fiduciary relations, namely, the nature and severity of the problem that the law is designed to solve. This Article shows that all fiduciary relations give rise to the problem of abuse of power, that the purpose of fiduciary law should be to solve this problem, and that the differences in the rules applicable to various fiduciary relations stem from differences in the extent of the problem. This analysis will identify the benefits that flow from fiduciary relations, and will develop a method to maximize the benefits and minimize the harm to both parties in a fiduciary relation. The purpose of this analysis is to develop a unified approach to the law governing fiduciary relations.

101. See id. at 809 ("While the fiduciary must be entrusted with power in order to perform his function, his possession of the power creates a risk that he will misuse it and injure the entrustor.").

102. See, e.g., Mitchell, supra note 97, at 1684 ("A fiduciary relationship is a relationship of power and dependency in which the dependent party relies upon the power holder to conduct some aspect of a dependent's life over which the power holder has been given and accepted responsibility.").

103. Frankel, supra note 53, at 811 ("If the entrustor can protect himself from abuse of power, there is no need for the intervention of fiduciary law."). Frankel coined the term "entrustor," and it has found a home in numerous academic treatments of fiduciary duty. See, e.g., Meredith J. Duncan, Legal Malpractice by any Other Name: Why a Breach of Fiduciary Duty Claim Does Not Smell as Sweet, 34 WAKE FOREST L. REV. 1137, 1149-50 (1999). Others find the word too limiting. See, e.g., Marc A. Rodwin, Managed Care and the Elusive Quest for Accountable Health Care, 1 WIDENER L. SYMP. J. 65, 80 n.55 (1996) (arguing that the word "suggests that the entrustor is giving power or authority to the trustee, which is not so in all situations. Sometimes a third party grants the authority or power to the fiduciary for the benefit of another."); Niels B. Schaumann, The Lender as Unconventional Fiduciary, 23 SETON HALL L. REV. 21, 27 n.26 (1992) ("The term is appealing, but, as Frankel recognizes, also potentially misleading insofar as the power may be entrusted to the fiduciary by someone other than the person to whom the fiduciary obligation is owed.").
required. Implicit in this form of analysis is the assumption that fiduciary duty is a relatively costly way to constrain behavior.

Although Frankel correctly identifies the potential for abuse of power and gaps in protection as justifications for finding a fiduciary relationship, she is unable to define such relationships in a manner that excludes nonfiduciary relationships. She identifies two attributes that characterize fiduciary relationships: (1) A fiduciary "serves as a substitute for the entrustor," and (2) a fiduciary "obtains power from the entrustor or from a third party for the sole purpose of enabling the fiduciary to act effectively." According to Frankel, substitution without the delegation of power is insufficient to create a fiduciary relationship because it does not distinguish fiduciary relationships from other relationships, such as an electrician's relationship with a homeowner or a parent's relationship with a child.

But how is "delegation of power" helpful to this analysis? Frankel broadly defines "power" to mean "an ability to make changes that affect the entrustor." It is the breadth of this definition that deprives it of descriptive force. For example, an electrician receives "power" from the homeowner "solely for the purpose of facilitating the performance of his functions." Likewise, a parent obtains power from the state "for the sole purpose of enabling the [parent] to act

104. See also Davis, supra note 10, at 44 (arguing that the "preemptive nature of the law's response to fiduciary opportunism in the trust and agency areas suggests that the law has little faith in a principal's capacity to fend for himself and little faith in the ability of market forces to check the fiduciary"). The scope of protection offered by contract remains uncertain. See Gilles, supra note 53, at 16 (opining that "outside the realm of commercial relations, contract law will often have little to offer a plaintiff who lacks a written contract"). To compensate for the absence of contractual remedies, some plaintiffs have successfully pursued remedies under the theory of promissory estoppel. See, e.g., Cohen v. Cowles Media Co., 445 N.W.2d 248 (Minn. Ct. App. 1989), aff'd in part and rev'd in part, 457 N.W.2d 199, 203-05 (Minn. 1990), rev'd, 501 U.S. 663, 666-72 (1991), on remand to 479 N.W.2d 387 (Minn. 1992).

105. Frankel, supra note 53, at 808-09.

106. Id. at 808. Patricia Illingworth argues that Frankel's "delegation of power" requirement does not accurately describe psychiatrist-patient relationships because "psychiatrists are unlike non-psychiatric physicians because they do not tell patients what to do (take action on their behalf) nor, do they give advice to patients." Patricia A. Illingworth, Patient-Therapist Sex: Criminalization and Its Discontents, 11 J. CONTEMP. HEALTH L. & POL'Y 389, 403-06 (1999).

107. Frankel, supra note 53, at 809 n.47.

108. Id. at 809.

109. The state's "traditional role as the guardian of persons under legal disability" is the state's parens patriae power. Maggie Brandow, Note, A Spoonful of Sugar Won't Help This Medicine Go Down: Psychotropic Drugs for Abused and Neglected Children, 72 S. CAL. L. REV. 1151, 1152 n.3 (1999) (quoting BLACK'S LAW DICTIONARY 1003 (5th ed. 1979)). Donald Hubin describes two interpretations of the parens patriae doctrine: the classical interpretation and the contemporary interpretation. Donald C. Hubin, Parental Rights and Due Process, 1 J.L. & FAM. STUD. 123, 127 (1999). Under the classical interpretation, the state holds the fundamental right to determine the care and custody of the child but delegates this right to the parents. Id. The contemporary interpretation suggests that the state has an interest in the care and custody of
effectively."\(^{110}\) In the end, therefore, Frankel does not realize her aspiration to "develop a unified approach to the law governing fiduciary relations"\(^{111}\) because she fails to provide the necessary content to the concept of "power."\(^{112}\) In addition, despite widespread use of Frankel's framework by academics,\(^{113}\) courts have not embraced it.\(^{114}\)

the child, but that parents' rights are not derived from this interest. \(\text{Id.}\) Both views are consistent with the common law approach to parents' rights. The Supreme Court has consistently found that parents have a "fundamental right to direct the upbringing and education of their children." Linda L. Schlueter, \textit{Parental Rights in the Twenty-First Century: Parents as Full Partners in Education}, 32 St. Mary's L.J. 611, 618 (2001). If parents abuse their parental rights in ways that conflict with the rights of their children, the state may intervene using its \textit{parens patriae} power (as defined by either interpretation). Jennifer L. Sabourin, Note, \textit{Parental Rights Amendments: Will a Statutory Right to Parent Force Children to "Shed Their Constitutional Rights' at the Schoolhouse Door?"} 44 Wayne L. Rev. 1899, 1908 (1999).

\(^{110}\) Frankel, supra note 53, at 809.

\(^{111}\) \(\text{Id.}\) at 808.

\(^{112}\) Cf. Easterbrook & Fischel, supra note 13, at 436 (asking rhetorically, "What kind of power, under what circumstances, with what ensuing duties?").


\(^{114}\) Frankel's article is cited in seven reported cases, and all but one of these cases cite Frankel for general propositions about fiduciary duty rather than her suggested approach to determining the existence of a fiduciary relationship. See Wirum & Cash, Architects v. Cash, 837 P.2d 692, 702 n.14 (Alaska 1992) (citing Frankel to support the proposition that "clear financial records delineate the parties' individual interests and deter self-dealing and mismanagement by providing a monitoring mechanism"); Barbara A. v. John G., 193 Cal. Rptr. 422, 431 (Cal. Ct. Appeals 1983) (citing Frankel to show that "technically, a fiduciary relationship is a recognized legal relationship such as guardian and ward, trustee and beneficiary, principal and agent, or attorney and client"); Konover Dev. Corp. v. Zeller, 635 A.2d 798, 806 n.11 (Conn. 1994) (citing Frankel for historical background); Schneider v. Plymouth State College, 744 A.2d 101, 105 (N.H. 1999) (citing Frankel to support the assertion that "the party reposing confidence becomes dependent on the fiduciary because he or she must rely on the fiduciary for a particular service"); Lash v. Cheshire County Sav. Bank, 474 A.2d 980, 981 (N.H. 1984) (citing Frankel in support of the statement that "once a person becomes a fiduciary, the law places him in the role of a moral person and pressures him to behave in a selfless fashion"); Nat'l Med. Enters., Inc. v. Godbey, 924 S.W.2d 123, 148 (Tex. 1996) (citing Frankel to show that "the circumstances out of which a fiduciary relationship will be said to arise are not subject to hard and fast rules").

The one exception to this use of Frankel's article is \textit{Martinelli v. Bridgeport Roman Catholic Diocesan Corp.}, 10 F. Supp. 2d 138, 156 (D. Conn. 1998), where the court used Frankel's reasoning to determine that a party such as the abusive Bishop in this case has tremendous opportunity to abuse the power relationship by dissembling and nondisclosure. The Court then
Other attempts to describe the fundamental attributes of fiduciary relationships have met a similar fate. For example, L. S. Sealy reviewed the development of fiduciary law and purported to find four categories of fiduciary relationships: (1) "where one person has control of property which... in the view of a court of equity is the property of another"; (2) where a person "has undertaken or is under an obligation... to act on another's behalf or for another's benefit"; (3) where a person with limited or partial interests in property obtains renewed or additional rights in the property; and (4) where "undue influence" exists, as in a "priest-devotee relationship." The multiplicity of categories appears to be the result of Sealy's insistence on tying each category to a specific case or set of cases. A time-honored method of systematizing the common law, this approach to fiduciary duties may effectively cover the field as of the day it is written, but it has limited utility in deciding future cases that do not fit neatly into one of the existing, narrowly drawn categories.

Austin Scott defined a fiduciary as "a person who undertakes to act in the interest of another person." This principle may not account for fiduciary relationships that are formed inadvertently, such as general partnerships. Even if the "undertaking principle" accurately described all fiduciaries, it contains no limiting principle that would exclude, for example, a random act of kindness.
J. C. Shepherd attempted to extract principles from the major attempts to rationalize fiduciary duties and combined them as follows: "A fiduciary relationship exists whenever any person receives a power of any type on condition that he also receive with it a duty to utilize that power in the best interests of another, and the recipient of the power uses that power." 123

The requirement that a fiduciary receive power "on condition that he also receive with it a duty" begs the question Shepherd is attempting to answer. Certainly, if that condition is explicit in a contract, fiduciary duties will adhere to the relationship, but the most difficult cases are those where the question of duty remains unanswered.

Economic analysis has not left fiduciary law untouched. Nevertheless, most of the work employing economic analysis has used principal-agent theory to examine the scope of fiduciary duties. 124 As to the existence of fiduciary duties, economic analysis has a very simple story: Courts supply fiduciary duties as default rules to reduce the costs associated with providing the fiduciary with incomplete instructions. 125 As Frank Easterbrook and Daniel Fischel have argued, "the duty of loyalty is a response to the impossibility of writing contracts completely specifying the parties' obligations." 126 This account glosses over the fact that incomplete contracts are ubiquitous,

Shepherd is right, then Scott's theory is little different from the standard judicial approach described in Part II and subject to all of the same criticisms.

123. Shepherd, Unified Concept, supra note 97, at 75. Shepherd identifies the following theories of fiduciary duty: unjust enrichment theory, commercial utility theory, reliance theory, unequal relationship theory, property theory, undertaking or contractual theory, power and discretion theory, and rule or dualistic theories. Id. at 53-73.

124. See, e.g., Cooter & Freedman, supra note 15. Cooter and Freedman offer the following description of "paradigmatic" fiduciary relationships: "[A] beneficiary entrusts a fiduciary with control and management of an asset." Id. at 1046. They do not attempt to generalize this description, however. Instead, they focus on the appropriate scope of fiduciary duties.

125. See, e.g., John C. Coffee, Jr., Privatization and Corporate Governance: The Lessons from Securities Market Failure, 25 J. CORP. L. 1, 28 (1999) (noting that "the common law's concept of fiduciary duty both enables and instructs the common law judge to fill in the gaps in an incomplete contract"); Jonathan R. Macey, An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties, 21 STETSON L. REV. 23, 25 (arguing that "fiduciary duties should properly be seen as a method of gap-filling in incomplete contracts").

126. Easterbrook & Fischel, supra note 13, at 426; see also, id. at 427 (contending that "a fiduciary) relationship is a contractual one characterized by unusually high costs of specification and monitoring"); Cooter & Freedman, supra note 15, at 1048 ("If the parties to this agreement possessed perfect information, disloyalty could be controlled or prevented by contract. In fiduciary relationships, however, the parties are unable to foresee the conditions under which one act produces better results than another.").
but fiduciary duties are imposed only in a subset of those relationships.¹²⁷

Edward Rock and Michael Wachter have made the only attempt to apply the property rights theory of the firm to fiduciary duty law,¹²⁸ though their goal was much different than the current effort. Rock and Wachter set out to show that the purpose of corporate law, including fiduciary duty, is to resolve problems of opportunism by facilitating norm governance.¹²⁹ Under a system of norm governance, when participants in a corporation are confronted with the temptation to act opportunistically, they are also confronted with the corresponding costs, which do not depend on judicial enforcement,¹³⁰ but rather on informal enforcement by other participants in the firm.¹³¹ In this setting, the fiduciary duty of loyalty is reserved for the most extreme instances of self-dealing. While most opportunistic

¹²⁷. As noted above, see supra note 49, at 1098, fiduciary relationships need not be contractual. Nevertheless, most fiduciary relationships are formed by contracts.


¹²⁹. Rock & Wachter, Islands, supra note 128, at 1622. Rock and Wachter refer to norms in this context as "NLERS," an awkward acronym that stands for "nonlegally enforceable rules and standards." Id. at 1623.

¹³⁰. Indeed, Rock and Wachter suggest that the role for courts in intrafirm disputes should usually be "forbearance." Id. at 1650.

¹³¹. Rock and Wachter offer this illustration of norm enforcement:

Suppose, for example, that it is an NLERS of the executive suite that investment proposals must pass a discounted cash flow ("DCF") test. Suppose a CEO is considering having the firm make a "vanity purchase" (say, a sports team) despite the fact that the purchase does not pass the DCF test, at least in part because of a willingness to overbid in order to satisfy the CEO's vanity. Assuming the firm is large enough (and with enough free cash flow) to cross-subsidize the sports team, the CEO's vanity would not be checked by the discipline of the product market. Similarly, although the stock price might drop a couple of points, that would not be enough to put the company into play, insulating the purchase from the discipline of the capital market.

Yet, we find relatively few of these types of purchases. Because the board, in many (although not all) cases, might well turn down such a proposal, and might well hold it against the CEO if that person were already in trouble, the CEO is constrained from either proposing it or pushing it on a reluctant board. Here, it is not the product of capital markets that constrain the CEO's conduct, nor is it narrow self-interest (the fun of owning the sports team might well outweigh the cost of a slightly lower stock price). Rather, when the sanctions for breaching the NLERS are taken into account, the CEO is discouraged from pursuing the investment. In other words, here, as in the contractual context, the NLERS helps support the relationship by providing an extra incentive to perform at crucial moments.

Id. at 1652-53.
behavior can be checked through norms, some temptations are simply too great. In the words of Rock and Wachter, "if one can get seriously rich, one can move to Aspen and ski for the rest of one's days. The soft (socially acceptable) norms sanctions cannot constrain such behavior[,] and so the law is needed."132

This account of the duty of loyalty is roughly consistent with the critical resource theory of fiduciary duty presented in this Article. Both rely on the duty of loyalty to check opportunism. The critical resource theory contemplates other methods to combat opportunism besides fiduciary duty. As described below,133 the property rights theory of the firm holds that residual control rights play a central role. Rock and Wachter simply add norms to the mix.

For some commentators, the inability to accurately define fiduciary relationships has led to resignation. Deborah DeMott evaluated various approaches and concluded that no single theory could adequately explain the myriad applications of fiduciary duty in the law. She observed:

One could justifiably conclude that the law of fiduciary obligation is in significant respects atomistic. Common core principles may justify the outcomes reached by courts in types or patterns of relationships, but they lose force as applied to other types of relationships... Described instrumentally, the fiduciary obligation is a device that enables the law to respond to a range of situations in which, for a variety of reasons, one person's discretion ought to be controlled because of characteristics of that person's relationship with another. This instrumental description is the only general assertion about fiduciary obligation that can be sustained.134

Such reasoning flows naturally from examining the development of fiduciary law. The common-law courts have created and expanded fiduciary duties in a long process that seemed to rely more on metaphor than principle.135 Nevertheless, the common law often displays more rationality and foresight than any individual judge.136 The critical resource theory of fiduciary duty presented in the

132. Id. at 1662.
133. See infra Part IV.A.
134. DeMott, supra note 3, at 915.
135. See Frankel, supra note 53, at 804 ("Courts currently examine existing prototypes, such as agency, trust, or bailment that are defined as fiduciary. Then, courts create rules for new fiduciary relations by drawing analogies with these prototypes."); Weinrib, supra note 97, at 1 ("This piecemeal treatment, effective enough for the disposition of individual disputes as they arise, has not on the whole been appropriate for the elucidation of the broader problems of policy which underlie the whole fiduciary concept.").
136. This is not intended as a claim that the common law is efficient. See generally E. Donald Elliott, The Evolutionary Tradition in Jurisprudence, 85 COLUM. L. REV. 38 (1985); George L. Priest, The Common Law Process and the Selection of Efficient Rules, 6 J. LEGAL STUD. 65 (1977); Mark J. Roe, Chaos and Evolution in Law and Economics, 109 HARV. L. REV. 641 (1996); Paul H. Rubin, Why Is the Common Law Efficient?, 6 J. LEGAL STUD. 51 (1977). Instead, it is merely an acknowledgement that the common law should be taken seriously. Cf. Weinrib, supra
next part of the Article attempts to extract shared principles from the various fiduciary relationships and weave a coherent story of fiduciary duty.

IV. THE CRITICAL RESOURCE THEORY OF FIDUCIARY DUTY

As noted above, the thesis of this Article is that fiduciary duties are imposed in relationships that have attributes similar to an economic "firm." While some fiduciary relationships do not qualify as "firms" - a term that is limited to commercial enterprises - all share a common structure. The purpose of this section is to describe that structure as a theoretical matter, then to apply that theory to various real-world relationships.

Section A explores the structure of fiduciary relationships through the lens of the property rights theory of the firm. The next three sections each deal with one attribute of the fiduciary relationship: Section B explains the "on behalf of" requirement; Section C describes the shortcomings of "property" as an animating concept for a theory of fiduciary duty and argues that a new concept - "critical resources" - is needed; and Section D explores the "discretion" requirement of the critical resource theory with special reference to the difficult case of service providers.

Note 12, at 5 ("The common law is a sophisticated justificatory practice that has been elaborated over many centuries. Such a practice could not have developed and endured unless it took its own systematic coherence seriously.").

137. This term is not confined to legal firms such as partnerships and corporations. Corporations with a single stockholder and no employees are legal firms, but they do not embody the relationship essential to the formation of an economic firm as described here. Similarly, parties who have not formed a legal firm may establish an economic firm by contract. In short, relationships are crucial to the conception of the firm. Cf. Harold Demsetz, The Economics of the Business Firm: Seven Critical Commentaries 15 (1995) (observing that a "single person can constitute a firm, producing goods for the use of others," but noting that "organizational problems arise for the multi-person firm that do not arise for single-person firms"). For more on the distinction between legal and economic firms, see Eric W. Orts, Shirking and Sharking: A Legal Theory of the Firm, 16 Yale L. & Pol'y Rev. 265 (1998).

Despite the many insights offered by economic theorists of the firm, a concise definition of "firm" is nowhere to be found. See Demsetz, supra, at 6 ("It is a peculiarity of Coase's and Knight's discussions, and much of the new literature on the firm, that precise definitions of the firm are lacking."). In their foundational paper, Grossman and Hart offered the following: "We define the firm as being composed of the assets (e.g., machines, inventories) that it owns." Grossman & Hart, supra note 18, at 692. The self-referential description is clearly inadequate, but improvements have been slow to develop.
A. The Structure of Fiduciary Relationships

Much of the economic analysis of fiduciary duties over the past two decades has employed principal-agent theory. While similar to the critical resource theory in its reliance on opportunism, principal-agent theory does not provide an account of the boundaries of the firm that would be useful for distinguishing fiduciary from nonfiduciary relationships. Indeed, the notion of a firm as a "nexus of contracts" implies the absence of any fixed boundaries.

The development of transaction-cost economics ("TCE") was a major step toward a more realistic theory of the firm. This theory builds on the work of Ronald Coase, who supplied the initial impetus to develop a theory of the firm with his 1937 article, The Nature of the Firm. Acknowledging the powerful effect of markets to coordinate productive behavior, Coase asked the now famous question, "Why is there any organization?" Coase suggested that the answer to this question lay in the firm's ability to economize on transaction costs. This insight remains at the core of all economic theories of the firm.


139. See HART, FIRMS, supra note 18, at 18-21.

140. Jensen and Meckling argue, "it makes little or no sense to try to distinguish those things which are 'inside' the firm . . . from those things that are 'outside' of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output." Jensen & Meckling, supra note 138, at 311.


142. Id. More thorough treatments tend to push the discussion back to the work of F.H. Knight, whose classic book Risk, Uncertainty, and Profit was cited by Coase, supra note 141, at 42 n.236. See Demsetz, supra note 137, at 2-4.

143. COASE, supra note 141, at 36.

144. Harold Demsetz argues that modern theories of the firm conflate two questions: (1) Why do firms exist, and (2) what accounts for the internal organization of firms? DEMSETZ, supra note 137, at 1. Moreover, he contends that this confusion started with Coase. Id. Regardless of the confusion, Demsetz argues that it is necessary to address transaction costs in order to answer both questions. See id. at 11 (noting that firms are efficient, among other reasons, because of the "prevalence of low, not high, transaction costs"); id. at 19 (observing the ability of firms to reduce problems associated with opportunism).
Oliver Williamson picked up where Coase left off, focusing on transactions—which he called “the basic unit of analysis”\(^{145}\)—and asking why firms had a comparative advantage over markets in organizing some transactions and not others.\(^{146}\) Williamson’s brand of TCE is based on two behavioral assumptions: (1) All human agents are constrained by bounded rationality—the notion that, try as they might, people cannot foresee all future contingencies;\(^{147}\) and (2) all human agents are given to opportunism, which Williamson defines as “a condition of self-interest seeking with guile.”\(^{148}\) In addition, TCE relies on the concept of asset specificity, which Williamson identifies as the “most critical dimension for describing transactions.”\(^{149}\)

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145. WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 10, at 18. He defines “transaction” as follows: “A transaction occurs when a good or service is transferred across a technologically separable interface.” Id. at 1. Presumably, a relationship as used in this Article would be comprised of numerous transactions.

146. Harold Demsetz objects to the framing of the issue in terms that compare the managed coordination of production decisions within firms to the coordination of production decisions by the price mechanism. He contends that it “comes close to identifying managed coordination as the essence of the firm.” DEMSETZ, supra note 137, at 15. The firm in this Article is not characterized by managed coordination alone, but the existence of a relationship is nevertheless fundamental.

147. Actually, bounded rationality is more complex than being limited in cognitive competence. It might also include an inability to negotiate future plans because parties “have to find a common language to describe states of the world and actions with respect to which prior experience may not provide much of a guide.” HART, FIRMS, supra note 18, at 23. Finally, bounded rationality might include an inability to write contracts in such a way that they can be enforced by a third party. Id.

Williamson suggests that economic agents cannot engage in comprehensive contracting, but they will nevertheless “learn and . . . look ahead, perceive hazards, and factor these back into the contractual relation.” OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 9 (1996) [hereinafter WILLIAMSON, MECHANISMS].

As Williamson acknowledges, the term “bounded rationality” was coined by Nobel Laureate Herbert Simon. See HERBERT A. SIMON, MODELS OF MAN 198 (1957) (describing the “principle of bounded rationality”). Williamson traces the recognition of this idea even further back, to the work of Chester Barnard. See CHESTER I. BARNARD, THE FUNCTIONS OF THE EXECUTIVE 12-45 (1938).

148. WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 10, at 30. He also observed:

I do not insist that every individual is continuously or even largely given to opportunism. To the contrary, I merely assume that some individuals are opportunistic some of the time and that differential trustworthiness is rarely transparent \(ex\ ante\). As a consequence, \(ex\ ante\) screening efforts are made and \(ex\ post\) safeguards are created. Otherwise, those who are least principled (most opportunistic) will be able to exploit egregiously those who are more principled.

Id. at 64.

149. Id. at 30. Elsewhere, Williamson notes, “it is the condition of asset specificity that distinguishes the competitive and governance contracting models.” Id. at 42. For another well-known perspective on asset specificity, see Benjamin Klein et al., Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J.L. & ECON. 297, 298-302 (1978). For a skeptical view of asset specificity, see Yoshiro Miwa & J. Mark Ramseyer, Rethinking Relationship-Specific Investments: Subcontracting in the Japanese Automobile Industry, 98 MICH. L. REV. 2636 (2000).
specificity is an awkward term used to describe a simple concept—namely, the extent to which an asset can be moved from one use to another without losing productive value.\textsuperscript{150}

Williamson combines these three concepts to explain the function of firms. If contracting parties are subject to bounded rationality, they cannot produce contracts that will fully anticipate all future contingencies. The resulting incomplete contracts fail to protect the value of relationship-specific assets, thus leaving the owners of those assets open to opportunism. The type of opportunism Williamson envisions is commonly referred to as a holdup problem.\textsuperscript{151} When one party owns relationship-specific assets, the other party may threaten to terminate the relationship unless new concessions are forthcoming. Under this view, the firm is a governance mechanism, the function of which is to eliminate the risk of holdup opportunism.

These insights represent an important step in understanding the contracting process and the formation of firms. It is important to note that integration solves the potential opportunism that concerned Williamson (the holdup problem). His approach was later criticized for “not spell[ing] out in precise terms the mechanism by which [the] reduction in opportunism occurs,”\textsuperscript{152} but he effectively solved the

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\item Williamson, Mechanisms, supra note 147, at 59.
\item See, e.g., Williamson, Economic Institutions, supra note 10, at 78 (noting that “[m]arket contracting gives way to bilateral contracting, which in turn is supplanted by unified contracting (internal organization) as asset specificity progressively deepens”). For an excellent description of the holdup problem, see Klein et al., supra note 149, at 298-302.
\item As suggested by the foregoing text, opportunism is central to Williamson’s account of the firm. In this respect, he seems to differ with Coase. See Demsetz, supra note 137, at 20:

Opportunistic behavior is not a problem that is mentioned by Coase in his famous paper, but it is clear from his later writings . . . that he does not believe opportunism offers a special justification for vertical integration. Therein lies a difference between Coase and those who see opportunism as an important source of vertical integration. Coase believes that there is a wide variety of coordination problems, of which opportunism is only one, and that all of these are candidates for resolution through managed coordination or through contractual arrangements made across markets. Which institutional arrangement seems best requires a judgment about the tradeoff between transaction and management costs, even in the case of opportunism.

This difference in view has important implications for the ability of economists to explain why vertical integration exists. Demsetz seems right when he observes that vertical integration has many explanations other than opportunism, including monopoly, “continuity of operations,” and “informational advantages accruing to managed direction of activities.” Id. at 21. Nevertheless, this debate is wholly beside the point when using the concept of firms to distinguish fiduciary and nonfiduciary relationships. As will be shown below, one of the main rationales for imposing fiduciary duties is to combat opportunism, but the potential for opportunism need not completely justify the existence of a firm. As long as the potential for opportunism exists in firms and that potential is not completely addressed by governance mechanisms, fiduciary duties have a purpose.

\item Oliver Hart, An Economist’s Perspective on the Theory of the Firm, 89 Colum. L. Rev. 1757, 1763 (1989) [hereinafter Hart, Perspective].
\end{enumerate}
\end{footnotesize}
problem that most concerned him. Because the holdup problem is caused by the structure of an independent contracting relationship, integration itself is the mechanism that curbs opportunism.

Williamson fell short of a complete theory of the firm in the sense that he did not identify a mechanism to combat the type of opportunism that emerges once firms are formed. Observing this shortcoming in transaction cost economics, Sanford Grossman, Oliver Hart and John Moore ("GHM") set out to construct a more robust theory of the firm that would account for such intrafirm opportunism. Building on the foundation laid by Coase and Williamson, this theory recognizes that asset specificity creates the potential for opportunism in market transactions, and that such opportunism cannot be eradicated in the market setting because of the inevitability of incomplete contracts. Moreover, the theory recognizes the efficiencies gained through asset specificity as crucial to the formation of a firm. But GHM go beyond Williamson by identifying asset ownership as the mechanism that combats opportunism within a firm. The intuition here can be illustrated by the following simple example:

Two parties—A and B—agree to work together to produce gourmet cheesecakes for sale to third parties. A has experience working in a bakery and has developed a proprietary, award-winning cheesecake recipe. A has agreed to use the recipe and to supply all of the ingredients necessary for producing cheesecakes. In addition, A will supervise production of the cheesecakes. For her part, B agrees to purchase and equip a production facility.

As an initial matter, B must choose whether to install customized baking equipment that is uniquely suitable for the manufacture of cheesecakes or more general equipment.

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153. Cf. Grossman & Hart, supra note 18, at 692:

While these statements [of transaction-cost economists] help us understand when the costs of contracting between separately owned firms may be high, they do not elucidate what the benefits are of "organizing the transaction within the firm." In particular, given that it is difficult to write a complete contract between a buyer and seller and this creates room for opportunistic behavior, the transactions cost--based arguments for integration do not explain how the scope for such behavior changes when one of the self-interested owners becomes an equally self-interested employee of the other owner.

Cf. Demsetz, supra note 137, at 6:

"Managed coordination" is used to represent the firm. [Modern theorists of the firm] treat the firm as if the managed coordination of resources is unique to the firm, but managed coordination is not so clean a cutting edge as their discussions suppose. Management takes place in households, which, I presume, are not firms. Furthermore, market transactions, which certainly are not regarded as firms in this literature, almost always require at least a modicum of management.

154. Hart, Perspective, supra note 152, at 1765.

155. The classic illustration of the importance of asset ownership is the well-known case of General Motors and Fisher Body. See Hart, Firms, supra note 18, at 29-33; Klein et al., supra note 149, at 308-10. The details and implications of this case are much debated. See, e.g., R.H. Coase, The Acquisition of Fisher Body by General Motors, 43 J.L. & Econ. 15 (2000).
that could easily be converted to other uses. The customized equipment would not cost materially more than the general equipment, but it would produce more and better cheesecakes, thus generating additional profits for the business. On the other hand, if B invested in the customized equipment, she would open herself to the potential for "hold up" by A. For example, once B invested in the customized equipment, A might threaten to withhold his recipe unless B would agree to adjust the compensation agreement to give A some larger share of any revenues generated by the business. As long as A cannot easily be replaced (in this case, because A has residual control over the award-winning cheesecake recipe), A’s threat will likely be effective.156

If A and B could write a complete contract—one that anticipated all potential actions by both sides—the potential for holdup could be addressed. When contracts are incomplete, however, there is a “distortion in relationship-specific investments.”157 That is, if B anticipated A’s threat, B might refuse to invest in the specialized equipment, thus creating a less efficient operation, but one in which any threat of defection by A could be met by an equally plausible threat of defection by B (because general kitchen equipment could be easily redeployed to another relationship).

From an efficiency standpoint, a better solution would allow B to invest in the specialized equipment and avoid the potential of holdup by A. Assuming that incomplete contracts are inevitable, the obvious means to accomplish this efficiency goal would be for B to acquire the award-winning cheesecake recipe. If B owned both the specialized kitchen equipment and the cheesecake recipe, A could not credibly threaten to defect because B could simply replace A with another person who could provide the necessary labor. In this way, the proper allocation of ownership rights158 eliminates the potential for

156. As illustrated by this example, market power may arise after a relationship is formed. See Klein, supra note 149, at 299 (“There may be many potential suppliers of a particular asset to a particular user but once the investment in the asset is made, the asset may be so specialized to a particular user that monopoly or monopsony market power, or both, is created.”).

157. HART, FIRMS, supra note 18, at 31.

158. The term “ownership” is typically associated with legal property. As a consequence, it fits nicely into the property rights theory of the firm, but seems somewhat awkward in the critical resource theory of fiduciary duty. Therefore, when discussing the critical resource theory, I will avoid using the term, favoring “residual control” instead. Residual control resides in the beneficiary and should be contrasted with “discretion,” which is exercised by the fiduciary.

GHM contend that “possession of residual control rights is taken virtually to be the definition of ownership.” HART, FIRMS, supra note 18, at 30. Of course, the reference to “residual control rights” implies some access to legal enforcement, which may or may not be available with respect to critical resources that do not constitute legal property. Id. Even if the law does not generally recognize property rights with respect to a critical resource—for example, one’s personal data or one’s body—those who exercise discretion with respect to those resources may have a right to exclude others from using them. Pamela Samuelson, Privacy as Intellectual Property?, 52 STAN. L. REV. 1125, 1130-31 (2000). Even absent such legal rights, we still perceive discretion in the fact of possession. For example, one who possesses noncommercial confidential information can choose whether to disclose the information (at least in the first instance, though they may not be able to inhibit subsequent disclosures).
holdup opportunism. Of course, the potential for opportunism is not necessarily eliminated when B takes ownership of the cheesecake recipe. For example, A may still remember the recipe (or have access to it in the course of his labor), and he could sell it to a competitor. This threat is the type of intrafirm opportunism imagined by GHM.

Under this property rights theory of the firm, the allocation of **residual control rights** determines the boundaries of the firm. GHM focus on residual control rights rather than residual financial rights because residual financial rights are so easily contracted away. When two parties enter a profit-sharing agreement, both are residual claimants. While both may also share residual control rights—as in a partnership—that is not always the case. For GHM, therefore, “residual income may not be a very robust or interesting theoretical concept.” Of course, because residual financial rights typically follow residual control rights, this distinction will not matter in most relationships.

There is a more pragmatic objection to the use of residual financial rights when determining fiduciary relationships—namely, that many “critical resources” that are the focal point of these relationships have no profit-generating potential. As will be discussed in some detail below, counseling relationships have a fiduciary character because of the confidential information conveyed during the

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159. Because ownership is the core concept in the property rights theory of the firm, much is at stake in defining it. Grossman and Hart suggest that residual control rights are “all the rights except those specifically mentioned in the contract.” Grossman & Hart, supra note 18, at 692; see also id. at 694 (stating that “ownership gives the owner all rights to use the machine that he has not voluntarily given away or that the government or some other party has not taken by force.”). Hart and Moore offer a slightly refined interpretation, arguing that “the sole right possessed by the owner of an asset is his ability to exclude others from the use of that asset.” Hart & Moore, Property Rights, supra note 18, at 1121. Rajan and Zingales propose the notion of access, defined as “the ability to use, or work with, a critical resource.” Rajan & Zingales, supra note 19, at 388. The ability to exclude (Hart and Moore) and the ability to grant access (Rajan and Zingales) seem like flip sides of the same coin and any differences are immaterial for present purposes. Rajan and Zingales contend that the “property rights view does not consider employees part of the firm.” Id. Rajan and Zingales define the firm “both in terms of unique assets (which may be physical or human) and in terms of the people who have access to those assets.” Id. This view “brings people other than owners within the boundaries of the firm.” Id. at 390.

160. Residual financial rights play a prominent role in the formation of partnerships. See UNIF. P'SHIP ACT § 7(4) (1914) (stating that “receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business”); REV. UNIF. P'SHIP ACT § 202(c)(3) (1997) (stating that a “person who receives a share of the profits of a business is presumed to be a partner in the business”). Residual financial rights are also significant in many accounts of corporations. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & ECON. 395, 403 (1983) (arguing that shareholders have the right incentives to maximize the value of the firm).

161. HART, FIRMS, supra note 18, at 64.

162. Id. at 64 (arguing that “residual control and residual income should often go together”).
course of the relationship. While this information may constitute a “critical resource” and may have value to the owner, it is not necessarily capable of being sold for a profit (unless one includes extortion among the methods of “sale”).

Once different types of opportunism are distinguished, the differences between Williamson and GHM are apparent. Williamson argues that firms form to solve the holdup problem, but GHM observe that the potential for a new kind of opportunism is created by the formation of a firm (e.g., appropriation of the firm’s assets). The key issue for GHM is identifying the mechanism that addresses this intrafirm opportunism. Their answer is that intrafirm opportunism can be mitigated through ownership rights—the same ownership rights that attack the holdup problem. While GHM apply their analysis to the question of why firms exist, the explanatory power of their theory also reaches the broader issue of how the allocation of residual control rights in critical resources mitigates opportunism in all fiduciary relationships, even those that are not “firms.”

B. The “On Behalf Of” Requirement

A fiduciary acts on behalf of a beneficiary. This requirement is familiar, appearing most prominently in the law of agency, but also arising in many common-law decisions involving fiduciaries outside the law of agency. In the critical resource theory of fiduciary duty, the primary function of this requirement is to distinguish fiduciary relationships from relationships in which one person exercises discretion over critical resources belonging to another, such as transfers of property rights like leases or exclusive licenses. The “on behalf of” requirement cannot effectively distinguish fiduciary

163. Distinguishing between the two forms of opportunism discussed here reveals why the holdup problem is irrelevant to fiduciary duty: It occurs only in relationships that do not fit the fiduciary mold, that is, in independent contractor relationships. Once the assets of the parties are integrated into a single firm, holdup is impossible. Therefore, any concern over asset specificity in the literature on the theory of the firm does not implicate the analysis of fiduciary duties.

164. RESTATEMENT (THIRD) OF AGENCY § 1.01 (Tentative Draft 2001) (“Agency is the fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.”); RESTATEMENT (SECOND) OF AGENCY § 1 (1958) (“Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and the consent by the other so to act.”).
relationships from many arm's-length contracts because mutual benefit is a central feature in most contracting relationships. The "on behalf of" requirement is rarely defined in abstract terms. One who represents another in transactions with third parties certainly satisfies the requirement, but such outside interactions are not prerequisite to the formation of a fiduciary relationship. More broadly, one person works on behalf of another by acting in accordance with the other's instructions. Again this conception seems too narrow in that the existence of a fiduciary relationship depends on the exercise of discretion. In other words, the most interesting behavior occurs in the absence of explicit instructions. The drafters of the Restatement (Second) of Agency often used the phrase "primarily for the benefit of" as a synonym for "on behalf of." While this standard encompasses many relationships that are not fiduciary in nature—including random acts of kindness—it provides a useful touchstone for identifying some fiduciary relationships.

Relationships of every kind are formed in hopes of conveying mutual benefits. Relying on the concept of "benefit" to distinguish

165. Cf. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. g (Discussion Draft 2000) ("In any relationship created by contract, the parties contemplate a benefit to be realized through the other party's performance. Performing a duty created by contract may well benefit the other party, but the performance is that of an agent only if the elements of agency are present.").


167. RESTATEMENT (THIRD) OF AGENCY, supra note 165, at § 1.01 cmt. g ("Employee and nonemployee agents who represent their principal in transactions with third parties act on the principal's account and behalf.").

168. Id. (stating that an employee works on behalf of an employer by doing "the work that the employer directs and [doing] it subject to the employer's instructions").

169. See Hynes, Dilemma, supra note 166, at 640 n.17 (quoting RESTATEMENT (SECOND) OF AGENCY § 13 cmt. b, supra note 164, which states: "the understanding that one is to act primarily for the benefit of another is often the determinative feature in distinguishing the agency relation from other relations."). See also RESTATEMENT (SECOND) OF AGENCY § 14J, supra note 164, (maintaining that "whether [one] is an agent for this purpose or is himself a buyer depends upon whether the parties agree that his duty is to act primarily for the benefit of the one delivering the goods to him or is to act primarily for his own benefit"); id. at § 14K ("One who contracts to acquire property from a third person and convey it to another is the agent of the other only if it is agreed that he is to act primarily for the benefit of the other and not for himself.").

170. Professor Warren Seavey was the Reporter for the Restatement (Second) of Agency. He distinguished "primarily for the benefit of" from mere "benefit" and relied heavily on this distinction. See Hynes, supra note 166, at 641 n.22 (quoting A Discussion of the Restatement (Second) of Agency, 32 A.L.I. PROC. 174 (1955)).
fiduciary from nonfiduciary relationships, therefore, may seem like an odd choice. Nevertheless, by expanding the notion from mere benefit to "primarily for the benefit of," the drafters of the Restatement (Second) of Agency strove to exclude arm's-length contracts from qualifying as principal-agent relationships. While many contractual relationships are more easily segregated using the "discretion" and "critical resource" requirements discussed below, the requirement that fiduciaries act "on behalf of" a beneficiary can assist in cases where a purported fiduciary meets both of the other requirements.

The case of A and B discussed in the previous section provides a useful illustration of the "on behalf of" requirement. If A were employed by B, then A would owe B fiduciary duties. A would not be allowed to use the proprietary cheesecake recipe to establish a new company without disgorging any profits to B. In other words, the duty of loyalty requires A to refrain from using any "critical resource" belonging to B to engage in self-interested transactions that constitute a wrong to B.

This fiduciary relationship differs from a relationship based on the transfer of rights in the cheesecake recipe, or more specifically, a relationship between a licensor and an exclusive licensee. If A were an entrepreneur whose company entered into an exclusive license for the cheesecake recipe from B, there would be no fiduciary relationship. An exclusive license to use the recipe may transfer rights in the recipe, but A's use of the recipe in a self-interested manner does not breach a duty to B, even though A exercises discretion with respect to the recipe in the same manner as she did while an employee of B. If anything, A has more control in this setting. The difference between the two cases is that A qua entrepreneur does not use the recipe on behalf of ("primarily for the benefit of") B, whereas A qua employee does.

171. See infra Parts IV.D and IV.C, respectively.

172. See, e.g., Wing v. Comm'r of Internal Revenue, 278 F.2d 656, 661 (8th Cir. 1960); In re Indep. Serv. Org. Antitrust Litig., 203 F.3d 1322, 1328 (Fed. Cir. 2000); Ortho Pharm. Corp. v. Genetics Inst., Inc., 52 F.3d 1026, 1032 (Fed. Cir. 1995); see also David R. Kuney, Intellectual Property Law in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses, 9 AM. BANKR. INST. L. REV. 593, 599 (2001) ("The Copyright Law recognizes the distinction between an exclusive license and a nonexclusive license. . . . The holder of the exclusive license is entitled to all the rights and protections of the copyright owner to the extent of the license.").

173. See RESTATEMENT (THIRD) OF AGENCY, supra note 165, § 1.01 cmt. f (providing examples involving licenses).
C. The "Critical Resources" Requirement

Like any theory of the firm, the primary goal of the property rights theory is to explain the existence of firms, not to identify firms or to differentiate firms from non-firms. In other words, firms are viewed as analytically prior to the theory. This approach suffices for a theory of the firm because no "real-world" consequences flow from the distinction between firms and nonfirms as a matter of economic theory. The theory merely illuminates the functions of firms.

By contrast, the distinction between firms and nonfirms may have important legal implications. Most significant for present purposes, that distinction may delineate fiduciary and nonfiduciary relationships. A useful theory of fiduciary duty, therefore, not only explains the existence of fiduciary duties, but also identifies fiduciary relationships and differentiates fiduciary and nonfiduciary relationships.

Unfortunately, the property rights theory of the firm does not form a complete foundation for a general theory of fiduciary duty. Two related shortcomings prevent the unmodified application of the property rights theory of the firm in the context of fiduciary law. First, as noted above, many fiduciary relationships are not "firms." While the boundaries of the firm are not fixed precisely by economic theory, many fiduciary relationships—notably the counseling relationships between doctors and patients, lawyers and clients, clergy and parishioners—do not fit the mold because they are not commercial enterprises.

Second, the meaning of "property" that lies at the heart of the property rights theory of the firm is highly contested as a matter of legal policy. Property theorists frequently begin a foundational examination of property with the observation that "property" is not a thing, but rather a "bundle of rights" with respect to a thing. The

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174. That is not to say that GHM are uninterested in the distinctions between firms and non-firms. See, e.g., HART, FIRMS, supra note 18, at 58 (distinguishing employment relationships from independent contractor relationships by reference to who "walks away with . . . the nonhuman assets" upon termination of the relationship). But such distinctions are clearly of secondary import.

175. See, e.g., Dagan, supra note 17, at 147-48 (observing that the "concept of property is too controversial and has too many manifestations and configurations in our own law to be able to answer the specific type of questions our doctrine needs to resolve").

176. Thomas W. Merrill & Henry E. Smith, What Happened to Property in Law and Economics?, 111 YALE L.J. 357, 358 (2001) (stating, tongue-in-cheek, that "[s]omeone who believes that property is a right to a thing is assumed to suffer from a childlike lack of sophistication—or worse").

tricky part is that the bundle of rights is not the same for all things. As a result, the designation of something as "property" does not say anything about the associated rights. Thus, the label "property" has come to be seen as "almost meaningless." GHM's assumption that the essence of "property" is the right to exclude comports with the views of several prominent property theorists but is far from a consensus view of property. Even if the right to exclude were universally recognized as the sine qua non of property, this conception of property is oddly circular: The right to exclude follows from a determination that property exists. One cannot identify property by locating a right to exclude. As a result, the legal notion of property is not useful in differentiating fiduciary and nonfiduciary relationships.

Property rights theorists of the firm have expended limited resources in defining the scope of the property that is the focus of their

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Merrill and Smith observe that this conception of property was a product of realist legal scholars who wanted to "undermine the notion that property is a natural right, and thereby smooth the way for activist state intervention in regulating and redistributing property." Merrill & Smith, supra note 176, at 365. Interestingly, they contend that Ronald Coase popularized a "hyperrealist conception of property" in his famous essay, The Problem of Social Cost, which became the foundation for economic analysis of property rights. Id. at 359, 366. Coase wrote: "We may speak of a person owning land and using it as a factor of production but what the landowner in fact possesses is the right to carry out a circumscribed list of actions." R.H. Coase, The Problem of Social Cost, 3 J.L. & ECON. 1, 44 (1960).

178. See Waldron, supra note 177, at 315 (noting that if the bundle of rights "remained constant for all or most of the cases that we want to describe as private property, the bundle as a whole could be defined in terms of its contents. But, of course, it does not remain constant, and that is where the difficulties begin.").

179. See Joan Williams, The Rhetoric of Property, 83 IOWA L. REV. 277, 297 (1998) ("Labeling something as property does not predetermine what rights an owner does or does not have in it.").

180. Merrill & Smith, supra note 176, at 357.

181. See J.E. PENNER, THE IDEA OF PROPERTY IN LAW (1997); see also Cohen, Sovereignty, supra note 177, at 12 (noting that "the essence of private property is always the right to exclude others"); Merrill, Right to Exclude, supra note 20, at 730 (stating that "the right to exclude others is more than just 'one of the most essential' constituents of property—it is the sine qua non").

182. Consider the following discussion by Merrill and Smith:

When we encounter a thing that is marked in the conventional manner as being owned, we know that we are subject to certain negative duties of abstention with respect to that thing—not to enter upon it, not to use it, not to take it, etc. And we know all this without having any idea who the owner of the thing actually is. In effect, these universal duties are broadcast to the world from the thing itself.

Merrill & Smith, supra note 176, at 359 (emphasis added). This description of property rights presupposes the designation of a thing as "property." If the task is identifying fiduciary relationships, however, the designation of a thing as "property" would be the question to be answered. The right to exclude offers no guidance on this question.
theory. While some reference may be made to legal concepts, the view of property rights in the theory of the firm has not been explicitly reconciled with any notion of legal property. Of course, many fiduciary relationships involve property in any sense of the word. The noncommercial confidential information that lies at the heart of many fiduciary relationships, however, probably would not be considered property by most courts or informed observers.

In the end, the concept of “property” adds nothing to the analysis of fiduciary duty that a less encumbered concept like “critical resource” cannot contribute. Whatever concept is selected, it must serve one crucial function: It must convey the idea that something resides at the core of the fiduciary relationship. This simple innovation would have important ramifications for the law of fiduciary duty. At a minimum, it would eliminate much of the confusion induced by current judicial standards in cases like Top of Iowa Cooperative v. Scheue, discussed above. Perhaps more importantly, as discussed in Part VI, recognition that a critical resource—and not just misplaced trust—is the basis for imposition of fiduciary duties goes a long way toward explaining the varying intensity of the duties imposed in different contexts. Where self-help protection of the critical resource is strong, the case for judicial protection through the imposition of loyalty obligations is weak, and vice versa.


But what are the rights of ownership? They are substantially the same as those incident to possession. Within the limits prescribed by policy, the owner is allowed to exercise his natural powers over the subject-matter uninterfered with, and is more or less protected in excluding other people from such interference. The owner is allowed to exclude all, and is accountable to no one . . .


185. The core idea underlying property rights in law is that if one person has a right, another has a duty to refrain from interfering with the person. For the classic statement of this position, see generally Wesley N. Hohfeld, Some Fundamental Legal Conceptions as Applied in Judicial Reasoning, 23 YALE L.J. 16 (1913-14).

186. In developing a “property approach” to the law of restitution, Daniel Friedmann recognized the limitations that burden traditional notions of property. He attempted to overcome these obstacles to his theory in part by expanding the notion of “property” to include “quasi-property,” which are “non-exclusive” property interests. Daniel Friedmann, Restitution of Benefits Obtained Through the Appropriation of Property of the Commission of Wrong, 80 COLUM. L. REV. 504, 509 (1980). But even this expansion of the notion of property is insufficient to reach fiduciary duty, and he ultimately argues for a separate category encompassing “exceptional cases of wrongdoing in which the property approach does not apply.” Id. In these cases, which include fiduciary duty claims, a “general principle of deterrence provides an alternative basis for restitution.” Id. at 509-10.

187. See discussion at notes 64-72 and accompanying text.
The natural question that follows from this analysis is: What things qualify as “critical resources,” thus justifying the imposition of fiduciary duty? This is very similar in form and substance to the question: What things qualify as “property”? The latter question has generated much of the voluminous and divided literature on property theory referenced above. Fortunately, much of that debate is superfluous for present purposes because the main focus in fiduciary duty cases is the potential for opportunism. Whether the existence of a particular thing justifies the imposition of fiduciary duties, therefore, depends on whether that thing provides the fiduciary with the occasion to act opportunistically. And whether that thing provides the fiduciary with the occasion to act opportunistically will depend in large part on whether society has made a normative decision that the thing belongs to the beneficiary. This decision is exogenous to the critical resource theory.

So what is a “critical resource”? Like property, critical resources may be tangible or intangible. The “owner” of critical resources need not have legally enforceable rights in the same way that an owner of property has such rights, but she must have residual control rights that, at a minimum, provide practical control over the resources. For example, a lawyer’s client may not have property rights in the confidential information conveyed to the lawyer, but the client nevertheless controls the initial disclosure of that information.

Hart contends that something “as little as a place to meet” or “even just . . . the difficulty [the firm’s] workers face in co-ordinating a move to another firm” might serve as the “property” around which a firm organizes.188 Assuming the “place to meet” is something along the lines of leased or owned office space—and not a public park—this seems uncontroversial. On the other hand, treating the “difficulty . . . in co-ordinating a move” as “property” stretches that concept beyond recognition. Even though “critical resource” is a more expansive concept than “property,” it is hard to see how “difficulty . . . in co-ordinating a move” would qualify as a critical resource. While it may reduce the potential for opportunistic behavior by employees (by making any threats of departure less credible), the employer in no sense “owns” it or has a right to exclude the employees from it.

The most important category of potential “critical resources” for purposes of fiduciary duty analysis is confidential information.189 The

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188. HART, FIRMS, supra note 18, at 57.

189. For early works on the value of information, see Harold Demsetz, Information and Efficiency: Another Viewpoint, 12 J.L. & ECON. 1 (1969); Jack Hirshleifer, The Private and Social Value of Information and the Reward to Inventive Activity, 61 AM. ECON. REV. 561 (1971);
law often treats confidential information as property, but this treatment does not extend to all confidential information. As a general matter, confidential information is "property" only when it serves some commercial purpose. In these circumstances, the owner of confidential information has long been permitted to restrict its dissemination in a manner similar to the manner in which an owner of physical property can restrict its use. Indeed, in many instances, the question of whether the information is property is irrelevant because the question boils down to whether the information is confidential. The reasoning of Oliver Wendell Holmes is instructive:

The word 'property' as applied to trademarks and trade secrets is an unanalyzed expression of certain secondary consequences of the primary fact that the law makes some rudimentary requirements of good faith. Whether the plaintiffs have any valuable secret or not the defendant knows the facts, whatever they are, through a special confidence that he accepted. The property may be denied, but the confidence cannot be. Therefore the starting point for the present matter is not property or due process of law, but that the defendant stood in confidential relations with the plaintiffs, or one of them.


The assertion here is not that a breach of fiduciary duty is equivalent to a breach of contract, a violation of statute, or a breach of confidence in a nonfiduciary setting. These examples are used merely to show that "confidential information" is susceptible of definition. Moreover, confidential information is not infinitely malleable. Courts seem quite willing to draw boundaries around the concept. See, e.g., City Slickers, Inc. v. Douglas, 40 S.W.3d 805, 811-12 (Ark. Ct. App. 2001) (holding that a contract defining "confidential information" as "all information I see, hear, come in contact with or otherwise gain knowledge of, in connection with my employment" was an unreasonable and unlawful restraint on trade); Halifax Hosp. Med. Ctr. v. News-Journal Corp., 724 So. 2d 567, 570 (Fla. 1999) (holding that a statute which stated that certain "strategic plans" are confidential was overly broad).

191. E.I. Du Pont de Nemours Powder Co. v. Masland, 244 U.S. 100, 102 (1917). Compare the words of Lord Upjohn in Phipps v. Boardman, 2 A.C. 46, 127-28 (1967): In general information is not property at all. It is normally open to all who have eyes to read and ears to hear. The trust test is to determine in what circumstances the information has been acquired. If it has been acquired in such circumstances that it would be a breach of confidence to disclose it to another then courts of equity will restrain the recipient from communicating it to another. In such cases such confidential information is often and for many years has been described as the property of the donor, the books of authority are full of such references; knowledge of
In recent years, the law’s unease with the notion of information as property has begun to fade as courts routinely hold that confidential information has the attributes generally associated with other intangible property. In the well-known case of United States v. O'Hagan, discussed above, in which the Supreme Court adopted the controversial “misappropriation” theory of insider trading, the majority asserted, “A company’s confidential information . . . qualifies as property to which the company has a right of exclusive use.”\(^{192}\) In connection with wire or mail fraud, several courts have recently noted that, “confidential information may constitute intangible ‘property’ and that its unauthorized dissemination or other use may deprive the owner of its property rights.”\(^{193}\) A federal court in Massachusetts recently struck down a state law requiring tobacco companies to disclose the ingredients in their products on grounds that the law would constitute a “taking” of the tobacco companies’ confidential information.\(^{194}\) Also, modern courts routinely refer to trade secrets as “property,” despite traditional resistance to such a characterization.\(^{195}\)

\(^{192}\) 521 U.S. 642, 654 (1997); see also United States v. Falcone, 257 F.3d 226, 230 (2d Cir. 2001). For the seminal case on this point, see Carpenter v. United States, 484 U.S. 19, 27-28 (1987) (treating information appropriated from a newspaper publisher as property under wire fraud statute). For an argument that O'Hagan is inconsistent with a property rights approach to insider trading, see Bainbridge, Path Dependent, supra note 77, at 1644-50.

\(^{193}\) United States v. Czubinski, 106 F.3d 1069, 1074 (1st Cir. 1997). See also United States v. Martin, 228 F.3d 1, 16 (1st Cir. 2000) (explaining that “confidential information may be considered property” for purposes of the mail and wire fraud statutes).


[The record establishes that the plaintiffs have valuable property interests in confidential brand-specific ingredient information; the confidential information qualifies as trade secret information under the laws of Massachusetts; the inevitable effect of the Disclosure Act will be to compel the public disclosure of some or all of the trade secrets; by destroying the secrecy of the information, public disclosure deprives the plaintiffs of their property interest in the trade secrets; the Commonwealth’s deprivation of the property interest in the secrets is a “taking” for which the Fifth and Fourteenth Amendments require just compensation to be made.).

\(^{195}\) See, e.g., BioCore, Inc. v. Khosrowshahi, 96 F. Supp. 2d 1221, 1238 (D. Kan. 2000) (“Even if confidential information can be something less than a trade secret, it must at least be a trade secret to give its owner a property right in it.”); Follmer, Rudzewicz & Co. v. Kosco, 362 N.W.2d 676, 680-81 (Mich. 1984) (“While an employee is entitled to the unrestricted use of general information acquired during the course of his employment or information generally known in the trade or readily ascertainable, confidential information, including information regarding customers, constitutes property of the employer and may be protected by contract.”). For the seminal case in this area, see Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1002 (1984) (describing how trade secrets are like traditional property). But see DTM Research, L.L.C. v. AT & T Corp., 245 F.3d 327, 332 (4th Cir. 2001);
In the end, however, the critical resource theory of fiduciary duty does not rely on the notion of information as property. Recent debates over privacy rights in personal data provide a useful perspective. While personal information conveyed to a spiritual advisor, an attorney, a psychiatrist, or other counselor may constitute a "critical resource" as defined in this Article, personal data is typically not thought to be "property." The fact that personal data is not classified as property, however, does not mean that personal data is unprotected. As Pamela Samuelson noted recently, "[I]ndividuals generally have a legal right to exclude other people from access to their private data." What is immediately apparent from this debate is that "ownership" (in the sense of having a right to exclude) is not limited to "property."

D. The "Discretion" Requirement

Many commentators have observed the importance of discretion in fiduciary relationships. Discretion arises because

While trade secrets are considered property for various analyses ... the inherent nature of a trade secret limits the usefulness of an analogy to property in determining the elements of a trade-secret misappropriation claim. The conceptual difficulty arises from any assumption that knowledge can be owned as property. The "proprietary aspect" of a trade secret flows, not from the knowledge itself, but from its secrecy. It is the secret aspect of the knowledge that provides value to the person having the knowledge.

On the traditional resistance to classifying trade secrets as "property," see Pamela Samuelson, Information as Property: Do Ruckelshaus and Carpenter Signal a Changing Direction in Intellectual Property Law?, 38 CATH. U. L. REV. 365, 365 (1989) ("Trade secret law has long afforded remedies to the possessor of secret information against those who use improper means to obtain the secret and those who disclose it in violation of confidential relationships, but the law has, in general, resisted characterizing the secret itself as property.").

196. See, e.g., Samuelson, supra note 158, at 1130-31:

Although the law often protects the interests of individuals against wrongful uses or disclosures of personal data, the rationale for these legal protections has not historically been grounded on a perception that people have property rights in personal data as such. Indeed, the traditional view in American law has been that information as such cannot be owned by any person.


197. Samuelson, supra note 158, at 1130.

198. See, e.g., Blair & Stout, supra note 25, at 1784 n.129 (stating that "a key characteristic of a fiduciary relationship is that the beneficiary cedes a wide range of discretion to the fiduciary"); Dagan, supra note 17, at 159-60 (noting that "the beneficiary's interests are subject to the fiduciary's discretion; the fiduciary should control and manage the asset in the beneficiary's best interest"); Edward C. Halbach, Jr., Uniform Acts, Restatements, and Trends in
contracts or other documents specifying the obligations of the fiduciary are necessarily incomplete; however, not all incomplete contracts form the basis for fiduciary relationships. One of the primary functions of a unified theory of fiduciary duty is to distinguish fiduciary relationships from arm's-length relationships, but some form of discretion is often present in both. Nevertheless, a closer examination of the object and extent of discretion can aid in making meaningful distinctions.

The first important clarification of the discretion requirement relates to the object of discretion. As discussed above, a fiduciary exercises discretion with respect to a critical resource belonging to the beneficiary. In contrast, a contracting party exercises discretion with respect to performance of the contract. While fiduciaries are often contracting parties—and therefore may exercise discretion with respect to performance under the contract—fiduciary relationships are distinguished from contractual relationships by allocation of discretion over critical resources. It is this additional quantum of discretion (or perhaps, one might say, this additional form of discretion) that justifies the imposition of more stringent loyalty obligations on fiduciaries than mere contracting parties.

The foregoing is not intended to suggest that one can sort fiduciary and nonfiduciary relationships merely by observing whether one party works with a critical resource of the other party. Certainly, parties in a contractual relationship often have access to critical resources belonging to their opposite number. For example, service providers, such as Frankel's electrician, typically work with critical resources belonging to their clients. To say that a fiduciary exercises discretion with respect to critical resources therefore implies something more than mere access to those resources. In such cases, the extent of control over the critical resources is important.

Unfortunately, the lines here are not bright. Fiduciary and nonfiduciary relationships do not occupy wholly separate realms, but instead lie on a continuum. Passage from one side of the continuum to the other is seamless; nevertheless, courts are tasked with locating a
Cases involving service providers straddle the divide, and the only reasonable approach is to articulate a principle that will assist courts in their sorting function. While bright lines are impossible to draw, substantial progress is made possible by distinguishing \textit{discretion} over a critical resource from \textit{mere access} to that resource.

The principle advocated here is that fiduciaries must exercise discretion with respect to a critical resource belonging to the beneficiary, where "discretion" connotes the power to use or work with the critical resource in a manner that exposes the beneficiary to harm that cannot reasonably be evaded through self-help. Discretion typically involves the exercise of control by the fiduciary to a greater extent than would occur with mere access. Discretion is granted to the fiduciary by the beneficiary or someone acting for the beneficiary. This grant is something short of a conveyance of the critical resource, however, because the beneficiary retains residual control over the critical resource. Discretion is also different from "authority" under agency law. While similar in spirit, a fiduciary need not qualify as an agent in every case. A recent case decided by the Connecticut Supreme Court—\textit{Hi-Ho Tower, Inc. v. Com-Tronics, Inc}\textsuperscript{201}—illustrates how the concept of discretion can be used to distinguish fiduciaries from non-fiduciaries.

In \textit{Hi-Ho Tower}, the plaintiff owned a communications tower, and the defendant provided service to the plaintiff\textsuperscript{202} The defendant used the plaintiff's tower in exchange for a monthly fee, which the plaintiff waived in exchange for the service work\textsuperscript{203} When the plaintiff discovered that the defendant had installed equipment on the tower and was receiving license fees from use of the equipment, the plaintiff sued for (among other things) breach of fiduciary duty\textsuperscript{204} The court recognized the difficulty of distinguishing fiduciary from nonfiduciary relationships and went to some lengths to articulate a coherent principle. The court structured its analysis around the familiar common-law standards requiring trust and vulnerability, concluding that the plaintiff did not demonstrate the "special trust" required of a fiduciary relationship because the plaintiff "retained

\footnotesize{\textsuperscript{200} James Gordley offers another metaphor to the same effect: "The task of the treatise writers was therefore like that of a British colonial administrator demarcating a boundary line between one tribe claiming the hills and one claiming the lowlands. The fact that he can see clear instances of hills and valleys does not make the boundary between them clear." Gordley, \textit{supra} note 8, at 1828.}
\footnotesize{\textsuperscript{201} 761 A.2d 1268 (Conn. 2000).}
\footnotesize{\textsuperscript{202} \textit{Id.} at 1270-71.}
\footnotesize{\textsuperscript{203} \textit{Id} at 1271 n.5.}
\footnotesize{\textsuperscript{204} \textit{Id.} at 1271.}
control of the day-to-day operations at the tower, including access to
the tower, customer relations and business transactions." Because
the plaintiff retained such control, it was able to protect its own
interests. Even the defendant’s alleged superior knowledge did not
sway the court because the plaintiff “fail[ed] to show that [the
defendant] undertook to act primarily for the benefit of the
plaintiff.”

In the end, the court’s reasoning is unpersuasive because it
focuses on whether the defendant undertook the obligations of a
fiduciary. As noted above, this aspect of fiduciary relationships
cannot effectively distinguish among fiduciaries and service providers
because everyone in these two categories works “on behalf of” another.
The court should have retained its focus on the defendant’s discretion
with respect to the tower. By concluding that the plaintiff retained
control over the tower, the court effectively held that the defendant
did not exercise the type of discretion one would expect of a fiduciary.
Importantly, the court added: “If we were to agree with the plaintiff,
all parties that possess a superior, technical skill, including
electricians, plumbers and mechanics, would owe a fiduciary duty to
their clients.”

V. APPLYING THE CRITICAL RESOURCE THEORY

The foregoing sections describe a set of requirements that is at
once discriminating and flexible. The need to discriminate arises from
concerns about imposing fiduciary duties in relationships that do not
comport with the requisite fiduciary structure. In such relationships—
routine contractual relationships, for example—the inappropriate
application of fiduciary duties can actually create the potential for
opportunism. On the other hand, flexibility enables courts to adapt
fiduciary duties to varied circumstances. While all fiduciary

205. Id. at 1280.
206. Id.
207. Id.
208. See supra Part IV.B.
209. Hi-Ho Tower, Inc. 761 A.2d at 1280.
210. Cf. Ribstein, supra note 75, at 576-77:
A broad and strict duty that ignores ex ante expectations in order to protect the
parties from ex post disappointment . . . may give them opportunities to get more than
they bargained for. It follows that imposing extra duties to reduce the parties’
vulnerability to the risk of disappointment may increase their vulnerability to
opportunistic litigation. This, in turn, increases the need for devices to deal with the
new vulnerability. Regulation thereby may increase the friction and attendant
transaction costs that trust is supposed to reduce. Some productive transactions might
be lost if these devices are not feasible.
relationships follow a similar pattern, they appear in a surprising 
diversity of contexts. The following sections explore some of the 
contexts in which the issue of fiduciary duty arises and shows how the 
critical resource theory clarifies the analysis.

A. “Easy” Cases

This section explores those relationships that courts have 
concluded are fiduciary in nature. They are “easy” cases in the sense 
that courts no longer feel an obligation to explain the existence of 
fiduciary duties in these contexts. Such duties are assumed to follow 
naturally from the existence of the relationship. If the critical resource 
theory of fiduciary duty is to have any prescriptive value, however, 
these easy cases must be shown to be in harmony with the theory. To

211. This section does not cover every relationship ever held to be fiduciary. For example, the 
United States has been held to be a fiduciary for Native American tribes. See Cherokee Nation v. 
Georgia, 30 U.S. 1, 17 (1831). Fiduciary duties have been imposed on nonprofit organizations. 
See Sarkeys v. Indep. Sch. Dist. #40, Cleveland County, 592 P.2d 529, 534-35 (Okla. 1979) 
(holding that a state attorney general has standing to enforce a charitable trust). Fiduciary 
duties have also been imposed on cotenants. See Cooper v. Cooper, 783 A.2d 430, 436 (Vt. 2001). 
Courts have also imposed fiduciary duties in myriad exceptional circumstances, many of which 
would fit comfortably within “confidential relationships,” which are discussed below.

Bailments are sometimes characterized as “fiduciary” in the general literature on fiduciary 
duties, see, e.g., Frankel, supra note 53, at 795; Scott FitzGibbon, Fiduciary Relationships Are 
Not Contracts, 82 MARQ. L. REV. 303, 306-07 (1999), but property scholars tend not to view the 
relationship as fiduciary in nature. A bailment exists when one person (a bailee) takes possession 
of property owned by another (the bailor). The possession requirement has two elements: 
physical control over the property and an intention to exercise that control. See RAY A. BROWN & 
WALTER B. RAUSENBUSH, THE LAW OF PERSONAL PROPERTY § 10.2 (3d ed. 1975). These elements 
distinguish bailments from mere custody. Id. § 10.4. Despite the bailee’s physical control, the 
bailor retains residual control rights through title to the property (thus distinguishing bailments 
from sales). Id. § 10.5. A bailee’s duties are phrased in terms of “care” rather than loyalty. See 
Roy Kreitner, The Gift Beyond the Grave: Revisiting the Question of Consideration, 101 COLUM. 
L. REV. 1876, 1889 (2001) (“The rule, as extrapolated from Roman law and reiterated in almost 
every common law discussion of bailment, was that a gratuitous bailee was responsible only for 
gross negligence, or held only to a slight duty of care, while a bailee for hire was responsible for 
negligence, or held to a duty of ordinary care.”) The bailee has an obligation to redeliver the 
subject of the bailment to the bailor—which would prohibit theft of the property—but this 
obligation is broader than a duty of loyalty in the sense that it regulates more than self-dealing 
on the part of the bailee. See Knowles v. Gilchrist Co., 289 N.E.2d 879, 885 (1972) (“[W]e hold 
that once the bailor proves delivery of the property to the bailee in good condition and the failure 
to redeliver upon timely demand, the burden of proof is irrevocably fixed upon the bailee to prove 
by a fair preponderance of the evidence that he has exercised due care to prevent the property’s 
loss or destruction. Our holding extends to all bailment for hire cases, whether brought in tort or 
contract, in which the bailee has exclusive control over the property at the time it was destroyed 
or damaged.”) Although a few cases outside of the United States treat bailments as fiduciary 
relationships, that characterization has not been adopted by U.S. courts. See FitzGibbon, supra, 
Hallett’s Estate (1880), 13 Ch. D 696, 708-09 (Aust.)). Bailments will therefore be omitted from 
further discussion.
that end, this section provides a brief description of each relationship and shows how it meets the framework constructed by the critical resource theory. More specifically, each section describes the parties in the relationship, shows how some critical resource defines the relationship, and identifies the holder of residual control rights over that resource. In addition, each section provides a short description of the duties imposed in each relationship.

1. Trusts

Trusts are quintessential fiduciary relationships, and they fit neatly into the critical resource theory of fiduciary duty described above. Indeed, the *Restatement (Third) of Trusts* describes a trust as "a fiduciary relationship with respect to property." While trusts appear in myriad contexts, every trust consists of at least one trustee and at least one beneficiary of the trust. In addition, trusts are formed by a settlor, who contributes the trust property and

212. "Trusts" as used here should not be confused with "resulting trusts" or "constructive trusts," which are often referred to as "implied trusts." See, e.g., Gabel v. Richley, 655 N.E.2d 773, 778 (Ohio Ct. App. 1995) (explaining the differences between express trusts and the two types of implied trusts, resulting and constructive trusts). "Resulting trusts" and "constructive trusts" may be—but are not necessarily—fiduciary relationships. *Id.* at 779-80.

A resulting trust is defined as a "reversionary, equitable interest implied by law in property that is held by a transferee, in whole or in part, as trustee for the transferor or the transferor's successors in interest." *Restatement (Third) of Trusts* § 7 (Tentative Draft No. 1, 1996) [hereinafter *Restatement of Trusts*].

A constructive trust is remedial. It arises "[w]here a person holding title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it." *Restatement (First) of Restitution* § 160 (1937). The imposition of a constructive trust does not create a fiduciary relationship. See *Austin W. Scott & William F. Fratcher, The Law of Trusts* § 462 (4th ed. 1987) ("It is to be noted, however, that a court of equity does not treat the constructive trustee for all purposes as though he were in reality a trustee; although it will compel him to surrender the property, it will not impose upon him the numerous fiduciary obligations that are imposed upon the trustee of an express trust."). Nevertheless, a constructive trust may arise in the context of a fiduciary relationship. See, e.g., Meinhard v. Salmon, 164 N.E. 545, 548 (N.Y. 1928); Beatty v. Guggenheim Exploration Co., 122 N.E. 378, 380 (N.Y. 1919).


214. The definition of "trust" has been narrowed over time. At common law, "trust" referred to various confidential relationships, "whether there was any strict trust of property or not." See Sealy, *supra* note 97, at 70. In modern usage, "trust" has been given a narrower meaning. Interestingly, the narrowing scope of "trust" appears to have left a gap in legal concepts that was quickly filled by the word "fiduciary." See *id.* at 71-72 ("The word fiduciary (which earlier had received very little judicial support) was adopted to describe these situations which fell short of the now strictly-defined trust.").

215. The requirement of two separate parties is contained in the definition of "trust," which contemplates one person "who holds title to the property" and "deal[s] with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee." *Restatement of Trusts* § 2.
establishes the terms of the trust. The trustee takes title to the trust property—often called the corpus of the trust—and manages this property for the benefit of the beneficiary. Nevertheless, the beneficiary has residual control rights over the property.

The core fiduciary duty of a trustee is an obligation to act in the interest of the beneficiary of the trust. The most important aspect of this obligation is a duty to avoid self-interested transactions. Of
course, trustees are also obligated to act prudently, but this duty is "comparable to the reasonable person rule of tort" rather than the duty of loyalty that is the focus of this Article. It is often said that the "duties of a trustee are more intensive than those of most other fiduciaries." Nevertheless, for honest trustees, the fiduciary obligation is not onerous.

2. Guardianships

Guardianships arise when one person (the "guardian") is appointed by a court to manage the property and affairs of another (the "ward"), who is suffering from some incapacity, such as infancy or insanity. Guardianships are distinguished from trusts primarily by the fact that the guardian does not take legal title to the ward's property. While the ward is not capable of exercising residual control rights over the property, the court exercises such rights on the ward's behalf. A guardian has a duty to the ward to deal with the property that is the subject of the guardianship for the benefit of the ward.

Guardians are often appointed to care for a person as well as for property. A guardian's duties with respect to the person are

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222. Langbein, supra note 198, at 656.
223. See Restatement of Trusts, supra note 208, § 2 cmt. b.
224. Cf. Langbein, supra note 198, at 657: The prudent investor rule is profoundly protective of trustees who have followed common investment-industry standards. The duty of loyalty, though it threatens draconian prophylactic liabilities for breach, is also easy enough to obey in ordinary cases. It says to the trustee, "You are left with the entire universe of investment possibilities as outlets for your entrepreneurial impulses; you are required only to stay away from the trust assets when you seek your own fortune."
225. Most often the laws governing guardianships are contained in state statutes. The Uniform Probate Code, which has been adopted in many states, governs guardianships and conservatorships with respect to minors and other incapacitated persons. See Unif. Probate Code § 5-101 to 5-312 (1993).
227. See id. § 7; see also George G. Bogart & George T. Bogart, The Law of Trusts and Trustees § 13 (2d ed. rev. 1984) (maintaining that guardians "are required to work for their beneficiaries with single-minded loyalty, to exclude all private gain, and to exhibit high candor and good faith in direct dealings with the one represented, and to perform personally the important functions of their positions").
228. The statutes that define the duties of a personal guardian are extremely broad. For example, Illinois's statute reads in part as follows:
To the extent ordered by the court and under the direction of the court, the guardian of the person shall have custody of the ward and the ward's minor and adult dependent children; shall procure for them and shall make provision for their support, care, comfort, health, education and maintenance, and professional services as are appropriate, but the ward's spouse may not be deprived of the custody and education of the ward's minor and adult dependent children, unless the consent of the spouse, unless the court finds that the spouse is not a fit and competent person to have that
considered fiduciary in nature. Although a person is not "property" in the United States, nothing prevents us from viewing the person as a critical resource. The imposition of fiduciary duties in this context has obvious appeal.

3. Agency

Generally speaking, courts are concerned with distinguishing agents from nonagents in two contexts: (1) claims by third parties against purported principals for the actions of purported agents, and (2) claims by purported principals against purported agents for breach of fiduciary duty. The efficacy of both sets of claims depends on the existence of an agency relationship. The Restatement (Second) of Agency defines agency as a "fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."

When evaluating third-party liability claims, courts correctly rely heavily on the notion of "control." The justification for imposing liability on one person for the acts of another rests heavily on the idea of moral responsibility, and whether one person is perceived to be morally responsible for the actions of another person often turns on whether the party to be held responsible exerts control over the other.

755 ILL. COMP. STAT. ANN. 5/11a-17 (West 1998).
229. See U.S. CONST. amend. XIII.
230. Cf. Scott & Scott, supra note 63, at 2430 (describing the appeal of imposing fiduciary duties on parents). Interestingly, fiduciary duties are not imposed on parents qua parents, probably more out of respect for the privacy of the family than out of deference to the concept that critical resources must be at the heart of a fiduciary relationship.
231. With respect to third-party claims sounding in tort, agency law draws a distinction between "servants" and "independent contractors." Restatement (Second) of Agency § 220 (1958) ("A servant is a person employed to perform services in the affairs of another and who with respect to physical conduct in the performance of the services is subject to the other's control or right to control.") Principals are liable for torts committed by their servants, see id. at § 219, but generally not liable for torts of independent contractors, even those independent contractors who are agents.
232. Id. § 1. The substance of this definition remains unchanged in the new Restatement. Restatement (Third) of Agency § 1.01 (Tentative Draft No. 1, 2000).
Nevertheless, the concept of control is not helpful in defining fiduciary relationships. What distinguishes fiduciaries from non-fiduciaries is not the control exercised by the principal, but rather the discretion exercised by fiduciaries over the critical resources of the principal.

The critical resources at the core of agency relationships are less visible than in trusts or guardianships, but they are present nonetheless. Agents have "power to affect the legal relations" of their principal, through actual or apparent authority or through inherent agency power. This constitutes discretion over the principal's critical resources.

Like trustees, agents have numerous detailed duties, but operate under a general obligation of loyalty. According to the Restatement, "an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency."

Many agents are employees, and a nagging question regarding the employment relationship is why employers do not owe fiduciary duties to employees. Marleen O'Connor has proposed fiduciary duty as a means of "encourag[ing] employee trust and reliance upon the new implicit employment agreements under participatory work programs." Oliver Hart argues that employees have few incentives to invest in relationship-specific assets without prior compensation or contractual protection. Others have argued that implicit contracts or norms protect employees.

The critical resource theory of fiduciary duty rejects the notion that employers should owe fiduciary duties to employees. If the relevant resource is "human capital," there is no reason (in the

233. On actual authority, see Restatement (Second) of Agency, supra note 227, § 7 (power "by acts done in accordance with the principal's manifestations of consent" to the agent); on apparent authority, see id. § 8 (power "by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons"); and on inherent agency power, see id. § 8A ("power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation").

234. Cf. Weinrib, supra note 97, at 4 (using "discretion... capable of affecting the legal position of the principal" as one of the two elements forming the "core of the fiduciary concept").


238. For an analysis of firm-specific human capital in the theory of the firm, see Margaret M. Blair, Firm-Specific Human Capital and Theories of the Firm, in EMPLOYEES AND CORPORATE GOVERNANCE 58, 77-80 (Margaret M. Blair & Mark J. Roe eds., 1999).
usual case) to suspect that an employer exercises discretion over that resource on behalf of the employee. Like the landlord-tenant case discussed above, this relationship meets the "discretion" requirement and the "critical resource" requirement, but not the "on behalf of" requirement. For firm-specific investments in human capital, implicit contracts or norms may be the only viable protection.

4. Partnerships and Joint Ventures

Partnerships are generally defined by statute to mean the "association of two or more persons to carry on as co-owners a business for profit." Partners are joint owners of the partnership's property, and each partner shares residual control rights. Although fiduciary duties have traditionally been formulated by common-law decisions, the Revised Uniform Partnership Act codified the duty of loyalty.

Larry Ribstein recently advanced the provocative thesis that fiduciary duties should not apply in the partnership context. His central claim is that "[i]n a horizontally governed firm involving co-equal owners, the owners can be assumed to have enough access to information that they do not need ex post judicial monitoring." This position is essentially an argument that ownership interests alone are sufficient to combat opportunism in the partnership context. Whether

239. See supra Part IV.B. The employee is in the position of the landlord as the party who owns the critical resource. The employer exercises discretion over that critical resource by dictating the manner in which it is used within the firm. Like the tenant, however, the employer does not exercise discretion on behalf of the owner of the critical resources, but rather for a personal benefit.

240. To the extent that employees are observed making relationship-specific investment in human capital, one might infer that implicit contracts and norms are fairly effective at protecting that investment. Of course, each time an employer acts opportunistically with respect to an employee who has invested in firm-specific human capital, one might infer a breakdown of the protective mechanisms.

241. REV. UNIF. P'SHIP ACT § 202(a) (1997); UNIF. P'SHIP. ACT § 6(1) (1914).

242. The most influential case by far in this area is Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928), in which the Chief Judge Cardozo wrote these oft-cited words:

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

243. REV. UNIF. P'SHIP ACT § 404(b) (describing three aspects of the duty of loyalty, including an anti-theft provision, a self-dealing prohibition, and a proscription against competition with the partnership).

244. Ribstein, supra note 12.

245. Id.
Ribstein is correct about the empirical question does not affect the analysis in this Article. The critical resource theory of fiduciary duty describes the structure of relationships in which courts apply fiduciary law. Partnerships fit easily within that structure, and courts predictably impose fiduciary duties in the partnership context. Whether courts should apply fiduciary law in all relationships described by the critical resource theory depends on the relative costs and benefits of fiduciary protection. That question is left for another day.

5. Corporations

In most accounts of the theory of the firm, the "firm" is conceptualized as a corporation. All of the attention showered on the corporation has not made its place in the theory of the firm less problematic. The source of these problems is the fact that—at least in large corporations—actual control resides with the directors rather than with the shareholders.246 Under the property rights theory of the firm, however, the focal point is residual control rights over the firm's property. GHM deal with this problem by asserting that shareholders delegate large tracts of authority to the directors.247 While this assertion is not helpful in defining in detail the relative roles of directors and shareholders because it does not define which functions of shareholders should be delegated and which should not,248 it is helpful in describing the presence of fiduciary duties in the corporation. It suggests that the key residual ownership right in the corporation is the right to elect directors.249

246. Incorporation statutes place substantial authority in the hands of directors. See MODEL BUS. CORP. ACT § 8.01(b) (1999) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors . . . .") (emphasis added); DEL. CODE ANN. tit. 8 § 141(a) (2001) ("The business and affairs of every corporation . . . shall be managed by or under the direction of the board of directors . . . ").

247. See Grossman & Hart, supra note 18, at 694 ("In a corporation the shareholders as a group have control and delegate this control to the board of directors (i.e., management). "). See also Rajan & Zingales, supra note 19, at 422 (Shareholders "could delegate many of the powers of ownership that are unlikely to be misused to a managerial hierarchy. . . [And they] will retain the power to fire the production team (or the managing hierarchy) from the assets if it does not specialize.").

248. See Robert B. Thompson & D. Gordon Smith, Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers, 80 TEX. L. REV. 261, 273 (2001) (arguing that when examining the division of power between directors and shareholders, "generalizations about the 'delegation' of control rights from shareholders to directors are inadequate.").

249. It follows from the foregoing analysis that as the ability of shareholders to curb opportunism through director elections diminishes, the importance of fiduciary duty increases.
The fiduciary duties of directors are sometimes described in statutes, and other times in judicial opinions. The core element of these duties, wherever articulated, is a requirement to abstain from self-interested behavior.\textsuperscript{250} Enforcing this obligation is complicated in closely held corporations, where the norm of majority rule bumps up against the prohibition of self-interested behavior. Majority shareholders in a closely held corporation are like partners in a partnership in the sense that their actions are necessarily self-interested. In this setting, whether the actions of a majority shareholder constitute a wrong toward the minority shareholders (often) depends on vague concepts of fairness.

Perhaps the most troublesome cases in the corporate context are those involving creditors. Courts have long held that directors owe fiduciary duties to creditors once the corporation is “in the vicinity of insolvency.”\textsuperscript{251} Insolvency here is often defined to mean “insolvency in fact, rather than insolvency due to a statutory filing.”\textsuperscript{252} To be insolvent in fact, the entity must be “unable to pay its debts as they fall due in the usual course of business.”\textsuperscript{253} The usual rationale for imposing fiduciary duties in this context is that creditors are the residual financial claimants of an insolvent firm.\textsuperscript{254}

Imposing fiduciary duties in these cases might seem problematic for the critical resource theory of fiduciary duty because bondholders do not have residual control rights (i.e., the right to elect directors) merely because the corporation is insolvent. In many cases, however, these invocations of “fiduciary” duty are really invocations of the duty of care. When a court says that the directors owe fiduciary duties to the creditors in these contexts, the court is typically referring to a duty to act in the interests of the creditors rather than the

\textsuperscript{250} The Model Business Corporation Act uses the concept of “[d]irector's conflicting interest transaction.” MOD. BUS. CORP. ACT § 8.60(2). Delaware cases simply refer to conflicts of interest or the duty of loyalty.

\textsuperscript{251} This language is from Chancellor Allen, from the well-known case, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

\textsuperscript{252} Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992).

\textsuperscript{253} Id. at 789. The court in Geyer offered a second definition of insolvency as a company having “liabilities in excess of a reasonable market value of assets held.” Id. More recent cases seem to have abandoned this second definition. See, e.g., Francotyp-Postalia AG & Co. v. On Target Tech., Inc., No. 16330, 1998 WL 928382, at *5 (Del. Ch. Dec. 24, 1998) (rejecting the second definition because “[i]t is all too common, especially in the world of start-up companies . . . , for a Delaware corporation to operate with liabilities in excess of its assets. . . .”). Fraudulent conveyance statutes use the broader definition of insolvency. See, e.g., 740 Ill. Comp. Stat. Ann. 160/3(a) (West 1993) (“A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at fair valuation.”).

\textsuperscript{254} See, e.g., In re Troy King Distribs., Inc., 256 B.R. 1, 167 (M.D. Fla. Bankr. 2000).
shareholders. In other words, the court is overriding the shareholder primacy norm, which is part of the duty of care rather than the duty of loyalty.

In other cases, creditors assert fiduciary duty claims based on activities that implicate the duty of loyalty. The imposition of fiduciary duties in favor of creditors in these cases seems reasonable, even if the creditors do not technically exercise residual control rights at the moment of the director action. Cases of insolvency invoke different considerations because they involve a contingent transfer of residual control rights from shareholders to creditors. Such transfers do not occur instantaneously or without warning. The imposition of fiduciary duties can protect creditors during the transitional period, when they are particularly vulnerable because the managers of the debtor would recognize the inevitability of the control transfer.

6. Counseling Relationships

Perhaps the most difficult of the “easy” cases, this category includes attorneys and clients, accountants and clients, psychiatrists and patients, medical doctors and patients, clergy and parishioners, and other relationships involving the provision of professional advice in a confidential setting. While such relationships may involve the counselor obtaining access to physical assets, the more challenging cases from the perspective of critical resource theory are those in which the fiduciary is given access to confidential information regarding the client. In such cases, the advice-giver assumes a nonfiduciary obligation to maintain confidentiality, as well as a fiduciary obligation to refrain from using the information for personal advantage.

Even a brief analysis of the counseling cases shows that their underlying justification fits neatly within the critical resource


256. See, e.g., Technic Eng’g, Ltd. v. Basic Envirotech, Inc., 53 F. Supp. 2d 1007, 1009 (N.D. Ill. 1999) (describing the transfer of the only significant asset of debtor corporation to another corporation owned by the same family); Main, Inc. v. Blatstein, No. CIV.A. 98-5947, 1999 WL 424296, at *15 (E.D. Pa June 23, 1999) (stating that “once [the company] became insolvent, both [defendants, as the company’s] directors and shareholders, owed fiduciary duties toward [the company], and its creditors . . . . [which] prevented [the defendants] from using [the company’s] assets for their personal gain in a manner contrary to its creditors’ best interests”).

In the attorney-client context, for example, fiduciary duty claims usually arise in two contexts. The first involves cases where the attorney engages in a business transaction with the client. Although the attorney sometimes exercises discretion with respect to the client's property in these cases, such discretion is unnecessary to see the application of the critical resource theory because the critical resource that often is most relevant to these

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258. In many instances, lawyers are literally agents for their clients. While the nature and scope of fiduciary duties in these cases may be tailored to the context, there is nothing exceptional about the existence of a fiduciary relationship. For purposes of this section, the cases involving an attorney's obligation to keep information about the client confidential provide a more challenging context for examining the application of fiduciary law.

259. Fiduciary duty claims might also arise from other aspects of an attorney's service, but such claims are easy to place within the critical resource theory of fiduciary duty. See, e.g., Brown v. Slenker, 220 F.3d 411, 414 (5th Cir. 2000) (involving an attorney who released for an improper purpose a client's check that had been intended as an appeal bond).

260. These cases sometimes invoke Model Rules of Prof'L Conduct R. 1.8(a) (1998), which reads:

A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

1. the transaction and terms on which the lawyer acquires the interest are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;
2. the client is advised and is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
3. the client consents in writing thereto.

Alternatively, the cases might invoke Disciplinary Rule 5-104(A), which reads:

A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise professional judgment therein for the protection of the client, unless the client has consented after full disclosure.

Model Code of Prof'L Responsibility DR 5-104(A) (1980).

In some instances, the cases refer only to the rules. See, e.g., In re Cordoza-Gonzalez, 996 F.2d 1334, 1335 (1st Cir. 1993) (attorney borrowed money from his client without disclosing that attorney did not own the property pledged as collateral and that he and his wife were involved in bankruptcy proceedings); In re Horine, 661 N.E.2d 1206, 1207 (Ind. 1996) (lawyer violated Rule 1.8 by negotiating and entering into contract with a client for purchase of a car without fully disclosing all aspects of the transaction or advising client to seek independent counsel); Comm. on Prof'l Ethics and Conduct of the Iowa State Bar Assoc. v. Humphreys, 524 N.W.2d 396, 398-99 (Iowa 1994) (lawyer improperly accepted corporate stock as payment for legal services rendered in organizing corporation and drafted by-laws to protect his position as officer and director). In other cases, the courts also refer to fiduciary duties. See, e.g., Fla. Bar v. Jamieson, 426 So. 2d 16, 17 (Fla. 1983) (lawyer used personal influence to induce client to make a gift to a foundation operated by lawyer); La. State Bar v. Williams, 498 So. 2d 727 (La. 1986) (it is improper to borrow money from client, interest-free, without having client seek independent counsel); Okla. Bar Ass'n v. McKenzie, 788 P.2d 1370, 1370 (Okla. 1989) (attorney who induced client to invest in risky racetrack venture in which attorney had substantial personal business interest breached fiduciary duty). Finally, in some cases, the courts refer simply to ethical obligations. See, e.g., In re Dato, 617 A.2d 1344 (N.J. 1992) (lawyer purchased property from client at an unfairly low price and resold for a large profit).
decisions is the information about the client possessed by the attorney. The attorney will often be privy to extensive information about a client’s assets and investment preferences that would typically not be disclosed in an arm’s-length transaction.

The second context is cases where the attorney seeks personal gain by using or disclosing confidential information of the client outside of direct transactions with the client. To the extent that confidential information constitutes a critical resource, these cases also fit neatly within the critical resource theory.

The pattern illustrated by the attorney-client cases holds in the other counseling relationships. With respect to physicians and patients, Marc Rodwin has stated, “the law holds doctors accountable as fiduciaries only in restricted situations.” Such situations include “requiring that physicians not abandon patients, keep information they learn confidential, obtain patients’ informed consent to treatment, and . . . disclose to patients any financial interest in clinical

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261. These cases are sometimes covered by Model Rule of Professional Conduct 1.8(b), supra note 260, which reads in pertinent part: “A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation . . . .” In other cases, courts cite Disciplinary Rule 4-101(B), which states that “a lawyer shall not knowingly reveal a confidence or secret of his client.” Confidentiality restraints cover a variety of activities. See, e.g., Quark, Inc. v. Harley, No. 96-1046, 1998 U.S. App. LEXIS 3864, at *4 (10th Cir. Mar. 4, 1998) (former corporate counsel disclosed confidential information, prompting a lawsuit against former employer); Fin. Gen. Bankshares v. Metzger, 680 F.2d 768 (D.C. Cir. 1982) (relying on confidential information, lawyer sent letter to a client proposing a scheme to sell controlling interest of another client’s stock to foreign bank at a premium price); In re Roache, 446 N.E.2d 1302, 1303 (Ind. 1983) (lawyer initially represented clients in purchase of business and then improperly withdrew from representation to represent another client in offering competing bid); In re Laitsch, 415 N.W.2d 836, 837 (Wis. 1987) (lawyer improperly used confidences to garnish client’s bank account on behalf of another client).

In some instances, the fiduciary relationship associated with the confidential information that passes between attorneys and clients may extend to other relationships where no formal representation exists. See Westinghouse Elec. Corp. v. Kerr-McGee Corp., 580 F.2d 1311, 1319 (7th Cir. 1978).


Certain features of patient-physician relations closely resemble classic fiduciary relationships. Physicians have specialized knowledge and expertise. They also control the use of medical resources which patients need: Only they can admit patients to hospitals, order diagnostic tests, and prescribe drugs. Patients are often ill or anxious about their health, which increases their dependence. The patient-physician relationship presupposes patients entrusting physicians to act on their behalf and physicians remaining loyal to their patients.

Rodwin, supra note 262, at 245-46. While all of this seems true, at least to the casual observer, it is utterly irrelevant to the determination of a fiduciary relationship. The key inquiry is whether the physician works with critical resources that belong to the patient.
The requirements to keep information confidential and to disclose financial interest fit easily into the critical resource theory, as previous discussion reveals.

The duty not to abandon and the duty to obtain informed consent are symmetrical—one encouraging the physician to treat the patient and the other limiting the scope of the treatment to matters for which the physician has obtained informed consent. Most cases implicating these duties do not involve self-serving behavior, but rather appear to target negligent behavior (or, in the case of informed consent, the intentional tort of battery). This fact suggests that a physician's duty in many instances is not "fiduciary" at all, but merely the type of duty of care common in many nonfiduciary relationships.

In cases involving self-interested behavior, the critical resource seems to be the patient's physical body. Although it would not be considered "property" in a legal sense, the body in these circumstances serves the same function as critical resources in other fiduciary contexts, that is, discretion with respect to the patient's body is the source of the physician's power, just as discretion with respect to property is the source of power for other fiduciaries.

The most celebrated and controversial case in this area is Moore v. Regents of the University of California, and it deserves closer inspection through the lens of the critical resource theory. The case involved a dispute over John Moore's cells. Doctors at the Medical Center of the University of California at Los Angeles extracted the cells from Moore while treating him for leukemia. The doctors subsequently obtained a patent on a cell line established from

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264. It may be impossible to find a set of cases in which the legal foundation of the claim is more confused than "informed consent" cases. Some courts assert that the duty to disclose has fiduciary origins, while other courts base the duty in negligence and malpractice. Still other courts throw both together. Willard v. Hagemeister, 121 Cal. App. 3d 406, 417 (Cal. Ct. App. 1981) ("The fiduciary relationship in this case also requires that the alternative negligence theories of malpractice and 'informed consent' be distinguished.").

The duty to disclose seems particular difficult of characterization as either a duty of loyalty or a duty of care. See Lawrence A. Hamermesh, Calling off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty, 49 VAND. L. REV. 1087, 1095-96 (1996) (noting that courts characterize the corporate duty of disclosure as "an ill-defined hybrid of the duties of care and loyalty"); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 (Del. 1995) (stating that the "duty of disclosure [is] an obligation that has been characterized as a derivative of the duties of care and loyalty").

265. Michelle Oberman refers to this set of cases under the rubric, "The Patient's Right to Autonomy and the Law of Informed Consent." Oberman, supra note 262, at 464.

266. 51 Cal. 3d 120 (Cal. 1990).

267. Id. at 125.

268. Id. at 126.
Moore's white blood cells. Moore sued the doctors, claiming, inter alia, breach of fiduciary duty and the tort of conversion. The California Supreme Court split on the conversion claim, but unanimously sustained the fiduciary duty claim. The majority opinion noted, "A physician who adds his own research interests to [the] balance may be tempted to order a scientifically useful procedure or test that offers marginal, or no, benefits to the patient."

The majority opinion grounded its notion of "fiduciary" obligation solely on the fact that a physician's "personal interests may affect professional judgment." As noted above, the essence of "fiduciary" obligation is to avoid behavior that simultaneously serves the interest of the fiduciary and constitutes a wrong to the beneficiary. The Court implies that self-interested behavior by physicians may harm patients, even if that harm is not primarily financial. This view seems unassailable.

It is worth noting the court's view that the nonphysician defendants did not stand in a fiduciary relationship with Moore. The court does not explain the basis for this conclusion. It may be that the court simply did not find any of these defendants to be within the recognized categories of fiduciary relationships. The critical resource theory offers a more convincing rationale: None of the other defendants had discretion with respect to Moore's body. Thus, none of the other defendants had the power to act opportunistically.

The psychiatrist-client relationship fits awkwardly into traditional rationales for fiduciary duty. To the extent that those

269. Id. at 127.
270. Id. at 125.
271. The seven justices issued four separate opinions. Four justices joined the majority opinion. Id. One justice issued a separate concurrence, and two justices dissented on the conversion claim but concurred with respect to the fiduciary duty claim. Id. In short, the Court was unanimous in holding that Moore and his physician had a fiduciary relationship that reached the use of Moore's cell tissue. Id.
272. Id. at 130.
273. The Court stated:
   In some respects, the term "fiduciary" is too broad. In this context the term "fiduciary" signifies only that a physician must disclose all facts material to the patient's decision. A physician is not the patient's financial advisor. As we have already discussed, the reason why a physician must disclose possible conflicts is not because he has a duty to protect his patient's financial interests, but because certain personal interests may affect professional judgment.
   Id. at 131 n.10.
274. At several points in the opinion, the court identifies the potential harm as harm to the patient's health. See, e.g., id. at 133 (explaining that "the existence of a motivation for a medical procedure unrelated to the patient's health is a potential conflict of interest and a fact material to the patient's decision").
275. Id.
rationales rely on notions of dependence, the fiduciary conception is at odds with “therapeutic approaches [that] are informed by the value of individual autonomy.” Psychiatrists who disclose confidential information may be held liable for a breach of the fiduciary duty of loyalty. While this result comports with the critical resource theory, broader fiduciary duties may be unwarranted in this context.

Even when the confidential information does not involve commercial transactions, the critical resource theory animates the underlying fiduciary relationship. For example, all of these counseling relationships reveal a disturbing pattern of the counselor using confidential information to pursue sexual relations with the client. The self-interestedness of this action is obvious. As one commentator has noted, “Preying on the vulnerabilities of someone for whom there is a fiduciary relationship is only for the benefit of the predator.”

The usual explanation for granting property rights in information appeals to the incentive effects of information production. Information may be extremely expensive to produce, but once produced, it is easily reproduced. As a result, people who are weighing the costs and benefits of producing information may decide against

276. Illingworth, supra note 106, at 404.
278. This result cannot be explained under Tamar Frankel's theory. See Illingworth, supra note 106, at 405:

To fit this into Frankel's framework, we would have to say both that there was a delegation of power to the psychiatrist, and that the fiduciary is, in some sense, a substitute actor for the patient. However, there is no sense in which the psychiatrist serves a substitution role. Ironically, the court's reaffirmation in MacDonald of the doctor's duty not to disclose confidential information, although grounded in the idea of a fiduciary relationship, indicates that the doctor is not to act as a substitute.

Consider the following scenario: When a physician takes it upon herself to disclose private information she is acting as a substitute for the patient. She is doing what some people might say the patient ought to be doing. For example, if a therapist, upon hearing from her patient that he is HIV positive and that he, nonetheless, plans to have sex with his spouse, discloses that information to the spouse, the therapist arguably is acting as a substitute for the patient.

279. See, e.g., Tante v. Herring, 453 S.E.2d 686, 687-88 (Ga. 1994) (finding that an attorney “was a fiduciary with regard to the confidential information provided him by his client just as he would have been a fiduciary with regard to money or other property entrusted to him by a client”); Hoopes v. Hammargren, 725 P.2d 238, 243 (Nev. 1986) (explaining that a physician might be held liable if patient proved vulnerability because of illness); F.G. v. MacDonell, 696 A.2d 697, 705 (N.J. 1997) (holding that a parishioner seeing a clergyman for counseling has a cause of action for breach of fiduciary duty if the clergyman uses the vulnerability of the parishioner to induce her into sexual relations); Roy v. Hartogs, 366 N.Y.S.2d 297, 301 (N.Y. City Civ. Ct. 1975) (holding psychiatrist liable for engaging in sexual activity with a patient).


280. Id. at 65-66.
production unless they are given the means to protect the fruits of their labors.\textsuperscript{281} Property rights in information partially address the concerns of information producers.

In counseling relationships, fiduciary claims (instead of "property" rights) are granted to encourage information disclosure. The fact of disclosure creates confidential information, and disclosure between individuals and their counselors is a valuable activity. Imposing a fiduciary duty of confidentiality on the counselor recognizes the fact that the information is a critical resource of the client or patient and provides the proper incentives for disclosure.

One might complain that the reliance placed on confidential information in this account of fiduciary duty is no different than the traditional judicial approach of looking for "confidences." Admittedly, in many cases, the traditional approach would reach the same result as property rights theory. The argument here is not that the common-law judges decided all cases incorrectly, but merely that the standards used were incapable of distinguishing fiduciary from nonfiduciary relationships. Under the traditional approach, the notion of "confidences" stretched beyond cases involving confidential information to cases in which one person merely trusted another. In these cases, "confidence" describes subjective reliance, not a critical resource.

\textbf{B. Hard Cases}

The prior section demonstrated how the critical resource theory of fiduciary duty provides a unified description of existing fiduciary relationships. In those contexts, understanding the theory animating the imposition of fiduciary duties can assist in determining the scope of the fiduciary relationship. The critical resource theory of fiduciary

\textsuperscript{281} See Krawiec, supra note 86, at 454 ("Traditional economic theory predicts that suppliers will recognize the inability to profit from information production due to [the] combination of inappropriability, high initial fixed costs, and low marginal cost of dissemination and will not enter the market, resulting in an underproduction of information."). For a lucid judicial pronouncement along these lines, see Judge Winter's separate opinion in United States v. Chestman: Information is ... expensive to produce, and, because it involves facts and ideas that can be easily photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it. Where the profit from an activity is likely to be diverted, investment in that activity will decline. If the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information.

duty could also assist courts in determining whether innovative relationships have a fiduciary character. 282

This section begins with a discussion of confidential relationships. These are the myriad associations discussed in Part II that do not fit into other established categories of fiduciary relationships. While confidential relationships and fiduciary relationships are sometimes distinguished, 283 this section is concerned with identifying those confidential relationships in which the imposition of fiduciary duties would be warranted. The sections that follow examine venture capital, strategic alliances, and franchising. In each of these contexts, courts have struggled to discern whether fiduciary duties should apply, and in each instance, the critical resource theory of fiduciary duty brings more clarity to the inquiry.

1. Confidential Relationships

Confidential relationships are discussed in some detail in Part II of this Article, and that discussion need not be revisited here. Nevertheless, a few points of clarification are in order. First, in light of the foregoing discussion, confidential relationships may be among the easiest of the hard cases. Focusing on critical resources eliminates many cases that the "trust" and "vulnerability" inquiry could not easily resolve. Many confidential relationships involve one person obtaining service from another, who gains access to or takes possession of a critical resource of the first. The traditional approach to these cases is to ask whether the service provider dominated the owner of the critical resource, 284 but this inquiry cannot systematically distinguish fiduciary relationships from arm's-length contracts.

The recent case of Daktronics, Inc. v. McAfee 285 is instructive. In that case McAfee and Baker were partners in a venture to develop a baseball pitch speed indicator. 286 After initially conceiving of the idea, Baker contracted with Daktronics to manufacture a prototype of

282. Weinrib, supra note 97, at 7 (arguing that "categories of fiduciary should not be considered closed").

283. See Restatement of Trusts, supra note 208, § 2 cmt. b ("Although the relationship between two persons is not a fiduciary relationship, it may nevertheless be a confidential relation.") Conversely, a fiduciary relationship may exist even though the parties do not enjoy a confidential relationship.

284. See High Plains Genetic Research, Inc. v. K.K. Mill-Iron Ranch, 535 N.W.2d 839, 842 (S.D. 1995) ("High Plains provided a specialized service and Stamison chose how and under what circumstances that service would be used.").


286. Id. at 360.
the machine. After successful construction of the prototype, the parties collectively marketed the machine to Major League Baseball clubs. Over a four-year period, McAfee and Baker ordered four machines from Daktronics. Several years after McAfee and Baker ordered their last machine, Daktronics began manufacturing and selling pitch speed indicators on their own. McAfee and Baker sued, claiming (among other things) that Daktronics had breached a fiduciary duty. In response to this claim, the Supreme Court of South Dakota reasoned, “Daktronics may have had superior knowledge and technical skills in the development and marketing of a speed pitch indicator, but McAfee and Baker were not in a dependent position, lacking in mental acuity or business intelligence.” As a result, the court rejected the fiduciary claim.

In situations like these, it is useful to ask, what would change about the relationship if McAfee and Baker had entered into a partnership with Daktronics? Would McAfee and Baker have less mental acuity or business intelligence? No, but Daktronics would still owe a fiduciary duty. What would change is that McAfee and Baker would become “co-owners” of the business with Daktronics, and each party would become an agent of the partnership.

By focusing on the supposed disparity between the positions of the parties instead of the allocation of ownership rights, courts enter an inquiry without guideposts. Relationships—particularly business relationships—always involve parties with disparate positions. It is difficult to imagine a situation in which the parties are perfectly symmetrical. One always has more money, more knowledge, more influence, etc., than the other. Indeed, the justification for trading is that each party possesses something that the other wants but does not currently have. As a result, the focus on domination, influence, or disparity of position leads to an uncertain inquiry into how much different is different enough to justify the imposition of fiduciary duties.

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287. Id.
288. Id.
289. Id.
290. Id.
291. Id. at 363.
292. Id.
293. REV. UNIF. P’SHP ACT § 202(a) (1997).
294. Id. § 301(1).
2. Venture Capital (Convertible Preferred Stock)

When venture capitalists invest, they typically demand preferred stock loaded with various financial and control rights.\textsuperscript{295} Unlike traditional preferred stock,\textsuperscript{296} the preferred stock issued to venture capitalists usually does not have fixed dividends, but carries the right to vote—including the right to elect representatives to the board of directors—and the right to convert the preferred stock into common stock.\textsuperscript{297} When venture capitalists and entrepreneurs clash,

\begin{itemize}
\item For a useful guide to venture capital contracts, see MICHAEL J. HALLORAN ET AL., VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION (3d ed. 1997).
\item This reference to "traditional preferred stock" is intended to connote a security that falls somewhere between the traditional classifications of equity and debt. A useful description of this type of security is provided by Arthur Pinto and Douglas Branson:

Preferred shares are equity authorized by statute. Preferred shares are usually authorized in the articles of incorporation or in a contract which is made a part thereof. In most cases, preferred shareholders are paid fixed dividends after the creditors are paid their interest but before the common shareholders are paid dividends. Since preferred shares are considered equity, their holders have no right to be paid like creditors. Rather, preferred shareholders are paid when the board of directors authorizes the payment (that is, declares the dividends). In liquidation, the preferred shareholders are paid their liquidation preference after the creditors but before the common shareholders. Therefore, preferred shareholders have higher risk than creditors in receiving a return and repayment. On the other hand, they usually do not have the rights of common shareholders to vote and control the corporation or share in the increased return if the corporation is successful.

Preferred shares are an unusual security which have the disadvantages of debt (little direct control or potential for increased return) and of common shares (lower priority and greater risk) without any of the advantages of either. One may ask why there is a market for preferred shares? Preferred shares attract investors because they tend to pay higher dividends. In addition, since dividend payments to corporate shareholders are partially nontaxable, there is a market for preferred shares among corporate investors.

ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 70-71 (1999); see also Brudney, supra note 44, at 648:

Preferred stock investors, like bondholders, have a claim to a prior but limited return, in exchange for which they offer funds to be risked at the discretion of the common stock. And like bondholders, their essential economic interest is in the return of principal and current distributions, rather than (as with common stock) with any increased inchoate value of the assets of the enterprise. But unlike bondholders, preferred stock investors commit funds to the discretion of commons without limit of time. Moreover, they have no unconditional contractual entitlement to receive either dividends or return of principal during the life of the firm, or during its insolvency.

See also WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 291-92 (8th ed. 2002) (describing preferred stock as a "hybrid" of equity and debt). These descriptions are, of course, oversimplified in the sense that the terms of preferred stock are defined by contracts that may have infinite variations on the theme. Nevertheless, they provide a useful point of departure for the discussion of preferred stock in the venture capital context.

297. For a study describing the terms of securities issued in venture capital investments, see Steven N. Kaplan & Per Strömberg, Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts, REV. ECON. STUD. (forthcoming 2002) (finding
the rules of engagement have often been worked out in advance through the extensive terms of the preferred stock.\textsuperscript{298} As with all long-term relational contracts, however, those terms do not anticipate every contingency.\textsuperscript{299} When advance planning fails to yield the desired results, the injured party may appeal to fiduciary duties for protection.\textsuperscript{300}

The thought of a venture capitalist seeking judicial protection through fiduciary duty claims seems almost laughable. After all, the usual portrait of a venture capitalist shows a dominant personality who holds all the cards. Indeed, such claims by venture capitalists are exceedingly rare, suggesting that the extensive contractual and

\footnotesize{convertible preferred stock in 189 of 200 financing rounds), available at http://www.restud.org.uk/accepted.htm.}

\textsuperscript{298} The primary terms associated with preferred stock are to be found in the certificate of designations or restated certificate of incorporation of the issuing company. In conjunction with the sale of the preferred stock, the parties usually negotiate other agreements, including a stock purchase agreement, a shareholders agreement, or a registration rights agreement. Throughout this Article, I refer to those agreements and the certificate of designations or restated certificate of incorporation collectively as "venture capital contracts."

\textsuperscript{299} This point was recently noted in a concise fashion by Thomas Smith: "All contracts have gaps." Thomas A. Smith, The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty, 98 MICH. L. REV. 214, 234 (1999). Comparing the metaphorical contracts between shareholders and the corporation with the real contracts between bondholders and the corporation, Smith usefully observes:

Contractors cannot anticipate all future contingencies. While the nature of bondholder claims is profoundly different from that of equity, both variable and fixed corporate claimants will have need of principles to fill the gaps in their incompletely specified voluntary arrangements. 

\textit{Id.}

Smith concludes that—even though the "obligations owed by managers to creditors are usually not characterized in law as fiduciary"—the principle necessary to fill gaps in bondholder contracts is the same principle that should be used to fill gaps in shareholder contracts, namely, that managers should be required to do "what rational parties would have agreed to ex ante." \textit{Id.} at 235. This familiar approach of looking to the hypothetical bargain yields interesting results. Relying on modern theories of corporate finance—specifically, the Capital Asset Pricing Model ("CAPM")—Smith concludes that managers have a "neotraditional" fiduciary duty to maximize the value of all financial claims against the firm. \textit{Id.} at 238. It is probably worth noting that Smith is not the first to suggest that managers should have a duty to maximize the value of the firm. \textit{See}, \textit{e.g.}, Morey W. McDaniel, Bondholders and Corporate Governance, 41 BUS. LAW. 413, 446 (1986) ("The management choice is not limited to maximizing stockholder wealth or maximizing bondholder wealth. There is another alternative: Maximize the value of the firm, which benefits both bondholders and stockholders.").

\textsuperscript{300} Perhaps the best illustrations of this strategy are two cases decided within one month of each other by Chancellor Allen. \textit{See} Orban v. Field, No. 12820, 1997 Del. Ch. LEXIS 48 (Del. Ch. Apr. 1, 1997); Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997). These cases are particularly instructive because one (\textit{Orban}) involved a lawsuit by an entrepreneur, and the other (\textit{Adams}) involved a lawsuit by the venture capitalists. The principle that seemed to unify the decisions was that "courts are inclined to enforce the bargain between venture capitalists and entrepreneurs," rather than relying on fiduciary duties. D. Gordon Smith, Venture Capital Contracting in the Information Age, 2 J. SMALL & EMERGING BUS. L. 133, 155 (1998) (discussing both cases).
market protections suffice to prevent entrepreneurial opportunism in most instances. Nevertheless, the contracts between venture capitalists and entrepreneurs are incomplete, and instances in which the venture capitalist is vulnerable may arise. For example, in *Equity-Linked Investors, L.P. v. Adams*, the venture capitalists did not have the power to liquidate a biopharmaceutical firm that was “on the lip of insolvency.”301 In an act of desperation, the entrepreneurs obtained an outside investment that significantly diluted the venture capitalists’ investments.302 In considering the venture capitalists’ claim of fiduciary duty protection, Chancellor Allen wrote:

While the board in these circumstances could have made a different business judgment, in my opinion, it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature. . . . The corporation is, of course, required to respect those legal rights. But . . . generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict.303

While preferred stock is usually in the nonfiduciary relationship column, such categorization may elevate form over substance. The preferred stock issued in most venture capital investments is much closer to common stock than to traditional preferred stock. From a critical resource perspective, venture capitalists hold residual control rights through their right to elect directors and to vote as a single class with the common shareholders.304 They normally should have the benefit of fiduciary duty protection.305

It is also possible that the entrepreneur would seek fiduciary protection from opportunistic behavior by the venture capitalist. Since entrepreneurs usually hold common stock, there is no question that the board of directors would owe the entrepreneur fiduciary duties. If

301. 705 A.2d 1040, 1041 (Del. Ch. 1997).
302. Id. at 1045.
303. Id. at 1042.
304. It is worth noting that the preferred stock issued to venture capitalists is usually convertible into common stock. While this right to obtain residual control rights seems very similar to actually holding residual control rights, the two are actually quite different from a property rights perspective. The key difference is that the holder of a convertible security must still make a payment to obtain the residual control rights—not a cash payment (as with an option), but rather a payment in the form of forfeiting other rights (those rights that make the stock “preferred”). From an economic standpoint, there is nothing to differentiate this person from the investor who is contemplating an investment in common stock. The law does not and should not recognize such potential owners as being in a fiduciary relationship.
the venture capitalist acted opportunistically through the board of
directors, therefore, the application of fiduciary duties would be
assured.

In an important contribution to the literature on fiduciary
duties and venture capital, Edward Rock and Michael Wachter have
argued that courts should refrain from attempts to protect minority
shareholders in “Silicon Valley start-ups” through the doctrine of
minority oppression. Their conclusion rests on two important
characteristics of Silicon Valley startups: (1) The “defining
characteristic of the Silicon Valley start-up is that its key assets are
specific to the match”; and (2) because the key assets in a Silicon
Valley startup are match-specific, “the company will be capital-
constrained with no easy access to outside financing at an appropriate
valuation of the assets.” While the firm is in this stage of
development, the argument goes, the potential for opportunistic
behavior is apparent:

If any of the company insiders could trigger dissolution of the enterprise midstream, the
forced sale of the match assets would result in substantial losses to the participants. . . .
If critical insiders could credibly threaten dissolution, they could use the threat to
extract a greater share of the value of the enterprise.

Rock and Wachter then argue that this potential for
opportunism is mitigated, though not eliminated, by the combined
effects of the limitations on exit that are inherent in closely held
corporations and the vigorous enforcement of rules prohibiting non-

306. Rock & Wachter, Omelet, supra note 128, at 915. Although they fail to define whether
the “minority shareholders” they have in mind are the entrepreneurs or the venture capitalists,
the context of their discussion suggests that they are most concerned with claims of minority
oppression brought by entrepreneurs against venture capitalists. Nevertheless, their analysis
invokes issues that have application to claims by venture capitalists against entrepreneurs in
the (admittedly) rare circumstances when they arise.

307. Id. at 918. Simply defined, match-specific assets are investments that are of value to
insiders but of little value to outsiders. Id. Rock and Wachter elaborate on the concept of match-
specific assets as follows:

Investments in match are defined as investments that are more valuable to the
contracting parties than to a third party. We use the term “match-specific” investment
in this article in place of the more common “firm-specific” training for several reasons.
First, the term “match-specific” investment captures the broader range of activities
that create a good partnership, including training and learning-by-doing, but also
including adaptations to each other’s styles of interaction. In addition, the term is
more general and does not restrain the investments to take place inside of a firm.
Finally, the term match-specific leads one to identify the specific asset created or
improved by the parties’ investments.

Id. at 918 n.14.  
308. Id. at 918.  
309. Id. at 919.  
310. These limitations on exit arise because the shareholders in a closely held corporation
lack access to public capital markets, and because, in contrast to partners in a general
pro rata distributions in corporations. Together, these attributes of the closely held corporation lock the participants into a relationship, thus reducing agency costs and encouraging investment in match-specific assets.

Rock and Wachter readily acknowledge that the lock-in they describe does not address all of the potential for opportunism, but they foreclose the possibility of using fiduciary duties (i.e., lawsuits based on minority oppression) to address that problem. They rely instead on the self-enforcing norms and other nonlegal constraints that govern the venture capital relationship, including the close working relationship between venture capitalists and entrepreneurs, which reduces information asymmetries and transaction costs; the commonly bargained-for right of venture capitalists to replace entrepreneurs, which protects venture capitalists and provides them with an incentive to invest in searching for replacement managers; and the market for venture capitalist reputation, which protects the entrepreneur from opportunistic termination.

partnership, shareholders in a closely held corporation have no statutory right to trigger dissolution and buyout.

311. Rock and Wachter discuss both direct and indirect prohibitions. The direct prohibition prohibits a majority shareholder from paying dividends to itself without paying proportional dividends to the minority shareholders. Indirect prohibitions include close judicial scrutiny of self-dealing transactions and special provisions addressing “end-game scenarios,” such as the appraisal right. Id. at 921-22.

312. Rock and Wachter also note that focusing on match-specific assets might help to explain why some businesses chose partnerships rather than corporations:

The dissolution at will feature of classical partnerships means that the form will best fit enterprises in which there are few if any assets that are not easily sold to third parties. In such cases, the benefits of dissolution at will are clear: by providing an easy exit, it prevents opportunistic rent-seeking. And the costs are minimal: when there are no sunk costs, when the principal assets are easily divided or sold, dissolution at will causes little harm.

Id. at 919.

313. Id. at 927.

314. Id. at 928-29.

315. Id. at 929. It seems improper to consider a termination opportunistic if the right to terminate was reserved in the initial bargaining. See Smith, Information Age, supra note 300, at 141-42 (noting that termination is only opportunistic if the entrepreneur did not get the benefit of reduced cost of capital). Nevertheless, where the potential for opportunism exists, reputational constraints are potentially powerful. Rock and Wachter describe those constraints as follows:

VCs are repeat players in the start-up business and are likely to be constrained on a number of fronts. First, they compete to provide financing for the most promising start-ups and are thus likely to be constrained by reputational effects in their aim to maintain their position in relation to other start-up companies. In addition, the VC has to replace the entrepreneur with another person. Wrongful discharge of the chief executive officer, even if protected from judicial second guessing by the employment at will doctrine, is not a strong starting point in any recruitment process. Finally, the discharge will raise questions with other capital suppliers. It is a negative signal under the best of circumstances and is likely to raise the company's cost of capital.
Rock and Wachter are not content to stop with their claim that minority oppression is unnecessary to address opportunism in the venture capital relationship. They further assert that judicial enforcement of fiduciary duties in this context would “jeopardize the web of features and protections that makes the close corporation form so attractive and popular for firms with substantial match-specific assets.”\footnote{Rock & Wachter, \textit{Omelet, supra} note 128, at 929.} Their reasoning is that the availability of minority oppression claims may enable a minority shareholder to act opportunistically against the majority shareholder.

Although their analysis is elegant, Rock and Wachter exaggerate the extent to which entrepreneurs and venture capitalists are locked into the relationship by the existence of “match-specific” assets.\footnote{Rock & Wachter, \textit{Omelet, supra} note 128, at 930.} The idea that entrepreneurs are locked in is belied by the fact that venture capitalists routinely insist on employment agreements and stock-vesting agreements to ensure that the entrepreneur does not leave the firm too quickly. Indeed, many entrepreneurs voluntarily leave companies that are not fully “cooked”\footnote{See generally, D. Gordon Smith, \textit{Exits} (working paper 2001).} because their talents lie in starting new companies, not in managing established companies. These so-called serial entrepreneurs specialize in starting innovative companies, and they often voluntarily leave to others the development and ongoing management of the firm.\footnote{As the title of their article suggests, Rock and Wachter compare entrepreneurial firms to omelets and describe the problems arising from the need to encourage match-specific investments as follows: \begin{quote} The problem is akin to making an omelet: between the time the eggs are broken and the omelet sets, the cook knows his grand plan for the omelet, but to outsiders, the half-cooked omelet is unappetizing. Forced sales of half-developed switches and uncooked omelets go poorly. \end{quote} Rock & Wachter, \textit{Omelets, supra} note 128, at 919.}

Venture capitalists avoid lock-in through staged financing, which provides an opportunity for the venture capitalist to credibly threaten dissolution of the firm.\footnote{The term “serial entrepreneur” refers to a class of entrepreneurs who start ventures, sell them, and then repeat the process, often in rapid succession. \textit{See} Mark Gimein, \textit{Silicon Valley’s Serial Netrepreneurs: Why Wait for the IPO?}, \textit{FORTUNE}, Feb. 21, 2000, at 269.} The threat is credible because of the combined effect of two nearly universal features (one legal and the other nonlegal) of venture capital relationships: (1) venture capitalists typically have a liquidation preference ensuring at least the return of...
their initial capital investment, and sometimes much more;\textsuperscript{321} and (2) the fact that a venture capitalist's refusal to continue funding a company will likely be interpreted by other venture capitalists as a "kiss of death" on the company.\textsuperscript{322} In other words, because entrepreneurs have no reasonable funding prospects without the endorsement of existing investors and because those existing investors have the right to receive a liquidation preference, staged financing enables investors to demand concessions from entrepreneurs. Moreover, the relatively short time periods between stages—usually less than one year and often just weeks or months—creates an environment in which entrepreneurs are almost constantly seeking new money.\textsuperscript{323} The implicit threat of nonfunding, therefore, provides an almost constant source of power to the venture capitalists.

In the end, Rock and Wachter correctly identify the potential for opportunism in the venture capital relationship as real and significant, and they properly assert that the protection offered to minority shareholders by the combination of mutual self-interest, contractual obligation, and reputational constraints is important. Nevertheless, these protections may be insufficient to completely address the problem. Although courts have been reluctant to impose fiduciary duties in the venture capital context,\textsuperscript{324} circumstances may call for such action. Moreover, the limited application of fiduciary duties would not unduly empower minority shareholders, avoiding new potential for opportunism against the majority.

3. Strategic Alliances

Alliances are an important source of investment for entrepreneurial firms. Although the contractual structures vary


\textsuperscript{322} D. Gordon Smith, Team Production in Venture Capital Investing, 24 J. CORP. L. 949, 967 (1999) (noting that the threat of abandonment is "particularly potent because the refusal by the Venture Capitalist to continue investing will likely be viewed by other potential investors as a signal that the company is unworthy of capital").


\textsuperscript{324} See Smith, Information Age, supra note 300, at 153-55 (discussing Orban v. Field and Equity-Linked Investors, L.P. v. Adams and noting that "courts typically treat these disputes as entirely contractual").
widely, the unifying principle is simple: Alliances involve cooperation among two or more firms to a greater degree than traditional discrete contracts, but to a lesser degree than mergers or acquisitions. In other words, alliances are prototypes of the relational contract. These relational contracts are typically heavily negotiated, nonstandardized agreements. Their detailed terms may provide the appearance of completeness, but their scope and length ensures that the contracts are incomplete. Indeed, disputes among alliance partners are common, and parties turn to the courts for guidance.325

The absence of standardization complicates analysis and undermines efforts to classify alliances. Most alliances consist of two or more of the following: supply agreements, distribution agreements, technology license agreements, research and development agreements, marketing agreements, and investment agreements. In some instances, alliances are governed exclusively by contracts. In other instances, the partners elect to form a separate business entity in an arrangement typically referred to as a joint venture.

The larger party often makes an equity investment in the smaller party. In these cases, the existence of a fiduciary relationship follows naturally from the formation of a stockholding relationship.326 In other instances, the parties invest in a joint project without making any direct investment in each other. Because of the tendency of alliance parties to invest more than financial capital, alliances are often referred to as “corporate partnerships.” Leading legal practitioners in this field have written:

These arrangements typically involve a substantial contribution of products, technology/intellectual property and/or research and development by one party (typically the smaller party) and some sort of investment (equity, debt or R&D funding) and/or services by the other party (typically the larger party). They also usually involve the allocation of manufacturing and/or distribution rights to technology and products arising from the arrangement.327

As with confidential relationships, determining whether alliances are fiduciary relationships is extremely fact-intensive, but the key facts still relate to allocation of ownership rights. A recent dispute between Tellabs Operations and Riverstone Networks is

325. The number of reported cases in this area is still small because strategic alliances have blossomed only during the late 1990s. Most strategic alliances are formed among high-technology or biotechnology companies, and disputes over intellectual property are common.
326. See, e.g., V. Compl. at 17, PerkinElmer, Inc. v. Williams (Del. Ch. No. 18671) (Feb. 15, 2001), available at http://webman.widener.edu/documents/complaints/18671-012.pdf (alleging that the directors of Genomic Solutions, Inc. (GSI) breached a fiduciary duty to PerkinElmer, Inc., a substantial shareholder in GSI).
instructive. Tellabs and Riverstone both build and sell equipment to
enhance the service quality of communications service providers. On
November 17, 2000, the two companies formed a strategic alliance for
the purpose of manufacturing and marketing specified hardware and
software manufactured by Riverstone.

In a complaint filed on August 28, 2001, Tellabs claimed that
representatives of Riverstone made certain representations during
negotiation of the Strategic Alliance Agreement, including statements
regarding the capabilities of Riverstone's products and an assertion
that Riverstone did not intend to compete against Tellabs in the sale
of the products that were the subject of the Strategic Alliance
Agreement. Tellabs contends that Riverstone acted contrary to
those representations by using marketing and pricing information
designated "Confidential" in the Strategic Alliance Agreement to gain
an advantage in selling the products. Tellabs terminated the
Strategic Alliance Agreement in August 2001 and sued Riverstone on
the same day. Tellabs claims that Riverstone owes Tellabs fiduciary
duties:

Riverstone owed fiduciary duties to Tellabs, which included (but were not limited to): (a)
a fiduciary duty to disclose to Tellabs all material information relating to independent
contacts with Tellabs' client contacts; (b) a fiduciary duty to refrain from exploiting
Tellabs' prospective business advantages for Riverstone's own gain; and (c) a fiduciary
duty to refrain from using Tellabs' confidential pricing information for Riverstone's own
financial gain.

The critical resource in this instance is confidential
information, and the success or failure of Tellabs' fiduciary duty
claims should turn on whether it can convince a court that the
information in question is really "confidential." Without confidential
information, Tellabs would seem to have no viable fiduciary duty
claim, as Riverstone appears to have used its own assets to
manufacture the products.

328. For Tellabs, see Company Profile at http://www.tellabs.com/news/backgrounder.html
(last visited Aug. 29, 2002), and for Riverstone, see Corporate Backgrounder at
329. Strategic Alliance Agreement, Nov. 17, 2000, between Riverstone Networks, Inc. and
Tellabs Operations, Inc. (on file with author).
331. Strategic Alliance Agreement, supra note 329, § 12.2.
4. Franchising

Perhaps franchising\textsuperscript{332} should appear under the heading of “easy” relationships because courts consistently hold that franchisors have no fiduciary duty to franchisees.\textsuperscript{333} Nevertheless, the issue is persistent. Plaintiff-franchisees regularly make claims against franchisors based on fiduciary duty, invoking the notions of “trust,” “confidence,” and vulnerability.\textsuperscript{334} Franchising certainly looks like a relationship that could qualify as a fiduciary relationship under traditional judicial standards,\textsuperscript{335} but the critical resource theory shows why the courts have reached the correct conclusion.

The franchise relationship is a contractual relationship, and both franchisors and franchisees contribute significantly to its success.\textsuperscript{336} In many instances, both franchisor and franchisee contribute financial capital. In all instances, however, both parties

\textsuperscript{332} For a definition of “franchise,” see Robert W. Emerson, \textit{Franchise Contract Clauses and the Franchisor’s Duty of Care Toward its Franchisees}, 72 N.C. L. REV. 905, 908 n. 1 (1994) (“A franchise involves a continuing contractual relationship in which the franchisor grants the franchisee a right to conduct business or sell products according to the franchisor’s marketing plan and in conjunction with the franchisor’s trademark.”).

\textsuperscript{333} Only a few cases have held that a franchisor has fiduciary duties to a franchisee. The best known is \textit{Arnott v. American Oil Co.}, 609 F.2d 873 (8th Cir. 1979), but subsequent cases in the same circuit have backed away from this conclusion. See Bain v. Champlin Petroleum Co., 692 F.2d 43, 48 (8th Cir. 1982) (noting that “[j]asmuch as the duty of ‘good faith and fair dealing’ is inherent in every business relationship, it was unnecessary to the decision to label that duty as ‘fiduciary.’”). For another case finding a fiduciary relationship, see \textit{Mister Donut of America, Inc. v. Harris}, 723 P.2d 670, 673 (Ariz. 1986).

A federal district court in North Carolina recently held that a franchisor and franchisee of a muffler chain had a fiduciary relationship, but the court of appeals reversed on the ground that “there is no indication that a North Carolina law would recognize the existence of a fiduciary relationship between franchisee and franchisor.” \textit{Broussard v. Meineke Discount Muffler Shops}, Inc., 155 F.3d 331, 347 (4th Cir. 1998).


\textsuperscript{335} In an oft-cited article, practicing attorney Harold Brown argued in favor of fiduciary treatment for franchise relationships. See Harold Brown, \textit{Franchising—A Fiduciary Relationship}, 49 TEX. L. REV. 650 (1971). He justified this conclusion by arguing that courts relied on three propositions to explain traditional fiduciary relationships: “the pervasive powers held by one party; the gross disparity of the parties in a complex transaction usually of long duration; and the rampant opportunities for abuse, particularly through clandestine self-preference.” Id. at 665. Robert Emerson has also argued that the franchise relationship should be considered fiduciary with respect to certain clauses of the franchise agreement. Emerson, \textit{supra} note 332, at 934.

\textsuperscript{336} For general background on franchise relationships, see \textit{FUNDAMENTALS OF FRANCHISING} (Rupert M. Barkoff & Andrew C. Selden eds., 1997); \textit{BUILDING FRANCHISE RELATIONSHIPS: A GUIDE TO ANTICIPATING PROBLEMS, RESOLVING CONFLICTS, AND REPRESENTING CLIENTS} (Ann Hurwitz & Rochelle B. Spandorf eds., 1998).
contribute more than financial capital. The franchise agreement is the basic governance document for the franchising relationship. Franchise agreements are notoriously lopsided in favor of the franchisors.\textsuperscript{337} Even though these agreements have very detailed provisions, they are incomplete contracts.\textsuperscript{338}

Franchisors typically contribute three things to the franchising relationship: (1) trademarks and trade dress,\textsuperscript{339} (2) trade secrets, which are part of what is often referred to as the “System”; and (3) services, often including site selection, training, promotion, bookkeeping, compliance with laws and system standards, and insurance.\textsuperscript{340} Franchisees typically pay a one-time franchise fee and ongoing royalties.\textsuperscript{341} These payments are often the source of conflict between the franchisor and franchisee. The franchisor’s incentive is to maximize the amount of sales—the basis on which royalties are calculated—which may not require the same actions as those that would maximize profits for the franchisees. In addition to the payment of royalties, the franchisee is usually required to pay for the development of the franchise store according to the franchisor’s specifications. Finally, franchisees often make an enormous personal investment in the business. For many franchisees, the franchise is their primary occupation.

\textsuperscript{337} See, e.g., La Guardia Assocs. v. Holiday Hospitality Franchising, Inc., 92 F. Supp. 2d 119, 125 (E.D.N.Y. 2000) (“The economic dominance of the franchisor may be brought to bear at the outset of the relationship to create a franchise contract that is unfair to the franchisee.”); Postal Instant Press v. Sealy, 51 Cal. Rptr. 2d 365, 373 (Cal. Ct. App. 1996) (“The relationship between franchisor and franchisee is characterized by a prevailing, although not universal, inequality of economic resources between the contracting parties.... The agreements themselves tend to reflect this gross bargaining disparity. Usually they are form contracts the franchisor prepared and offered to franchisees on a take-it-or-leave-it basis.”).

\textsuperscript{338} Peter C. Lagarias, Uniformity in California Franchise Agreements, 21 FRANCHISE L.J. 136, 140 (2002) (“Franchise agreements, despite their painstaking detail, are incomplete, because they cannot possibly cover all current and future aspects of the franchise relationship and instead simply reserve many rights and considerable discretion to the franchisor.”); Emerson, supra note 332, at 907 (“Franchisors and franchisees... tend to have legitimate expectations about their franchise relationship that often go far beyond the terms specified in their written agreement.”).


\textsuperscript{340} See Lagarias, supra note 338, at 136 (surveying ten franchise agreements contained in Uniform Franchise Offering Circulars registered with the Department of Corporations in California); see also Emerson, supra note 332, at 966 (reviewing one hundred franchise agreements).

\textsuperscript{341} Lagarias, supra note 338, at 137; Emerson, supra note 332, at 955-56.
Most franchise agreements address a franchisee's territorial rights, usually granting a specific area of exclusivity. From the franchisee's perspective, territorial rights produce a monopoly of sorts and can significantly improve sales. A frequent source of litigation between franchisors and franchisees has been the so-called encroachment claim, where franchisees argue that their territorial rights have been infringed by the franchisor. If the contract between the parties is clear, courts will generally enforce it. On the other hand, courts have not been particularly receptive to claims that restraint is required by an implied covenant of good faith and fair dealing.

Most franchises are granted for multi-year terms, usually between five and twenty years. Long terms encourage franchisees to make relationship-specific investments. Many franchise agreements are also renewable, at the option of the franchisee, upon the expiration of the prior term, as long as the franchisee has maintained compliance with the terms of the previous franchise agreement. At the time of renewal, franchisees are typically required to upgrade their outlets to then-prevailing system standards. Where renewal is contingent on franchisor approval, some states have adopted statutes prohibiting franchisors from withholding consent unreasonably. All franchise

342. Lagarias, supra note 338, at 138 (explaining that nine of ten franchise agreements provide for exclusive territories); Emerson, supra note 332, at 944-45.


344. See, e.g., Cook v. Little Caesar Enters., Inc., 210 F.3d 653, 656 (6th Cir. 2000) (refusing to take account of alleged oral representations about the size of exclusive territory that were in conflict with the franchise agreement).

345. See, e.g., Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir. 1999); Hobin v. Coldwell Banker Residential Affiliates, Inc., 744 A.2d 1134 (N.H. 2000). But see Scheck v. Burger King Corp., 756 F. Supp. 543, 549 (S.D. Fla. 1991) (holding that franchisee lacked contractual right to an exclusive territory, but the franchisor may "not act to destroy the right of the franchisee to enjoy the fruits of the contract"); In re Vylene Enters., Inc. 90 F.3d 1472 (9th Cir. 1996) (finding breach of the covenant of good faith and fair dealing where competing restaurant was constructed within a mile and a half from franchisee's restaurant); Emporium Drug Mart, Inc. v. Drug Emporium, Inc., Bus. Franchise Guide (CCH) ¶ 11,966 (AAA, Dallas, Tex. Sept. 2, 2000) (arbitration of a well-publicized case of "Internet encroachment").

For an argument that the implied covenant of good faith and fair dealing should be applied more forcefully against franchisees, see Thomas J. Chinonis, Note, Implied Covenant of Good Faith: A Two-Way Street in Franchising, 11 DePaul BUS. L.J. 229 (1998).

346. Lagarias, supra note 338, at 137 (noting that nine of ten franchise agreements provided terms within five to twenty years).

347. Id. at 138 (describing "qualified" right of renewal). Absent a contractual right to renew, courts are usually reluctant to imply a right. See, e.g., Zuckerman v. McDonald's Corp., 35 F. Supp. 2d 135 (D. Mass. 1999).

348. See, e.g., Deborah S. Coldwell et al., Franchise Law Update, 54 SMU L. REV. 1477 (2001) (discussing Texas statute). In addition to state statutes, Congress has adopted the
agreements allow the franchisor to terminate the franchise relationship upon a material breach by the franchisee. Franchises are usually not terminable at will, but most franchise agreements and statutes provide ample possibilities for franchisor termination.

Even this brief and incomplete description of the franchise relationship reveals why courts routinely deny claims by franchisees alleging a fiduciary relationship. While the franchisee is authorized to use assets of the franchisor, the franchisor does not exercise discretion over any of the critical resources of the franchisee. Fiduciary claims arise most often with respect to decisions to terminate the franchise. Such decisions may have the potential for opportunism, but only if the franchisee has left herself unprotected in the franchise agreement.

Despite the lack of success in claims by franchisees, franchising relationships are regularly held to be agency relationships. These cases are inevitably claims by third parties seeking damages against franchisors for the actions of a franchisee. These holdings suggest that


351. Emerson, supra note 332, at 949 (noting that "franchises are subject to termination by franchisors for all sorts of violations, even ones that would—absent the contractual clause about materiality—constitute de minimis breach"). Courts sometimes limit the power of franchisors to terminate using the contract doctrine of good faith and fair dealing. See 7-Eleven, Inc. v. Dar, 757 N.E.2d 515 (Ill. App. Ct. 2001).

352. The potential for opportunism is enhanced by the fact that most franchisees are subject to covenants not to compete. See Robert W. Emerson, Franchising Covenants Against Competition, 80 IOWA L. REV. 1049, 1064 (1995). Other areas that seem ripe for potential for opportunism are the assignment of franchise rights, see Burger King Corp. v. Ashland Equities, Inc., 181 F. Supp. 2d 1366 (S.D. Fla. 2002), and the repurchase of franchise property, see Victory Lane Quick Oil Change, Inc. v. Hoss, No. 00-01-73104-DT, 2001 U.S. Dist. LEXIS 16520 (E.D. Mich. Sept. 28, 2001).


franchises are sometimes fiduciary relationships, but any fiduciary duties would run from the franchisee to the franchisor. Given that franchisors have extensive contractual protections against opportunism and that franchisees are typically the less wealthy party, the absence of any decisions imposing fiduciary duties in this context is understandable.

VI. THE IMPLIED JUSTIFICATION FOR THE CONTENT OF FIDUCIARY DUTY

The critical resource theory unifies fiduciary law behind the notion that all fiduciary relationships conform to the structure described above, namely, that the fiduciary acts on behalf of the beneficiary when exercising discretion with respect to a critical resource belonging to the beneficiary. Moreover, the critical resource theory holds that the purpose of fiduciary duty is to combat opportunism in such relationships. When combined, these insights imply that the content of fiduciary duty should depend on the potential for opportunism, which in turn depends on various aspects of the relationship structure. The implication is that courts should calibrate fiduciary duties to fit the situation before them. The purpose of this section is to link the foregoing description of fiduciary relationships with the content of fiduciary duties.

Warren Seavey, Reporter for the Restatement (Second) of Agency, has observed, “The duties of loyalty are substantially the same for all fiduciaries, varying only in intensity.” Commentators have from time to time attempted to reconcile the relative strictness of fiduciary obligation in various settings, but only modest efforts have been made to catalogue fiduciary relationships along these lines.

Still, the general intuition seems to be that fiduciary duties become more intense as the fiduciary’s power grows. The critical resource theory provides a similar justification for the variable intensity of

356. See, e.g., Claire Moore Dickerson, Cycles and Pendulums: Good Faith, Norms, and the Commons, 54 WASH. & LEE L. REV. 399, 409-10 (1997) (“The highest level of fiduciary duty is found in classic trust law.... [The acting partner’s fiduciary duty is generally less than that of a trustee.”); Donald J. Weidner, RUPA and Fiduciary Duty: The Texture of Relationship, 58 LAW & CONTEMP. PROBS., Spring 1995, at 81, 83 (1995) (defending RUPA’s mandatory fiduciary duties on the ground that the “basic mission of RUPA is to serve small partnerships”).
357. Cf. Dickerson, supra note 356, at 409 (noting that the “level of fiduciary duty owed should decrease as the fiduciary’s relative power and conflict decrease”); Fallany O. Stover & Susan Pace Hamill, The LLC Versus LLP Conundrum: Advice for Businesses Contemplating the Choice, 50 ALA. L. REV. 813, 828 (1999) (“The more management authority acquired by the non-managing members, the greater the level of fiduciary duties owed.”).
fiduciary duty: The law provides protection against opportunistic behavior, and the strength of that protection varies inversely with the potential for self-help on the part of the vulnerable party.358

Courts can vary the intensity of the fiduciary obligation in at least three ways: scope, scrutiny, and substance. The scope of fiduciary duty determines which actions are reviewed. Some relationships are thoroughly fiduciary while others are primarily contractual with some fiduciary elements. For example, every action taken by corporate directors qua directors is subject to fiduciary constraint, but physicians act as fiduciaries in only a narrow range of activities. The scope of a fiduciary relationship is determined by reference to the fiduciary's discretion with respect to critical resources belonging to the beneficiary.359 Where such discretion exists, fiduciary duties follow.

The level of judicial scrutiny may vary from one situation to the next. In corporate law, the use of this mechanism is a common strategy for calibrating fiduciary duty to the potential for opportunism.360 Where the potential for opportunism is high, judicial scrutiny will be intense. Where the potential for opportunism is low, judges are deferential.

The substance of fiduciary duty varies depending on the relationship. Trustees are "under a duty to administer the trust solely


359. One area in which the proper scope of fiduciary obligation is much debated is the corporate opportunity doctrine. See, e.g., Victor Brudney & Robert Charles Clark, A New Look at Corporate Opportunities, 94 HARV. L. REV. 998, 998 (1981) (arguing that a "principled doctrine . . . between contexts involving public corporations and those involving close corporations"); Pat K. Chew, Competing Interests in the Corporate Opportunity Doctrine, 67 N.C. L. REV. 435, 435 (1989) (proposing "express negotiations between corporations and fiduciaries on their respective rights, or, absent such negotiations, a heightened judicial recognition of the parties' reasonable expectations in creating their business relationship"); Eric Talley, Turning Servile Opportunities into Gold: A Strategic Analysis of Corporate Opportunities Doctrine, 108 YALE L.J. 277, 280 (1998) (arguing that "the contours of an 'optimal' doctrine turn critically on the extent to which corporate fiduciaries possess private, unverifiable knowledge about the relevant characteristics of new projects"). The most difficult issue in this area is deciding which opportunities belong to the corporation. As noted above, whether a critical resource belongs to the beneficiary must be decided by principles outside of fiduciary law, but the corporate opportunity doctrine provides a vivid illustration of the way in which the scope of the fiduciary relationship makes a difference.

360. For example, the Delaware courts apply "enhanced scrutiny" to defensive actions in the hostile takeover context to account for the "omnipresent specter" of self-interest. Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946, 954 (Del. 1985). They apply an "entire fairness" standard to conflict-of-interest transactions. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). And they employ a "compelling justification" test when the primary purpose of board action is to interfere with the effectiveness of a stockholder vote. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988).
in the interest of the beneficiaries.” 361 Similarly, “an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.” 362 By contrast, corporate directors are required simply to treat shareholders fairly. 363

Along each of these dimensions, courts vary the intensity of fiduciary duty in ways that tolerate more or less self-interested behavior by fiduciaries. The potential for opportunism depends on the likelihood of harm and the potential magnitude of the harm. An examination of the development of partnership fiduciary duties illustrates how the intensity of fiduciary duty responds to the potential for self-help by beneficiaries.

Common-law fiduciary duties in the partnership context are generally seen as fairly strict. 364 The classic statement of those duties is Cardozo’s vaulting rhetoric in Meinhard v. Salmon:

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 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. 365

Under the critical resource theory of fiduciary duty, the strict duties imposed in partnerships imply that partners are highly vulnerable and incapable of adequate self-help. The source of this vulnerability may be that partners have unlimited personal liability for obligations of the partnership. This distinguishes partners from shareholders in a corporation, whose liability is limited. 366 It also

365. 164 N.E. 545, 546 (N.Y. 1928). Many cases are full of references to a strict fiduciary duty for partners. See, e.g., Venier v. Forbes, 25 N.W.2d 704, 708 (Minn. 1946) (noting that “the relationship between partners is essentially one of mutual trust and confidence and that the law imposes upon them the highest standard of integrity and good faith in their dealings with each other”); Salhinger v. Salhinger, 105 P. 236, 237 (Wash. 1909) (“There is no stronger fiduciary relation known to the law than that of a copartnership, where one man’s property and property rights are subject to a large extent to the control and administration of another.”).
366. Courts have, from time to time, imposed partnership-like fiduciary duties in the context of closely held corporations. The most important case in this line is Donohue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505 (Mass. 1975), which was later modified by Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976). Despite misgivings by the
distinguishes partners from other beneficiaries—including trust beneficiaries—whose exposure to harm is limited to the size of the critical resource under the discretion of the fiduciary. In short, partners have traditionally been subject to strict fiduciary duties because the potential magnitude of the harm is high.

The recent trend in partnership law—epitomized by the Revised Uniform Partnership Act ("RUPA")—has been in the direction of displacing these traditional standards and substituting fiduciary duties with a narrower scope and less demanding substance.\(^3\)\(^6\)\(^7\) RUPA pointedly asserts that a "partner's duty of loyalty to the partnership and the other partners is limited to" the duties listed in the statute.\(^3\)\(^6\)\(^8\) The statute specifies three discrete duties: (1) an "anti-theft" duty;\(^3\)\(^6\)\(^9\) (2) a prohibition against self-dealing; and (3) a prohibition against

Massachusetts Supreme Court, the strict duties imposed by Donohue are still widely employed. See, e.g., Hollis v. Hill, 232 F.3d 460 (5th Cir. 2000); Berreman v. West Pub. Co., 615 N.W.2d 362 (Minn. Ct. App. 2000); A. Teixeira & Co., Inc. v. Texeira, 699 A.2d 1383 (R.I. 1997). The rationale for strict duties in this context is not unlimited liability, but rather the absence of exit options. See Donohue, 328 N.E.2d at 514-15:

"[T]he true plight of the minority stockholder in a close corporation becomes manifest [when he attempts to liquidate his investment]. He cannot easily reclaim his capital. In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation. In a partnership, a partner who feels abused by his fellow partners may cause dissolution by his "express will... at any time"... and recover his share of partnership assets and accumulated profits.... By contrast, the stockholder in the close corporation or "incorporated partnership" may achieve dissolution and recovery of his share of the enterprise assets only by compliance with the rigorous terms of the applicable chapter of the General Laws.... To secure dissolution of the ordinary close corporation subject to [the state dissolution statute], the stockholder, in the absence of corporate deadlock, must own at least fifty per cent of the shares... or have the advantage of a favorable provision in the articles of organization.... The minority stockholder, by definition lacking fifty per cent of the corporate shares, can never "authorize' the corporation to file a petition for dissolution... by his own vote. He will seldom have at his disposal the requisite favorable provision in the articles of organization.

Whereas strict fiduciary duties in the partnership context could be rationalized by appeal to the potential magnitude of harm, strict fiduciary duties in the corporate context are rationalized by reference to the likelihood of harm.


\(^3\)69. This provision was carried over from Section 21 of the Uniform Partnership Act, which was often referred to as an "anti-theft" provision. U.P.A. Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, Should the Uniform Partnership Act Be Revised?, 43 BUS. LAW. 121, 151 (1987).
competing against the partnership.\textsuperscript{370} In a dramatic gesture that shows how far RUPA departed from \textit{Meinhard},\textsuperscript{371} the statute states, "A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest."\textsuperscript{372} The most controversial innovation in RUPA is a provision forbidding the elimination of the duty of loyalty, though allowing partners to "identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable."\textsuperscript{373}

The drafters of RUPA defended the narrowing of the fiduciary obligation by claiming that it was a "compromise on an extraordinarily controversial topic."\textsuperscript{374} On one side of the debate were those who criticized the traditional common-law duties, either because they set an "unrealistically high standard of behavior among partners"\textsuperscript{375} or because partners are not fiduciaries at all, at least not in the same sense as trustees.\textsuperscript{376} On the other side of the debate were commentators who approved of expansive fiduciary protection in the partnership context.\textsuperscript{377} The relative merits of each position are not central to this Article. Instead, the important point is that the drafters sided with the critics of traditional fiduciary duties and lessened the intensity of those duties because they perceived partners as having a relatively strong capacity for self-help.\textsuperscript{378}

\textsuperscript{370} § 404(b)(1)-(3).
\textsuperscript{371} There is no doubt that \textit{Meinhard} was the focus of these statutory duties. In describing Section 404(e), the drafters alluded to Cardozo's language: "RUPA deletes the traditional agency rule that would require abnegation of self." Donald J. Weidner & John W. Larson, \textit{The Revised Uniform Partnership Act: The Reporters' Overview}, 49 BUS. LAW. 1, 20 (1993).
\textsuperscript{372} § 404(e). With respect to this provision, Allan Vestal commented, "This shift is breathtaking. In one stroke of the pen the drafters have made the partners adversaries, whereas before they were bound by 'the duty of the finest loyalty,' not merely 'the common standards of competitors.' This is a sea change in the law." Allan W. Vestal, \textit{Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992}, 73 B.U. L. REV. 523, 535 (1993).
\textsuperscript{373} Revised Uniform Partnership Act § 1.03(b)(3)(i). Donald Weidner called this provision "an unprecedented statutory attempt to specify those aspects of fiduciary law that reflect mandatory rules, and to distinguish them from aspects that reflect merely default rules." Weidner, \textit{supra} note 356, at 86.
\textsuperscript{374} Weidner & Larson, \textit{supra} note 371, at 18.
\textsuperscript{375} \textit{Id.} at 17.
\textsuperscript{376} \textit{Id.} at 17-18.
\textsuperscript{378} In describing the factors that motivated the changes, Dean Weidner and Professor Larson rely almost exclusively on this justification:

The specific and exclusive nature of the section was motivated in part by a sense that vague, broad statements of a duty of loyalty cause too much uncertainty. It was suggested that overly broad judicial language has left practitioners uncertain about
VII. ADDITIONAL IMPLICATIONS OF THE CRITICAL RESOURCE THEORY

The primary contributions of the critical resource theory of fiduciary duty described above are that it effectively distinguishes fiduciary from nonfiduciary relationships and provides a coherent explanation for the judicial imposition of loyalty obligations. In addition to these contributions, the critical resource theory of fiduciary duty clarifies certain other issues. Each of the following subjects could easily justify a separate article-length treatment. Indeed, each of the topics has attracted the attention of more than one scholar. What follows, therefore, is simply suggestive of the direction these issues might take under the critical resource theory of fiduciary duty.

A. Fiduciary Duty and the Duty of Good Faith and Fair Dealing

The analysis above shows how fiduciary duties supplement residual control in the battle against opportunism in fiduciary relationships, but why should courts stop at opportunism in the fiduciary context? Why not attack opportunism in every setting where it is found to exist, even in arm's-length contracts? The answer to these questions is that courts do not confine their efforts to fiduciary relationships, but judicial efforts to police opportunism in contractual relationships tend to be limited to the contract doctrine of good faith and fair dealing.\(^{379}\) The purpose of this section is to describe the connection between that doctrine and fiduciary duty.

Fiduciary duty and the duty of good faith and fair dealing are variations on a theme.\(^{380}\) Both are judicially imposed loyalty obligations designed to attack the potential for opportunism in

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379. Occasionally, courts recognize claims of tortious breach of the duty of good faith and fair dealing. See, e.g., Foley v. Interactive Data Corp., 254 Cal. Rptr. 211, 227-39 (Cal. 1988) (describing the development of such actions, but rejecting application of tort principles in the employment context). Steven Burton has observed that the tort action "seems to be dying outside of the insurance contract context and perhaps closely related contexts involving quasi-fiduciary relationships." Steven J. Burton, Racial Discrimination in Contract Performance: Patterson and a State Law Alternative, 25 HARV. C.R.-C.L. L. REV. 431, 470 n.142 (1990).

380. Other commentators have noticed the affinity of these two doctrines. See, e.g., Easterbrook & Fischel, supra note 13, at 438 n.28 ("The concept of the duty of good faith like the concept of fiduciary duty is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute."); Dickerson, supra note 356, at 405 (arguing that "good faith and fiduciary duty are on the same continuum").
relationships. Treating the duty of good faith as a *loyalty* obligation may seem a bit startling to some who are familiar with the doctrine, which is sometimes characterized as nothing more than a minor qualification on the self-interestedness that normally characterizes contract. Courts certainly use the duty of good faith to enforce reasonable or justifiable expectations of contracting parties, but courts also use the duty of good faith to “redefine contractual obligations in circumstances about which the parties probably had no expectations when the contract was made.” In either role, the doctrine requires each contracting party to consider the interests of the other contracting party when contemplating self-interested actions. To that extent, the duty of good faith is similar to fiduciary duty.

Despite this similarity, the scope of these two doctrines is sufficiently different that they are not often viewed as tackling related problems. Fiduciary duty is typically more expansive than contractual duty. While fiduciary duty is determined by the structure of the relationship, the obligation of good faith and fair dealing emanates from the terms of the contract. The varying intensity of these obligations is attributable to the range of opportunistic behavior.

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381. In his oft-cited article on the duty of good faith, Steven Burton describes the function of the duty in terms that are very similar to the “trust” and “vulnerability” approach to fiduciary duty:

The good faith performance doctrine thus may be used to protect a “weaker” party from a “stronger” party. Unlike the unconscionability doctrine, however, weakness and strength in this context do not refer to the substantive fairness of the bargain or to the relative bargaining power of the parties. Good faith performance cases typically involve arm’s-length transactions, often between sophisticated business persons. The relative strength of the party exercising discretion typically arises from an agreement of the parties to confer control of a contract term on that party. The dependent party then is left to the good faith of the party in control.


382. See, e.g., Ribstein, *supra* note 12 (good faith “qualifies rather than negates the assumption of selfishness that applies to the contract”).


384. Interestingly, this characterization of the duty of good faith is more likely to emerge from the writings of scholars whose expertise lies more in the realm of fiduciary law. See, e.g., Brudney, *supra* note 296, at 633 n.101 (concluding that “‘good faith’ requires one party to ‘consider’ the other party’s interest in exercising discretion under their contract and thus seeks limits on the extent to which the party may serve his own interests.”).

385. Lawrence Mitchell described the purpose of the doctrine of good faith and fair dealing as follows: “The purpose of the good faith doctrine is to prevent a contracting party from opportunistically capitalizing upon the ambiguities of language to defeat the other’s legitimate contractual expectations.” Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443, 456 (1996).
possible in each context. As noted above, the intensity of fiduciary duty should depend on the likelihood of harm and the potential magnitude of the harm. Both the likelihood of harm and the potential magnitude of the harm are often less in an arm’s-length contract than in a fiduciary relationship because the allocation of residual control over the relevant resources provides fewer opportunities for self-serving behavior. As a result, the duty of good faith is typically weaker than fiduciary duty.

The content of the implied obligation of good faith and fair dealing in contract law is much debated. The modern debate traces to the adoption of the good faith standard in the Uniform Commercial Code\textsuperscript{386} and subsequent embrace by the Restatement (Second) of Contracts.\textsuperscript{387} Recent commentary tends to focus on the well-known positions articulated by Robert Summers and Steven Burton in a series of articles and responses.\textsuperscript{388}

Summers views good faith as an “excluder.”\textsuperscript{389} That is, good faith is best understood as the absence of bad faith. Summers identifies six categories of bad faith: evasion of the spirit of the deal; lack of diligence and slacking off; willful rendering of only substantial performance; abuse of a power to specify terms; abuse of a power to determine compliance; and interference with, or failure to cooperate in, the other party’s performance.\textsuperscript{390} This form of analysis is reminiscent of the efforts made by Sealy to categorize fiduciary relationships,\textsuperscript{391} and it shares the same shortcoming, namely, limited utility in deciding future cases that do not fit neatly into one of the existing categories.\textsuperscript{392} Moreover, the excluder approach can just as easily operate from the other direction, beginning with known

\textsuperscript{386} U.C.C. § 1-203 (2002).
\textsuperscript{387} RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”)
\textsuperscript{389} Summers writes, “It is a phrase without general meaning or (meanings) of its own and serves to exclude a wide range of heterogeneous forms of bad faith. In a particular context the phrase takes on specific meaning but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically ruled out.” Summers, Good Faith, supra note 388, at 201.
\textsuperscript{390} Id. at 232-43.
\textsuperscript{391} See supra notes 97, 116 and text accompanying note 116.
\textsuperscript{392} See Steven J. Burton, An Introduction to Law and Legal Reasoning 31-36 (1996).
instances of good faith and thereby excluding bad faith. In short, Summers’s approach to the duty of good faith is highly indeterminate.394

Just as Deborah DeMott argued that fiduciary duties are "atomistic," Summers contends that the duty of good faith cannot be unified.395 By contrast, Burton strives to construct a unified theory of good faith,396 which fits nicely astride the critical resource theory of fiduciary duty. Burton writes:

Good faith limits the exercise of discretion in performance conferred on one party by the contract. When a discretion-exercising party may determine aspects of the contract, such as quantity, price, or time, it controls the other's anticipated benefits. Such a party may deprive the other of these anticipated benefits for a legitimate (or good faith) reason. The same act will be a breach of the contract if undertaken for an illegitimate (or bad faith) reason.397

The similarity between this description and the description of fiduciary relationships under the critical resource theory of fiduciary duty is striking. In both instances, the duty-owing party exercises discretion in a manner that has the potential to harm the other party in the relationship. In both instances, the legal rule is designed to limit that discretion.398 The only material difference between the relationships is that contracting parties "exercise... discretion in


Llewellyn's vision closely resembles the hermeneutic circle. To define the agreement of the parties, one must look at their language. To understand the language, one must investigate the commercial background of its use. To determine the expectations of the parties, one must evaluate both their language and the circumstances surrounding contract formation. Thus, understanding any single element requires an understanding of the totality.


395. Summers, Good Faith, supra note 388, at 204-07.

396. Not surprisingly, Burton justifies his attempt to create a unified theory of good faith on grounds that the doctrine is too indeterminate. See Burton, Breach, supra note 199, at 371-72 (noting that current standards "direct attention to the amorphous totality of the factual circumstances at the time of formation, and fail to distinguish relevant from irrelevant facts within that realm").

397. Id. at 372-73.

398. With respect to the duty of good faith, Michael Van Alstine has observed that "a solid consensus currently exists in the courts that a core function of the duty of good faith lies in imposing limitations on a party's exercise of a discretionary power to control an aspect of a contractual relationship after formation." Van Alstine, supra note 383, at 1256; see also DeMott, supra note 3, at 896 ("The constraint of a good faith obligation—like that of fiduciary obligation—applies only to situations in which a person may exercise discretion.").
performance” whereas fiduciaries exercise discretion with respect to a critical resource.399

B. Contracting Out of Fiduciary Duty

Fiduciary duty and the duty of good faith and fair dealing both exist because contracts are less than complete.400 In fiduciary relationships, discretion provides the fiduciary with the opportunity to expropriate value from the beneficiary; in contractual relationships, discretion provides one contracting party with the opportunity to “recapture opportunities forgone at formation.”401 This account raises the oft-debated question concerning the ability of parties to contract around fiduciary duty.

Legal scholars have produced a substantial literature on the issue of contracting out of fiduciary duties.402 On the one hand, so-called progressive scholars like Lawrence Mitchell assert that “fiduciary duty, where it applies, trumps contract.”403 On the other

399. Burton, Breach, supra note 199, at 394 n.109 ("A fiduciary must act on behalf of the other party... It thus forgoes the opportunity to act in its own interest at all. Good faith performance of a contract creating a fiduciary duty should be understood in this sense.")

400. With respect to the duty of good faith, see Van Alstine, supra note 383, at 1228 ("The duty of good faith performance springs from the simple idea that certain expectations of fair and reasonable conduct are so fundamental that the parties rarely mention them in negotiation, and almost never distill them into express terms."). See also Burton, Breach, supra note 199, at 371:

The good faith question often arises because a contract is an exchange expressed imperfectly and projected into an uncertain future. Contract parties rely on the good faith of their exchange partners because detailed planning may be ineffectual or inadvisable. Therefore, express contract terms alone are insufficient to determine a party's good faith in performance.

401. Burton, Breach, supra note 199, at 387 ("A recapture by one party of forgone opportunities necessarily harms the other. A reasonable person accordingly would enter a contract that confers discretion on the other party only on the belief that the discretion will not be used to recapture forgone opportunities."). In subsequent writings, Burton has suggested that this view of the duty of good faith is also captured by the more conventional phrasing, “justified expectations.” STEVEN J. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH 40 (1995) (contending that “justified expectations... is a clearer way to express the same thought”).


403. Mitchell, supra note 385, at 458. Mitchell uses this conclusion to distinguish fiduciary duty from the implied obligation of good faith and fair dealing: “If fiduciary duty trumps
hand, contractarian scholars like Henry Butler and Larry Ribstein claim that "fiduciary duties are not distinct from the contract but are simply one of many drafting alternatives." Under the critical resource theory, fiduciary duty supplements self-help in combating opportunism. Contracts are an effective means of self-help. It would seem to follow that fiduciary duty can be tailored to fit the beneficiary's sense of vulnerability.

This view of the contracting-out debate essentially embraces the contractarian position without endorsing the notion—sometimes associated with contractarianism—that fiduciary duties are "not a distinctive topic in law or economics." That parties to a fiduciary relationship define the contours of their relationship through contract does not mean that fiduciary duties are simply contractual gap-fillers. As emphasized repeatedly throughout this Article, the critical resource theory of fiduciary duty holds that fiduciary relationships are distinctive.

Nevertheless, in most fiduciary settings, parties may modify default rules of fiduciary duty through contract. In the trust context, for example, the trustee's duty to act "solely in the interest of the beneficiary" may be modified to allow the trustee to "sell trust property to himself individually, or as trustee to purchase property from himself individually, or to lend to himself money held by him in trust, or otherwise to deal with the trust property on his own account." Mandatory minimum fiduciary duties, such as those found

contract, then it can hardly be the case that it is functionally analogous to a doctrine designed for the limited purpose of ensuring the performance of contracts." Id. The problem here lies not in Mitchell's logic, but in a faulty premise. As shown in this section, fiduciary duty does not "trump" contract any more than contract "trumps" fiduciary duty.

404. Butler & Ribstein, supra note 402, at 29.

405. The interrelationship between fiduciary duty and contract may produce strange results. If the beneficiary is particularly good at self-preservation and bargains for effective protections in the contract, the scope for fiduciary obligation is diminished. On the other hand, if the beneficiary is particularly poor at self-preservation and bargains away fiduciary protections, the scope for fiduciary obligation is also diminished.

406. Easterbrook & Fischel, supra note 13, at 446.


409. § 170(1) cmt. t. For further discussion of the trust context, see Langbein, supra note 198, at 658-60.
in the Revised Uniform Partnership Act, are inconsistent with this view.\footnote{10}

\section*{C. Restitution for Breach of Fiduciary Duty}

Modern fiduciary law originated in the English courts of equity.\footnote{11} Unlike torts and contracts,\footnote{12} fiduciary duty was not recognized as an action at law. While the usual remedy in legal actions is money damages measured by reference to the harm incurred by the plaintiff, the remedy most often associated with a breach of fiduciary duty is disgorgement of profits.\footnote{13} Disgorgement is measured by the amount of the fiduciary's gain rather than by the amount of the beneficiary's loss,\footnote{14} implying that the primary goal of providing the remedy is deterrence.\footnote{15} The purpose of this section is to propose that


Presumably, the duty of good faith and fair dealing would apply to any contract purporting to modify fiduciary duties; therefore, the Revised Uniform Partnership Act's requirement that any modifications to fiduciary duty be reasonable may mirror the common law.

\footnote{11. See Sealy, supra note 97, at 69-72. Nevertheless, the principles of restitution that are intertwined with fiduciary law originate in the civil law. Gordley, supra note 8, at 1869.

\footnote{12. As noted by James Gordley, “common lawyers had not thought in terms of tort and contract,” but rather in terms of various forms of action. Gordley, supra note 8, at 1821. The distinction between tort and contract was borrowed from the civil law. Id. For additional historical background, see DAVID IBBETSON, A HISTORICAL INTRODUCTION TO THE LAW OF OBLIGATIONS 220-44 (1999).

\footnote{13. See RESTATEMENT (THIRD) OF RESTITUTION, supra note 32, at § 3 cmt. c (noting that disgorgement is “ordinarily limited to instances of conscious wrongdoing,” but that fiduciaries may be required to disgorge profits that result from an unintentional breach so that the law may serve a “prophylactic function.”); see also Cooter & Freedman, supra note 15, at 1051 (describing “perfect disgorgement” as a sanction that restores the wrongdoer to the same position that she would have been in but for the wrong”). The mechanism employed to effect that remedy is a constructive trust. Id. at 1051 n.14.

\footnote{14. This principle unifies the law of restitution. See Friedmann, supra note 12, at 1889; Gordley, supra note 8, at 1869 ("Traditionally, there was no law of restitution as such, but rather a hodgepodge of remedies with one characteristic in common: the plaintiff's recovery was not limited by the loss that he had actually suffered."). Of course, if the beneficiary's loss exceeds the fiduciary's gain, compensatory damages would normally be enforced. See Gergen, supra note 27, at 1934-35.

\footnote{15. See Edelman, supra note 34, at 1876 ("The cases in which disgorgement damages have been recognized have... been limited to instances in which there is a profound need for deterrence not fulfilled by compensatory damages," such as in cases involving a breach of fiduciary duty.). As noted by Cooter and Freedman, however, the effectiveness of fiduciary duty as a deterrent depends not only on the magnitude of the sanction, but also on the probability that the sanction will be imposed. Cooter & Freedman, supra note 15, at 1052-53. Fiduciary law
the dichotomy between compensatory remedies for torts and contracts, on the one hand, and remedies of deterrence for fiduciary duty, on the other hand, is not mere historical happenstance. Instead, the different remedies respond to substantive differences in the structure of the relationships.

The critical resource theory is consistent with a conception of private law that accepts the necessity of "correlativity," that is, the notion that liability imposed on fiduciaries must correspond to the beneficiary's entitlement. The beneficiary becomes entitled to the fiduciary's loyalty when the fiduciary exercises discretion with respect to the beneficiary's critical resources. If the principle of correlativity holds, this remedial scheme implies that the beneficiary's entitlement may in some cases exceed the beneficiary's actual loss. This, in turn, employs a "cluster of presumptive rules," whose purpose is to increase the probability of enforcement, thus improving the deterrent effect of the law. But see Weinrib, supra note 12, at 1 (proposing a view of restitution as corrective justice and asserting that "[r]estitutionary damages should not be seen as serving a deterrent or punitive function; such a function cannot account for why the plaintiff, of all people is entitled to the defendant's gain."). Deterrence is a utilitarian justification for disgorgement. The nonutilitarian defense relies on the notion that a person ought not to profit from wrongdoing. See Gergen, supra note 27, at 1934.

416. Ernest Weinrib embraces the principle of correlativity as a cornerstone to his theory of private law as "corrective justice." Weinrib, supra note 12, at 1. The animating idea underlying corrective justice is that "liability is the consequence of the parties' being correlatively situated as the doer and sufferer of an injustice, and the remedy is seen as undoing that injustice to the extent possible." Id. The principle of correlativity holds that "injustice done and injustice suffered, far from being coincident but independent events, are normatively inseparable." Id. at 3-4. The focus of corrective justice, therefore, is "the bipolar relationship between the plaintiff and the defendant." Id. at 3. Weinrib examines corrective justice in more detail in his book. See ERNEST J. WEINRIB, THE IDEA OF PRIVATE LAW (1995).

While accommodating the concept of correlativity, the critical resource theory of fiduciary duty does not embrace the view that private law is only about corrective justice. Indeed, Hanoch Dagan has convincingly argued that corrective justice is an incoherent framework for thinking about private law. Dagan, supra note 17, at 147-53. The thrust of his argument is that "some sort of normative apparatus or social vision" is required to define the entitlements that allow law to make determinations of "injustice." Id. at 149. Correlativity, therefore, is necessarily distributive. Id. at 150.

417. See Dagan, supra note 17, at 150 (suggesting that correlativity "is essential for any justificatory theory of private law"). Dagan describes the importance of correlativity in the following passage:

Correlativity is crucial for private law because private law adjudication—like adjudication in general—is a coercive mechanism run by unelected officials and therefore must be a justificatory practice. To be a justificatory practice, private law adjudication must be able to justify to the defendant each and every aspect of its state-mandated power. In particular, given the unique characteristic of private law... namely, its structure as a zero-sum game between a particular plaintiff and a particular defendant—private law needs to be able to justify to the defendant both the identity of the recipient of any detriment imposed on her and the exact benefit this recipient receives. The correlativity thesis answers exactly this concern. . . .

Id. at 150-51.

418. On the interaction between "harm caused" and "benefit received," see Christopher T. Wonnell, Replacing the Unitary Principle of Unjust Enrichment, 45 EMORY L.J. 153, 162-74
implies that fiduciary law vindicates some value other than the material well-being of the beneficiary. Hanoch Dagan has identified that value as control over the beneficiary’s entitlement to the fiduciary’s loyalty.419 As discussed above, the beneficiary controls the fiduciary in the first instance by exercising residual control rights over the critical resources that lie at the heart of the fiduciary relationship.420 Fiduciary law provides a backstop in the event such control rights are ineffective.

Restitution is a remedy that is triggered by various events often assembled under the heading “unjust enrichment.”421 Within the past fifteen years, commentators have challenged this view of restitution, arguing that events other than unjust enrichment may trigger restitution.422 While the potential causes of restitution vary depending on the commentator, all who contend that restitution is broader than unjust enrichment agree that at least two such events are “unjust enrichment” and “wrongs.”423 As noted above, breach of fiduciary duty would typically be classified as a wrong.424

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419. See Dagan, supra note 17, at 160 (contending that fiduciary duty involves a “normative choice of the extent to which the beneficiary has control over her entitlement to the fiduciary’s loyalty”).

420. See supra Part IV.A.

421. See, e.g., LORD GOFF OF CHIEVELY & GARETH JONES, THE LAW OF RESTITUTION 3 (Gareth Jones ed., 5th ed. 1998) (“The law of restitution is the law relating to all claims, quasi-contractual or otherwise, which are founded upon the principle of unjust enrichment.”); Kull, supra note 26, at 1196 (“My proposition is that the law of restitution can be defined exclusively in terms of its core idea, the law of unjust enrichment.”). The Restatement (Third) of Restitution asserts, “A person who is unjustly enriched at the expense of another is liable in restitution.” RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT, supra note 32, at § 1 (Discussion Draft 2000). This would seem to leave open the possibility of other causal events for restitution, but the comment to this section states flatly, “The law of restitution is the law of unjust enrichment.” Id. at cmt. b. See also id. at cmt. c (“When used in this Restatement to refer to a theory of liability or a body of legal doctrine, the terms ‘restitution’ and ‘unjust enrichment’ will generally be treated as synonymous.”).


423. Birks, supra note 27, at 1770.

424. See supra Part I.
The existence of a wrong does not necessarily imply the availability of a restitutionary remedy.\textsuperscript{425} The critical resource theory of fiduciary duty suggests a reason for imposing restitution in fiduciary duty cases: the deterrent effect of restitution mitigates the temptation for a fiduciary to act opportunistically. Restitution does not involve merely giving back something that has been wrongly taken, but also giving up anything wrongly obtained, even if not obtained from the party who claims the right to restitution.\textsuperscript{426} By precluding the perpetrator of the wrong from benefiting, restitution is well-suited to achieving the goal of deterrence that animates fiduciary duty.

Disgorgement and similar restitutionary remedies are not limited to fiduciary claims. In tort and occasionally in contract,\textsuperscript{427} restitution evinces a "goal of denying a profit from conscious wrongdoing."\textsuperscript{428} While not unique to the fiduciary context, therefore,

\textsuperscript{425} See Birks, supra note 27, at 1783 ("The occurrence of an event with the generic description 'wrong' may trigger remedial rights of various kinds, rights to compensation, rights to punitive awards, rights to restitutionary awards.").

\textsuperscript{426} This phrasing is inspired by Peter Birks. \textit{Id.} at 1773. See also \textit{Restatement (Third) of Restitution, supra} note 32, at § 1 cmt. c ("[T]here are significant instances of liability based on unjust enrichment that do not involve the restoration of anything the claimant previously possessed."); Laycock, \textit{supra} note 23, at 1279-83 (discussing various meanings of the word "restitution").

\textsuperscript{427} The concept of "restitution" in contract law is ambiguous, but it traditionally referred to restoration: "its purpose was not the reversal of unjust enrichment, but rather the reversal of a contractual performance." Andrew Kull, \textit{Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts, 79 Tex. L. Rev. 2021, 2029 (2001).} This began to change in the \textit{Restatement (Second) of Contracts}, but restitution as remedy for unjust gain remains an unusual remedy in contract law. Andrew Kull recently described the domain of restitution as follows:

[Disgorgement] is, of course, the characteristic remedial response of the part of the law of restitution that is concerned with benefits wrongfully obtained: benefits acquired by a defendant from a consciously wrongful interference with the plaintiff's legally protected interests. Because the dominant objective of restitution in such cases is to strip the defendant of any profit from the transaction (thereby removing any possibility that a transaction undertaken in knowing disregard of the plaintiff's interests could ultimately be profitable for the defendant), it is no objection to the disgorgement remedy that it awards the plaintiff more than he lost—more than his restoration interest—leaving him better off than if the transaction with the defendant had never taken place. The result is familiar in the context of profitable and intentional torts (typically trespass, conversion, or infringement) and profitable breaches of fiduciary duty. A persuasive case can be made that disgorgement is the appropriate response to one narrow category of breach: cases in which the defendant's election to default is both profitable and opportunistic. Outside this specific set of cases, however, the proposition that there could be disgorgement for breach of contract—meaning a recovery in excess of plaintiff's loss, intended to strip the defendant of the profits of a wrong—is essentially unknown. The recent decisions in [EarthInfo, Inc. v. Hydrosphere Res. Consultants, Inc., 900 P.2d 113 (Colo. 1995)] and [Winstar Corp. v. United States, 64 F.3d 1531 (Fed. Cir. 1995), aff'd, 518 U.S. 839 (1996)] are seemingly the first in which the suggestion has been made.

\textit{Id.} at 2030-31; see also Gergen, \textit{supra} note 27, at 1937-38 (justifying disgorgement in some cases involving breach of contract by a "moralistic view").

\textsuperscript{428} Kull, \textit{supra} note 427, at 2021.
restitution unites fiduciary claims and promotes deterrence of opportunism in the fiduciary context.

CONCLUSION

The critical resource theory of fiduciary duty asserts that the allocation of discretion to a person who acts on behalf of another with respect to critical resources belonging to the other determines whether a particular relationship should be treated as a fiduciary relationship. The line between fiduciary and nonfiduciary relationships is drawn in this way because relationships of the type described are susceptible to a peculiar form of opportunism. Residual control over the assets—the right to withdraw them from the relationship—remains with the beneficiary and decreases the potential for opportunistic behavior. Fiduciary duties strive to fill the remaining gaps, which are likely to be substantial in some cases.

Given this framework, the justification for fiduciary duties is clear. When one person is authorized to act on behalf of another and to exercise discretion over critical resources belonging to the other, a duty of loyalty helps to align incentives. This account of the role played by fiduciary law is consistent with prior learning on the subject. Tamar Frankel argued that the main problem addressed by fiduciary duties is "abuse of power." While the beneficiary has power by virtue of the residual control, the fiduciary has power by virtue of discretion. As noted by Robert Cooter and Bradley Freedman,

Once a consensual relationship in which the principal relinquishes control or management of her asset to the agent is formed, the resulting separation of ownership from control or management creates opportunities for the agent to appropriate the asset or some of its value. Taking advantage of these opportunities whether by theft, diversion, conversion, or trespass would violate the agent's duty of loyalty. In general, however, an agent must choose between two courses of behavior: other-regarding acts, which the principal prefers, and self-regarding acts, which benefit the agent at the principal's expense.429

Simply stated, the role of fiduciary duty is to curb such self-interested behavior in the absence of complete specification of the fiduciary's obligations. Given that the critical resource theory of fiduciary duty arrives at the same rationale for imposing fiduciary duties as other theories, it is not surprising that the resulting case law is largely harmonious with this new theory. The primary value of the theory is not that it forces a complete reassessment of fiduciary law, but rather that it provides a common thread that unifies the cases. It makes easy cases more consistent, and hard cases easier.
