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Motivation, Information, Negotiation: Why Fiduciary Accountability Cannot Be Negotiable

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Abstract

In the debate over contractual freedom or enabling-versus-mandatory rules in fiduciary law, those who do not adhere to an unbridled contractatian approach tend to justify fiduciary law's strict posture by appealing to transaction cost reasoning. In this view, fiduciary law more efficiently sets rules that the parties would adopt or, also efficiently, sets penalty default rules that they would not adopt. Drawing on new institutional economics and information economics, this paper advances another theory on the appropriate scope of contractibility with regard to fiduciary loyalty. The present account highlights information asymmetries that are more tenacious than those stemming from information production costs - to wit, asymmetries due to unobservable and unverifiable information. These asymmetries provide a compelling justification for a strict, full-disclosure-based accountability regime. A similar analysis vindicates a rather similar legal policy in traditional insurance law, in which insurance relations are based on utmost good faith and impose a duty of full disclosure on the insured. Keywords: fiduciary, loyalty, full disclosure, accountability, irreducible core, contractual freedom, insurance, information asymmetry

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JEL Classifications: D82, G30, G38, K10, K22, M41, M42

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Amir N. Licht*

Chapter for the Research Handbook on Fiduciary Law (Andrew Gold & D. Gordon Smith, eds., forthcoming)

Abstract

In the debate over contractual freedom or enabling-versus-mandatory rules in fiduciary law, those who do not adhere to an unbridled contractatian approach tend to justify fiduciary law's strict posture by appealing to transaction cost reasoning. In this view, fiduciary law more efficiently sets rules that the parties would adopt or, also efficiently, sets penalty default rules that they would not adopt. Drawing on new institutional economics and information economics, this paper advances another theory on the appropriate scope of contractibility with regard to fiduciary loyalty. The present account highlights information asymmetries that are more tenacious than those stemming from information production costs - to wit, asymmetries due to unobservable and unverifiable information. These asymmetries provide a compelling justification for a strict, full-disclosure-based accountability regime. A similar analysis vindicates a rather similar legal policy in traditional insurance law, in which insurance relations are based on utmost good faith and impose a duty of full disclosure on the insured.

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I. INTRODUCTION

In the light of the fact that modern fiduciary law traces its roots at least eight hundred years back,[1] it is rather remarkable that to date, we still debate whether and to what extent should parties to fiduciary relations be allowed to define their relations contractually. While common law jurisdictions around the world exhibit substantial similarity in most basic features of fiduciary loyalty,[2] fiduciary law is particularly diverse - perhaps even unclear - with regard to this question. Against this backdrop, this paper advances a theory of the extent and the limits of contractual freedom with regard to fiduciary obligations, or, put otherwise, of the irreducible core of such obligations. The key insight on which this theory hinges holds that fiduciary obligations constitute a social institutional response to acute information asymmetries, especially of the unobservable and unverifiable kind. Courts have acknowledged this phenomenon long ago and modern economic analysis gives it more structure.

The fiduciary's informational advantage due to unobservable and unverifiable information provides her with power vis-à-vis the beneficiary. As a definitional matter, this power is absolute in that the beneficiary cannot fend against it, regardless of the resources available to her. A well-known "market for lemons" dynamics may ensue in such circumstances, in which the best response of the negotiating parties would be to continually discount their willingness to engage with one another. In the pure case, the market collapses. To avoid market failure due to contract failure, a societal-level intervention is necessary. In fiduciary law this intervention is embodied

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[1] *See* Amir N. Licht, Lord Eldon Redux: Information Asymmetry, Accountability and Fiduciary Loyalty, OXFORD J. LEGAL. STUD. (forthcoming); *see also* S.J. Stoljar, *The Transformations of Account*, 80 L.Q. REV. 203 (1964); PAUL BRAND, KINGS, BARONS AND JUSTICES: THE MAKING AND ENFORCEMENT OF LEGISLATION IN THIRTEENTH-CENTURY ENGLAND (2003).

[2] I borrow this term from MATTHEW CONAGLEN, FIDUCIARY LOYALTY: PROTECTING THE DUE PERFORMANCE OF NON-FIDUCIARY DUTIES (2011).

in the fiduciary's unwaivable duty to account, at the core of which lies a duty of full disclosure. Notwithstanding substantial differences between fiduciary relations and insurance relations, this legal regime is not unlike the duty of full disclosure that is part of the duty of utmost good faith in traditional insurance law. In both cases, severe information asymmetries that threaten the viability of a market for socially important services call for societal-level legal intervention.

II. FIDUCIARY RELATIONS: PROFESSOR WILLIAMSON MEETS LORD ELDON

In the basic scenario of fiduciary relations there is a party operating for or on behalf of another[3] - a manager taking an office in a business corporation, an attorney representing a client in court, a partner joining a partnership. Scenarios of this type give rise to Hohfeldian power-liability relations.[4] Power entails the former party's ability unilaterally to affect the interests of the latter party, who is liable to that power. The desirable legal regime for such relations should strive to bring the use of power to a socially optimal level. Since firm-manager, client-attorney and similar relations are crucial for the functioning of teams, groups, and organizations in the society, such an optimal level of power should allow individuals maximum freedom in forming these relations on the one hand, while bringing the abuse of power to a minimum on the other hand (with "abuse" indicating use that is incompatible with social conventions).

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[3] *See Bristol and West Building Society v. Mothew* [1998] Ch 1, 18.

[4] *See* Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning,* 23 YALE L.J. 16 (1913). On power in fiduciary relations *see* Paul B. Miller, *Justifying Fiduciary Duties*, 58 MCGILL L. J. 969 (2013); Paul B. Miller, *The Fiduciary Relationship*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 63 (Andrew S. Gold & Paul B. Miller eds., 2014).

Several strands of economic literature address these issues.[5] Most closely related to the subject matter is "agency theory", which deals with principal-agent relations.[6] Here, a business owner hires a manager to help her run the business. Agency theory analyses the difficulties that arise from potential conflicts between the parties (the "agency problem"), the mechanisms that may mitigate these difficulties, and the costs entailed by the problem and by its mitigation ("agency costs"). Agency theory is affiliated with the broader field of inquiry of "(incomplete) contract theory", which deals with designing incentive schemes (contracts) for situations, in which adversary parties seek to cooperate but fear that their counterparty might renege on their undertakings.[7] Such contracts may vary from simple promises to supply goods or services to more complex franchise agreements[8] to full-fledged agency relations. These theories in turn are linked to the "theory of the firm", which considers cases where parties altogether abandon contracts as a means for cooperation in favor of hierarchical arrangements (firms) or simply ownership,[9] and to "transaction cost

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[5] *See* Paul Walker, *Contracts, Entrepreneurs, Market Creation and Judgement: The Contemporary Mainstream Theory of the Firm in Perspective*, 29 J. ECON. SURVEYS 317 (2015); *see also* Philippe Aghion & Richard Holden, *Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?*, 25 J. ECON. PERSPECTIVES 181 (2011). For law-and-economics-oriented discussions *see* Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 89 BOSTON U. L. REV. 1038 (2011); Robert Flannigan, *The Economics of Fiduciary Accountability*, 32 DEL. J. CORP. L. 393 (2007); Anthony Duggan, *Contracts, Fiduciaries and the Primacy of the Deal*, in EXPLORING PRIVATE LAW 275 (Elise Bant & Matthew Harding, eds., 2010); for early contributions *see* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425 (1993).

[6] The obligatory references are Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

[7] *See e.g.*, J Jean-Jacques Laffont & David Martimort, THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL (2002).

[8] *See* Francine Lafontaine, *Agency Theory and Franchising: Some Empirical Results*, 23 RAND J. ECON. 263 (1992).

[9] For the classic exposition *see* Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); *see also* OLIVER HART, FIRM, CONTRACTS, AND FINANCIAL STRUCTURE (1995) (hereinacter HART 1995); Douglas B. Bernheim & Michael Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88

economics", which analyses contracts and firms through a lens that focuses on hindrances to the formation of and compliance with contracts.[10] These theories are now highly interrelated.

At bottom, all agency/fiduciary relations face a similar fundamental challenge: opportunism. Oliver Williamson famously defined it as follows:

> By opportunism I mean self-interest seeking with guile. This includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating. Opportunism more often involves subtle forms of deceit. Both active and passive forms and both ex ante and ex post types are included. ... More generally, opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse. It is responsible for real or contrived conditions of information asymmetry, which vastly complicate problems of economic organization.[11]

The key point for understanding the menace posed by opportunism is that it is a binary compound. Two distinct factors - one motivational and one informational - interact with one another and together engender the problem. Williamson's compact definition - "self-interest seeking with guile" - reflects both facets. The motivational factor is self-interestedness; it is (nearly) straightforward. The informational factor refers to information asymmetries, while adding to it an element of nastiness - reflected in "guile" - that alludes to the elusive nature of its operation.

AM. ECON. REV. (1998) 432; Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1998); Oliver Hart, *Incomplete Contracts and the Theory of the Firm*, 4 J. L. ECON. & ORG. 119 (1988).

[10] *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975) (hereinafter "WILLIAMSON 1975"); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985) (hereinafter "WILLIAMSON 1985"); *see also* Walker, *supra* note 5; Oliver E. Williamson, The *Theory of the Firm as Governance Structure: From Choice to Contract*, 16 J. ECON. PERSP. 171 (2002); Oliver D. Hart, *Thinking about the Firm*, 49 J. ECON. LIT. 101 (2011).

[11] WILLIAMSON 1975, *supra* note 10, at 47-48. Gordon Smith refers to additional definitions of opportunism. *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002). Those definitions don't capture the compound quality that Williamson's definition does.

A. Motivation

In unpacking opportunism here, I will touch on the motivational factor relatively briefly. The basic rationality assumption in neo-classical economics holds that individuals act with a view to maximizing their expected utility - namely, that people, agents included, will prefer courses of action that they hope will further their personal interest as much as circumstances allow. Objections to this view need not resort to accusations against *homo economicus*. People in numerous situations take others' interests into account at the expense of their own.[12] In tandem, individuals also differ in their preferences for authority and power regardless of the cost or benefit that they may entail.[13] These observations should be considered together with broader findings in social psychology about individual-level diversity in motivational profiles as reflected in personal value preferences that include pro-social preferences.[14]

Any general stance about people's propensity for opportunism - and (fiduciary) law must take a general stance on this issue - thus runs the risk of misfit with regard to individuals with less opportunistic motivational profiles. Adopting such a stance in legal policy inevitably entails social costs due to such misfit. On the one hand, a regime that erred on the safe side by assuming a ubiquitous inclination to opportunism may inhibit other-regarding motivations among certain individuals due to a crowding out effect.[15] It might consequently enhance rather than inhibit

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[12] *See* Joel Sobel, *Interdependent Preferences and Reciprocity*, 43 J. ECON. LIT. 392 (2005); Stefano DellaVigna, *Psychology and Economics: Evidence from the Field*, 47 J. ECON. LIT. 315 (2009).

[13] *See* Ernst Fehr, Holger Herz & Tom Wilkening, *The Lure of Authority: Motivation and Incentive Effects of Power*, 103 AM. ECON. REV. 1325 (2013).

[14] *See* Amir N. Licht, *Law for the Common Man: An Individual-Level Theory of Values, Expanded Rationality, and the Law*, 74 L. & CONTEMP. PROBS. 175 (2011).

[15] *See* Dirk Sliwka, *Trust as a Signal of a Social Norm and the Hidden Costs of Incentive Schemes*, 97 AM. ECON. REV. 999 (2007); Tore Ellingsen & Magnus Johannesson, *Pride and Prejudice: The Human Side of Incentive Theory*, 98 AM. ECON. REV. 990 (2008); *see also* Kristen Underhill, *When Extrinsic*

opportunism in particular cases. On the other hand, a regime that ignored the risk of opportunism, allowing individuals to bring out the good in them, might encourage opportunistic behavior by unscrupulous agents. This, while discouraging potential principals from entering into power-liability relations, and thus inhibiting cooperation among individuals in joint projects.

Courts have looked at this aspect of human nature in the context of fiduciary relations with a combination of sobriety, compassion, and alarm. Already in *Keech v. Sandford*, which involved a trustee taking a business opportunity that the beneficiary could not have exploited, Lord King alluded to selfish motivations as so self-evident that they need no explication:

> [I]t is very proper that rule should be strictly pursued, and not in the least relaxed; for it is very obvious what would be the consequence of letting trustees have the lease, on refusal to renew to *cestui que* use. [16]

The House of Lords expressed this assumption more explicitly in *York Buildings Co. v. Mackenzie*:

> He that is entrusted with the interest of others, cannot be allowed to make the business an object of interest to himself; because from the frailty of nature, one who has the power, will be too readily seized with the inclination to use the opportunity for serving his own interest at the expence of those for whom he is entrusted.[17]

The most famous formulation perhaps of the judicial perception of fiduciaries' innate self-interestedness is Lord Herschell's dictum in *Bray v. Ford*:

> I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect.[18]

Incentives Displace Intrinsic Motivation: Designing Legal Carrots and Sticks to Confront the Challenge of Motivational Crowding-Out, 33 YALE J. ON REG. 213 (2016).

[16] (1726) Sel. Cas. Ch. 61.

[17] (1795) 8 Bro. P.C. 42, 63, 3 E.R. 432, 446; *see also Breen v. Williams* (1996) 186 CLR 71, [27].

[18] [1896] AC 44, 51.

In line with these judicial observations, current literature, too, has underscored the motivational factor of self-interestedness as a focal concern for fiduciary law.[19] In this context, self-interest should be construed broadly. It encompasses, in addition to the fiduciary's own personal interest, any other interest that is not strictly the beneficiary's. That the fiduciary cares enough about an interest that if foreign to the beneficiary - namely, that "a real sensible possibility of conflict"[20] arises - makes that interest sufficiently related to the fiduciary's self so as to potentially distract her attention from fulfilling her fiduciary mission.[21] Seen this way, legal concerns about self-interestedness support the strict no-conflict rule as a prophylactic protection with regard to both duty-interest and duty-duty conflicts.

B. Information

Let us turn to information asymmetries, which, I will argue, provide a more compelling justification for fiduciary law's strict approach to fiduciary loyalty. Recall the guile element in Williamson's conception of opportunism, and consider a generic setting in which P engages A to perform a task on P's behalf that involves discretionary management of assets. Milgrom and Roberts explicate the implications of the agent's informational advantage:

> Only the agent knows what action he has taken in pursuit of his or the principal's goals, or only the agent has access to the specialized knowledge on which his action is based. The principal's problem is to design a compensation and control (monitoring) system that attracts and retains good agents and motivates them to behave appropriately (in the principal's interest). The asymmetry of information

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[19] *See*, in particular, Lionel Smith, *Can We Be Obliged to be Selfless?*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 41 (Andrew S Gold & Paul B Miller eds., 2014); Lionel Smith, *Deterrence, Prophylaxis and Punishment in Fiduciary Obligations*, 7 J. EQUITY 87 (2013); Lionel Smith, *The Motive, Not the Deed*, in RATIONALIZING PROPERTY, EQUITY AND TRUSTS: ESSAYS IN HONOUR OF EDWARD BURN 53 (Joshua Getzler ed., 2003). See also Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Robert Flannigan, *The Core Nature of Fiduciary Accountability*, 2009 N.Z. L. REV. 375; Paul B Miller, *The Fiduciary Relationship*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 63 (Andrew S Gold & Paul B Miller eds., 2014).

[20] *Boardman v. Phipps* [1967] 2 A.C. 46, 124 (Upjohn LJ).

[21] *See* CONAGLEN, *supra* note 2.

> prevents easy determination of whether a particular observed action or outcome corresponds to desirable behavior and thus renders the problem nontrivial.[22]

Conceptually, three types of information incompleteness may cause the principal to be at an informational disadvantage vis-à-vis his agent:[23]

Costly information - Both parties have an incentive to agree to a variety of monitoring mechanisms, including stock taking, reports, audits, surveillance systems, etc., which would deter the agent from breaching because they would provide proof of the breach. Such mechanisms are costly, however, in terms of direct expenses for installing them and the resources to be spent by both parties on compliance and review. But for human nature being what it is, monitoring would have been wasteful. In reality, it is not. Beyond a certain threshold, where its marginal cost equals marginal product, monitoring ceases to be worthwhile. Both parties will then expect the agent to be swayed by interest more than by duty.

Unobservable information - A necessary condition for the principal to be able to protect his rights is to know about a breach. In certain circumstances, however, information about performance or breach and about the circumstances surrounding it (referred to as the "state of nature") might be unavailable. This will be the case, for instance, if the agent has unique skills, for which reason she may have been hired in the first place, such that the principal cannot assess her performance. After discounting the possibility of hiring experts to monitor the agent - which would shift the analysis to information costs - there will remain situations in which the principal may be ignorant of the agent's breach as well as of circumstances that might justify it. In other cases, the parties may be unable even to imagine certain future contingencies

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[22] Paul Milgrom & John Roberts, *An Economic Approach to Influence Activities in Organizations*, 94 AM. J. SOC. S154, S154-S155 (1988).

[23] Economists differ in the emphasis they give to each type of incompleteness. *See*, generally, HART 1995, *supra* note 9; Laffont & Martimort, *supra* note 7; Walker, *supra* note 5.

and therefore fail to stipulate them in the contract.[24] Such a situation is conceptually equivalent to ex ante non-observability because if such an unstipulated contingency materialized the agent could take advantage of it with impunity.

Unverifiable information - It often happens that both the principal and the agent are well aware that the latter had breached her undertaking, as both of them have the special skills needed to observe the breach, yet the principal cannot enforce his right to performance as agreed or sue for another remedy because the information about the breach is beyond the grasp of a judge. Generally stated, the principal may be unable to verify certain information to an objective third party. Such cases may involve issues that are impressionistic by nature like quality, effort, and so forth. Frustrating as it may be for the principal, this type of information asymmetry allows the agent to take advantage of the principal at least by providing "perfunctory" rather than "consummate" performance.[25]

The source of the fiduciary's power lies in these information asymmetries. Information asymmetries create "blind spots", in which the agent can operate beyond any means of control by the principal. When coupled with self-interestedness, these two factors render the agency problem a problem without solution. Granted, every voluntary relationship exhibits some level of information asymmetry that gives rise to power and vulnerability. Franchisees, contractors, landlords - indeed, even tenants - all have opportunities for opportunism in performing their contracts. However, some voluntary relations - those that the law classifies as fiduciary - stand out in that their

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[24] *See* Jean Tirole, *Cognition and Incomplete Contracts*, 99 AM. ECON. REV. 265 (2009); *see also* Herbert A. Simon, *A Formal Theory of the Employment Relationship*, 19 ECONOMETRICA 293 (1951).

[25] *See* WILLIAMSON 1975, *supra* note 10, at 69; *see also* Oliver Hart & John Moore, *Contracts as Reference Points*, 123 Q. J. ECON. 1 (2008); Ernst Fehr, Oliver Hart, & Christian Zehnder, *Contracts as Reference Points - Experimental Evidence,*101 AM. ECON. REV 493 (2011); *compare* Erik Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83 (1999).

very purpose is to vest one party with discretionary power over interests of the other.[26]

All that society can hope for, therefore, is to minimize the adverse effects of the agency problem in the light of human fallibilities. Between the two factors that cause this problem, incomplete information is more acute than self-interestedness. People in general are aware of the possibility of their counterparty's selfishness. While they may vary in their assessments about its likelihood and severity, people can make choices on the means they may want to implement for coping with it. More importantly, in addition to individual-level countermeasures for coping with opportunism and in addition to formal (legal) measures which are the topic of this paper, societies implement informal (non-legal) social institutions to curb selfish behaviour through cultural orientations and social norms. In contrast, information asymmetry resembles a force of nature in that no individual-level or societal-level mechanism can help one know what one cannot know beyond the information one can obtain. Cultures vary in their treatment of uncertainty - namely, the unknowable - but they cannot affect it.[27]

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[26] The literature proposes to overcome this problem through ownership or using fixed-claim rather than open-ended contracts. *See* Jeremy C. Stein, *Agency, Information and Corporate Investment*, in HANDBOOK OF THE ECONOMICS OF FINANCE 109 (G.M. Constantinides et al. eds., 2003). These options are irrelevant for fiduciary relations, which are established for delegating discretionary power to the agent.

[27] On the importance of social norms against opportunism in the United Kingdom *see* JOEL MOKYR, THE ENLIGHTENED ECONOMY: AN ECONOMIC HISTORY OF BRITAIN 1700-1850 384-386 (2009). I leave the implications of cultural diversity on the regulation of fiduciary relations and accountability for another occasion. *See, generally*, Amir N. Licht, *Culture and Law in Corporate Governance*, in OXFORD HANDBOOK ON LAW AND CORPORATE GOVERNANCE (Jeff Gordon & Gerog Ringe, eds., forthcoming 2016).

Courts began to recognize these insights and translate them to doctrine already during the 18th century.[28] According to the report of *Whelpdale v. Cookson*, a 1747 case involving a purchase of trust assets by the trustee, Lord Hardwicke said he "would not allow it to stand good, although another person being the best bidder bought it for him at a public sale; for he knew the dangerous consequence: nor is it enough for the trustee to say, you cannot prove any fraud, *as it is in his own power to conceal it*".[29] Citing *Keech* and *Whelpdale* with agreement, the House of Lords in *York Buildings* in 1795, found support for a strict "no profit" policy in the combination of self-interestedness and information asymmetry:

> The danger of temptation, from the facility and advantages for doing wrong, which a particular situation affords, does, out of the mere necessity of the case, work a disqualification; nothing less than incapacity being able to shut the door against temptation where the danger is imminent, and *the security against discovery great*, as it must be where *the difficulty of prevention or remedy is* inherent *to the very situation* which creates the danger.[30]

The legal repercussions of information asymmetry in fiduciary relations came to full fruition in a series of decisions by Lord Eldon. *Lacey*[31], *James*[32], and *Bennett*[33] all dealt with actors in fiduciary positions - a trustee in the first case and solicitors to a commission of bankruptcy in the other two - who had purchased estate property in circumstances that were objectively fair (e.g., in an open bidding), without causing harm to the beneficiary, and without allegations of fraud. In *Lacey*, Lord Eldon emphasised that neither the beneficiary nor the court have effective means for

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[28] For a thorough analysis *see* Joshua Getzler, *Rumford Market and the Genesis of Fiduciary Obligations*, in MAPPING THE LAW: ESSAYS IN MEMORY OF PETER BIRKS, 577 (Andrew Burrows & Alan Rodger eds., 2006).

[29] (1747) 1 Ves. Sen. 9, 27 E.R. 856 (emphasis added).

[30] *York Buildings*, *supra* note 17, at 64. The case dealt with a solicitor acting on behalf of creditors of a bankrupt's estate.

[31] Ex parte *Lacey*, (1802) 31 E.R. 1228.

[32] Ex parte *James* (1803) 32 E.R. 385.

[33] Ex parte *Bennett* (1805) 32 E.R. 893.

obtaining private valuable information that the fiduciary may have acquired in connection with her office:

> [The trustee] must according to the rules of this Court be watched with infinite and the most guarded jealousy; and for this reason; that the Law supposes him to have acquired all the knowledge a trustee may acquire; which may be very useful to him; but the communication of which to the *Cestuy que* trust the Court can never be sure he has made. … though you may see in a particular case, that he has not made advantage, it is utterly impossible to examine upon satisfactory evidence in the power of the Court, by which I mean, in the power of the parties, in ninety-nine cases out of an hundred, whether he has made advantage, or not.[34]

Lord Eldon repeated these ideas in *James*, where he opened by stating that "no Court is equal to the examination and ascertainment of the truth in much the greater number of cases."[35] Alluding to *Keech*, in which there was no alternative to the purchase by the trustee, he said that nonetheless, "even in such a case it is so difficult to be sure, there was not management, a difficulty, that might exist in a much greater degree in many other cases".[36] The trustees, Lord Eldon pointed out, are "out of the reach of investigation".[37] Moreover, the whole situation is hopeless: a professionally informed trustee is simply beyond the grasp of the court.[38] The upshot is that "the trustee or solicitor bringing [an asset] to sale may have a great deal of information... So there may be a great many clandestine dealings, which may bring it to a price far short of that, which would be produced, if full information was given."[39]

In *Bennett*, Lord Eldon consolidated *Whelpdale*, *York Buildings*, *Lacey*, and *James* into a general principle that "the safety of mankind requires".[40] The

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[34] *Lacey*, *supra* note 31, at 1228, 1229.

[35] *James*, *supra* note 32, at 345.

[36] *ibid*.

[37] *ibid*, at 346.

[38] *ibid*, at 348–349.

[39] *ibid*, 349–350.

[40] *Bennett*, *supra* note 33,, at 385, 393, 395–396; *compare Parker v. McKenna* (1874-1875) L.R. 10, Ch. App. 96, 124-125.

justification for a strict principle against unauthorised purchases rests on "human infirmity [which] will in very few instances permit a man to exert against himself that providence" - namely, self-interestedness *a la York Buildings* and *Bray* - coupled with the risk that the fiduciary may obtain special information while "all the rest of the world may be ignorant of that circumstance' and without the court being able to 'get a discovery of the fact, that he acquired that knowledge before the sale; and never communicated it."[41] In sum,

> the Court can with as little effect examine, whether that was done by making an undue use of the information, received in the course of their duty, in the one case as in the other. No court of justice could institute investigation to that point effectually in all cases;… the inquiry into the truth of the circumstances may fail in a great proportion of cases.[42]

These decisions reveal deep concerns about information asymmetries in fiduciary relations. Even the extensive quotes above do not do justice to the scope that he dedicated to analyzing this subject, while taking self-interestedness for granted or mentioning it in passing. According to Lord Eldon, the danger to beneficiaries and to courts lurks in the sphere that is known and knowable only to the fiduciary and is unknown and unknowable to the beneficiary and to the court. Albeit without using modern economic jargon, his analysis exhibits an understanding of and sensitivity to all three types of information asymmetry that current economic theory distinguishes - in particular, due to unobservability and unverifiability.

While *Lacey* and its progeny are cited as authorities to this day, Lord Danckwerts in *Holder v. Holder* questioned Lord Eldon's reasoning "in the light of Lord Bowen's famous dictum that 'the state of a man's mind is as much a matter of fact as the state of his digestion', and the almost daily experience of any judge

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[41] *ibid*, at 394.

[42] *ibid*, at 400.

engaged in ascertaining the knowledge and intentions of a party to proceedings."[43] Langbein thus argues that "much of the concern voiced by Hardwicke, Eldon, and Kent—that without the sole interest rule the beneficiary would be not able to prove trustee misbehavior—is archaic" due to subsequent "revolution in Equity's fact-finding".[44] Relatedly, Gilson and Schwartz claim that "[a]n effective court commonly can recover the facts relevant to answering this question [of fairness]. Contract terms and prices are verifiable, market prices for similar transactions may exist, and expert testimony is often useful. Hence, courts can effectively police self-dealing."[45]

These views share a common weakness, that, to a varying degree among authors, they are tautological. Their authors *assume* that in exercising *ex post* review of fiduciary action tainted by breach of loyalty - in particular, self-dealing - the court can obtain the necessary information. In this view, the court is constrained only by its own expertise and the sophistication of the legal ecosystem in which it operates, including procedural rules, litigation lawyers, other experts, etc. This problem is particularly salient in Gilson and Schwartz's approach, who explicitly make this assumption while referring to observable information.[46] Langbein's view, too, focuses on observable, though costly, information, as it hinges on the drop of information gathering costs. Improved competence of the court - due to experience,

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[43] [1968] Ch 353, 398.

[44] John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 947 (2005); *see also* Andrew D. Hicks, *The Remedial Principle of Keech v Sandford Reconsidered*, 2010 CAMB. L.J. 287.

[45] Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review*, 169 J. INSTITUTIONAL & THEORETICAL ECON. 160, 167 (2013). This article originated in a report the authors filed on behalf of certain Israeli pyramid groups analyzing a proposed corporate governance reform program.

[46] In a separate paper, Gilson and Schwartz assume that information may be unverifiable and at times, unobservable, but also assume that some level of unregulated unilateral taking by the fiduciary is socially desirable. *See* Ronald J. Gilson & Alan Schwartz, *Corporate Control and Credible Commitment*, 43 INT'L REV. L. & ECON. 119 (2015).

technology, etc. - may indeed increase the amount of available information and thus decrease the scope of fiduciary breach. However, no level of expertise can overcome the disadvantage stemming from unobservable and unverifiable information. This information inferiority is existential, deriving from our qualities as human beings.

Several scholars consider the informational challenge as serious. Getzler, for example, integrates the evidential aspect with the detection aspect, rephrased in modern economic terminology as "costs of monitoring".[47] Cox gets closer to the crux of the matter, arguing that "the informational advantages of those in control [in a corporation] permits them… to understand better than outside shareholders the full effects of a bylaw change they propose. As a consequence, they can act opportunistically to pursue self-interested ends, the effects of which only they can be fully aware."[48] I have argued elsewhere that the fiduciary obligation to account emerged as a social institutional response to information asymmetries, especially of the unobservable and unverifiable kind - originally in distinct categories like bailiff and receiver in the Middle Ages, and later gradually expanding into a general category of fiduciaries.[49]

The upshot is that fiduciary relations emerge as a legal regime in certain circumstances in order to regulate the power that stems from information asymmetries (coupled with self-interestedness). The fiduciary "is not subject to fiduciary obligations because he is a fiduciary; it is because he is subject to them that he is a

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[47] *See* Getzler, *supra* note 28, at 586-589; *see also* Joshua Getzler, *"As If." Accountability and Counterfactual Trust*, 91 B.U. L. REV. 973, 986–987 (2011); Charles Mitchell, *Causation, Remoteness, and Fiduciary Gains*, 17 KING'S COLLEGE L.J. 325, 326 (2006); Robert Flannigan, *The Strict Character of Fiduciary Liability*, 2006 N.Z. L. REV. 209, 235-237.

[48] James D. Cox, *Corporate Law and the Limits of Private Ordering*, WASH. U. L. REV. (forthcoming 2016), http://ssrn.com/abstract=2671850, at 18. *See also* Robert H. Sitkoff, *An Agency Cost Theory of Trust Law*, 89 CORNELL L. REV. 621, 636-639 (2004).

[49] *See* Licht, *supra* note 1.

fiduciary."[50] Moreover, the regime of fiduciary loyalty is not limited to a strict proscription of action while there is a real sensible possibility of conflict. This is only one facet of the duty of loyalty. Another facet, of equal importance, is a duty of full disclosure. Fiduciary loyalty thus consists of two components, each one designed to counter a respective element in the problem of opportunism. The no-conflict rule addresses self-interestedness, while the full disclosure duty addresses information asymmetries. Neither limb of the duty of loyalty can eradicate its respective phenomenon. Managers, guardians, and lawyers remain selfish, while companies, wards, and clients are often clueless. All we can hope for is that fiduciary law could minimize the likelihood of opportunism to a level that would enable teams, organizations, etc. to function.[51]

III. INSURANCE: LORD MANSFIELD MEETS PROFESSOR DIXIT

Full disclosure thus emerges as a crucial element in fiduciary loyalty. The following Part draws on the above insights to develop a theory on the limits of the negotiability of fiduciary obligations. To buttress that argument from a different angle, this Part takes a brief look at the obligation of full disclosure that insurance law imposes on the insured. At first glance, fiduciary relations and insurance relations could not be more different. In the former, the power that the fiduciary enjoys is clear because of her control over the beneficiary's assets. In insurance relations, we usually perceive the insurer as more powerful and the insured - as deserving law's protection. Hence the long-standing rule that ambiguity of exclusion clauses generally would be construed against the insurer, invariably the drafting party; and, more fundamentally,

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[50] *Mothew*, *supra* note 3, at 18, citing PAUL D. FINN, FIDUCIARY OBLIGATIONS 2 (1977).

[51] *See* Licht, *supra* note 1.

that insurance policies are a special specie of contracts, the interpretation of which is different than that of regular contracts, being stricter with the insurer.[52] In certain contexts, however, the insured enjoys an informational superiority vis-à-vis the insurer that is so consequential that the law thwarts it in the strictest of measures.

Traditional insurance law classifies insurance policies as contracts of "utmost good faith" (*uberrima fides*; the contract is said to be *uberrimae fidei*). Crucially, this doctrine imposes on the *insured* a pre-contractual duty to make full disclosure of all material information. Failure to observe this duty entitles the insurer to avoid the policy and thus completely escape liability - undoubtedly, a harsh consequence. The insured's full disclosure duty originated in the seminal decision by Chief Justice Mansfield in *Carter v. Boehm*, where he said:

> Insurance is a contract on speculation: the special facts usually lie in the knowledge of the insured only. The underwriter trusts to him, that he conceals nothing, so as to make him form a wrong estimate. If a concealment happens without any fraudulent intention by mistake of the principal or his agent, still the policy is void, because the risk, which is run, is not that which the underwriter intended.[53]

Lord Mansfield was at the time attempting to introduce into English commercial law a general principle of good faith, known in Civil Law and in the Law Merchant, an attempt which was ultimately unsuccessful. Lord Mansfield further defined this rule as a rule of law, as opposed to a presumption about an implied

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[52] References are legion. *See*, recently, the Australian Federal Court decision in *Todd v. Alterra at Lloyds Ltd (on behalf of the underwriting members of Syndicate 1400)* [2016] FCAFC 15, [40].

[53] (1766) 96 E.R. 342. The following draws liberally on Lord Hobhouse's opinion in *Manifest Shipping Company Limited v. Uni-Polaris Shipping Company Limited ("The Star Sea")* [2001] UKHL 1, [40]-[50]; *see also* Stephen Watterson, *Carter v Boehm (1766)*, in LANDMARK CASES IN THE LAW OF CONTRACT 59 (Charles Mitchell & Paul Mitchell eds., 2008); Rob Merkin & Özlem Gürses, *The Insurance Act 2015: Rebalancing the Interests of Insurer and Assured*, 78 MODERN L. REV. 1004 (2015); Warren J. Marwedel & Stephanie A. Espinoza, *Dagger, Shield, or Double-Edged Sword?: The Reciprocal Nature of the Doctrine of* Uberrimae Fidei, 83 TUL. L. REV. 1163 (2009); Hilary K Wham, *If They Wanted to Know, Why Didn't They Ask? A Review of the Insured's Duty of Disclosure*, 20 AUCKLAND U. L. REV.73 (2014).

contractual term.[54] Subsequent developments distinguished insurance contracts as contracts of utmost good faith, and forged the rule of the insured's full disclosure duty with its uniquely strict remedy. This rule is part of a broader regime that governs both the insured and the insurer and applies, in addition to the pre-contractual state, also through the duration of and even after the contract period. The English Marine Insurance Act, 1906 codified *Carter* and subsequent case law, including the insured's duty of full disclosure on pain of policy avoidance. This regime applied beyond marine insurance to all insurance contracts.[55] Material information has been defined as facts which would influence the judgment of a prudent underwriter, yet it need not have actually affected the final underwriter's decision.[56] One problematic practice that has developed in connection with the insured's disclosure duty was the "long-standing problem of 'data-dumping', whereby a broker or assured provides a mass of information, often in CD form, which contains deeply buried material information."[57]

Legislative reforms in Australia and in the U.K. introduced substantial changes to the traditional regime.[58] The details of these reforms are beyond the present scope. Suffice is to say that they were motivated, among other things, by modern considerations of consumer protection and business practice. Merkin and Gürses write with regard to U.K. law that "the duty of disclosure has been retained for business policies, reflecting the established market reliance on disclosure, so that a business assured remains under the dual obligations to disclose and not to

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[54] *See Pawson v. Watson* [1778] 2 Cowp. 785; 98 E.R. 1361, 1362.

[55] *See Pan Atlantic Insurance Co. v. Pine Top Insurance Co. Ltd*. [1995] 1 AC 501; *The Star Sea*, *supra* note 53.

[56] *See Pan Atlantic Insurance*, *id.*; Merkin & Gürses, *supra* note 53, at 1008-1009.

[57] Merkin & Gürses, *supra* note 53, at 1011.

[58] *See*, respectively, Insurance Contracts Act 1984 (Aust.), Insurance Act 2015 (U.K.).

misrepresent material circumstances."[59] The nature of insurance contracts as contracts of utmost good faith was retained as an interpretive principle.[60]

An economic analysis of the insured's full disclosure duty sheds light on its underlying logic and thus helps in understanding the fiduciary duty of full disclosure. Insurance is a transaction on risk.[61] For a price, the insurer takes upon itself an economic risk that the insured would rather be relieved from because he is more risk averse.[62] Insurers can sustain a viable business model only if they can assess the risk incidence accurately enough. For this task they depend crucially on information about the particular insured in relation to the entire population. Information asymmetries bedevil the insurance relations both before and during the insurance period, however. These asymmetries prevent the insurer from accurately pricing her risk in a particular contract because the insured may fail to disclosure in the pre-contractual stage that he is prone to that risk (consider careless driving - known as "adverse selection"), or, knowing that he is fully covered once the contract is in force, he may become more prone to that risk (known as "moral hazard"). As Akerlof has shown in his model of the "market for lemons", when contracting is susceptible to

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[59] Merkin & Gürses, *supra* note 53, at 1009-1010. The U.K. Consumer Insurance (Disclosure and Representations) Act 2012 already imposed on consumers a duty to take reasonable care to avoid misrepresentation, thereby abolishing any disclosure requirement and leaving the onus squarely on the insurers to ask questions. *Id.*

[60] Merkin & Gürses, *supra* note 53, at 1008.

[61] *See* Georges Dionne et al., *Adverse Selection in Insurance Contracting*, in HANDBOOK OF INSURANCE 231 (Georges Dionne ed., 2nd Ed. 2013); *see also* Pierre-Andre Chiappori & Bernard Salanié, *Asymmetric Information in Insurance Markets: Predictions and Tests*, *id.*, at 397; *compare* Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223 (2004).

[62] The insured need not be human to be risk averse. While firms are not emotionally risk averse, their stakeholders may be and thus may prefer the firm to avoid excessive business fluctuations.

information asymmetries of this sort, a spiral dynamic, in which "the 'bad' cars tend to drive out the good",[63] may ensue, and the market may collapse.

Insurers are not entirely at the mercy of their insureds. Had they been, a market for insurance could not have existed. Insurers thus may design the contract with a view to minimizing the scope of the problem. For example, insurers may require a deductible or impose a cap on coverage.[64] Insurers also can request information. Yet asking questions is helpful only to a degree because the most sensitive information could be unobservable or unverifiable, such that the insured could fail to respond with impunity.

Against this backdrop, Dixit has analyzed the problem at the social institutional level - that of the law - in addition to the individual level - that of the contract.[65] Roughly put, Dixit vindicates Lord Mansfield's strict approach in *Carter v. Boehm*. Somewhat more technically, Dixit considers insurance contracting where the contract is under *uberrima fides* when an insured makes full disclosure of all facts pertaining to his risk that are known to him ex ante. The insurer may ask questions about the individual risk at the pre-contractual stage but may investigate the truth only when the claim is made, to reduce the audit costs. If the answers are found ex post to be false the insurer can refuse to pay the claim. Dixit shows that this *uberrima fides* legal rule is Pareto-improving when compared to the purely contractual approach. This social institution thus prevents the parties from falling into an Akerlofian spiral

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[63] George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 490 (1970).

[64] The pioneering work is Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976).

[65] *See* Avinash Dixit, *Adverse Selection and Insurance with* Uberrima Fides, in INCENTIVES, ORGANIZATION, AND PUBLIC ECONOMICS: PAPERS IN HONOUR OF SIR JAMES MIRRLEES 41 (Peter J. Hammond & Gareth D. Myles eds., 2000); *see also* Avinash Dixit & Pierre M. Picard, *On the Role of Good Faith in Insurance Contracting*, in ECONOMICS FOR AN IMPERFECT WORLD: ESSAYS IN HONOR OF JOSEPH E. STIGLITZ 17 (Richard Arnott et al. eds., 2003).

that could end in market failure - a clearly undesirable result inasmuch as insurance markets are concerned.[66]

The above insights shed new light on fiduciary relations. There are both similarities as well as differences between the two relationships that explicate the fiduciary's duty of full disclosure. In both cases, a duty of full disclosure is implemented to counteract potentially devastating consequences of contract failure due to information asymmetries. The type of relevant information is also similar. The definition of material information in English insurance law is remarkably close to the way American (corporate) fiduciary law defines this concept, where an information item is material if there is a substantial likelihood that a reasonable shareholder would consider it important in making a decision. This requirement is satisfied if the disclosure of an omitted fact would have been viewed by the reasonable shareholder/investor merely as having significantly altered the total mix of the information made available.[67] The U.S. "buried facts" doctrine prohibits "data dumping" in the context of corporate disclosure,[68] not unlike the situation in the English insurance context. Both cases exemplify "obfuscation" in Williamson's description of opportunistic behavior, where apparent compliance is in fact abusive.

The need for a strict full disclosure duty is in fact more pressing in fiduciary relations because principals in many fiduciary relations cannot fend for themselves as insurers can. First, while insurers are economically powerful, as this is a pre-requisite for their business operation, beneficiaries come in all shapes and sizes, including the

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[66] Dixit, *id.*, at 42, notes that "in France, where the legal system is different, a similar doctrine is enforced even more strictly."

[67] *See Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944-45 (Del. 1985), implementing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

[68] *See, e.g., Blanchette v. Providence & Worcester Co*., 428 F.Supp. 347 (D. Del., 1997); Michael R. Siebecker, *Trust & Transparency: Promoting Efficient Corporate Disclosure through Fiduciary-Based Discourse*, 87 WASH. U. L. REV. 115, 131-134 (2009).

meekest and poorest. Second, insurers operate on the basis of statistical assessments of risks based on large amounts of information that they gather about the entire population. Insurers face multiple clients whose distribution approximates that of the population, and can (and are often required to) resort to consortium fellows and reinsurers in order further to spread the idiosyncratic risk in their portfolio. In contrast, fiduciary relations, more often than not, have a one-on-one structure or close to that. Regardless of her economic clout, a typical beneficiary in such relations does not have access to the background information needed for recognizing and assessing likely manifestations of opportunism by her fiduciary. Third, and perhaps most fundamentally, a key factor in insurance relations is the claim. Once a claim is made, the insurer gets an opportunity to investigate it and perhaps discover information that would invalidate it. If the insured does not make a claim for coverage, she does not care about any opportunistic behavior the former may engage in. In fiduciary relations, however, the fiduciary can engage in both types of opportunistic behavior - namely, taking ("looting" or "tunneling") and neglect ("shirking") - without ever making a claim to the beneficiary beyond regular claims for compensation. This feature exacerbates the beneficiary's vulnerability due to his information inferiority, which strengthen the case for a strict full disclosure regime.

IV. NEGOTIATION: FUNCTIONALITY AND THE CORE

It is trite law that a fiduciary and a beneficiary can agree on the former's duties and liability. "For a fiduciary to escape liability to account because of breach of his fiduciary duty he must show that full informed consent has been given by the

beneficiaries after a full and proper disclosure has been made."[69] Now if the beneficiary can validly agree to a single breach she can surely agree to a handful, and if so, why not to every breach? The freedom of parties to fiduciary relations to negotiate the scope of the fiduciary's legal responsibility has been hotly debated in different sub-fields of fiduciary law and in various common law jurisdictions. Drawing on the insights in the previous parts, this Part turns to the limits of contractual freedom about fiduciary duties, while focusing mainly on full disclosure. It is submitted that for fiduciary loyalty to be deserving of its title, it must retain a duty of full disclosure at its core.

A. Fiduciary Obligations: From Voluntary Undertakings to Contractual Freedom

Becoming a fiduciary is inextricably linked with voluntary undertaking. Lord Millet's statement in *Mothew*, that "[a] fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence,"[70] reflects the law in several jurisdictions.[71] In practice, hardly anyone becomes a fiduciary by accident. Even if one does find oneself in an undesired fiduciary position, one can usually resign.[72] Granted, there may be exceptions and there may be borderline cases, like parents whose

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[69] *Crown Dilmun v. Sutton* [2004] 1 B.C.L.C. 468, [137]. *See also Mothew*, *supra* note 3, at 18. But *see* a cautionary note on the effect of informed consent in Joshua Getzler, *Ascribing and Limiting Fiduciary Obligations: Understanding the Operation of Consent*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 39, 55 (Andrew S. Gold & Paul B. Miller eds., 2014).

[70] *Mothew*, *supra* note 3, at 18.

[71] *See Breen v. Williams* (1996) 186 C.L.R. 71 (Aust.); *Galambos v. Perez* [2009] 3 S.C.R. 247 (Can.). Israeli law currently adheres to a power-based theory of fiduciary loyalty. *See* CA 817/79 *Kossoy v Bank Y. L. Feuchtwanger Ltd*, 38(3) PD 253 (Isr.).

[72] *See CMS Dolphin Ltd v. Simonet* [2001] EWHC Ch 415, [87]; *but see OptimisCorp v. Waite*, 2015 Del. Ch. LEXIS 222; *Kossoy*, *id.*, for limits on this freedom.

classification as fiduciaries is controversial.[73] Controlling shareholders may inherit their control block, yet they are deemed fiduciaries of their company, at least in certain circumstance, in some jurisdictions.[74]

It is one thing to say that fiduciary service is voluntary; it is quite another thing to hold that fiduciary relations are contractual. Recently, there is a surge in scholarly discourse of this topic, especially in connection with the nature of the fiduciary office as contractual versus status-based.[75] Klass thus defends, persuasively, only a "minimalist contractualism about the content of fiduciary duties" that focuses on the fiduciary's volition.[76] Even in the earliest stages of the development of fiduciary law, centuries ago, service in a fiduciary-like position required consent. When English landlords experimented with for-profit direct farming of their manors in the 13th Century, there developed a hierarchy of proto-fiduciaries comprising stewards, bailiffs, and reeves, who were all liable to account.[77] The reeve was part of the status-based feudal system of that time, a landholding peasant, whom the unfree tenants of the manor elected annually from among themselves. Nevertheless, a reeve-elect could redeem himself from this service, thus exhibiting the necessity of consent

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[73] In Canada, parents are considered fiduciaries. See *M.(K.) v. M.(H.)* [1992] 3 S.C.R. 6 (Can.). *See generally* Elizabeth S. Scott & Robert E. Scott, *Parents as Fiduciaries*, 81 VA. L. REV. 2401 (1995); Margaret Brinig, *Parents, Trusted but not Trustees, or (Foster) Parents as Fiduciaries*, 91 B.U. L. REV. 1231 (2011).

[74] For U.S. law *see*, e.g., *Pepper v. Litton*, 308 U.S. 295 (1939); for Israel *see Kossoy*, *supra* note 71.

[75] *See*, in particular, James Edelman, *When Do Fiduciary Duties Arise?*, 126 L.Q. REV. 302 (2010); Matthew Conaglen, *Fiduciary Duties and Voluntary Undertakings*, 7 J. EQUITY 105 (2013); Daniel Markovits, *Sharing Ex Ante and Sharing Ex Post: The Non-Contractual Basis of Fiduciary Relations*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 209 (Andrew S. Gold & Paul B. Miller, eds. 2014); Stephen R. Galoob & Ethan J. Leib, *Intentions, Compliance, and Fiduciary Obligations*, 20 LEGAL THEORY 106 (2014); D. Gordon Smith, *Contractually Adopted Fiduciary Duty*, 2014 U. ILL. L. REV. 1783; Gregory Klass, *What If Fiduciary Obligations Are Like Contractual Ones?*, in CONTRACT, STATUS, AND FIDUCIARY LAW (Paul B. Miller & Andrew S. Gold, eds., 2016); Lionel Smith, *Contract, Consent, and Fiduciary Relationships*, in CONTRACT, STATUS, AND FIDUCIARY LAW, *id.*

[76] Klass, *id.*, at 3.

[77] *See* Licht, *supra* note 1; MARK BAILEY, THE ENGLISH MANOR C. 1200-C. 1500, 98-100 (2002); H.S. BENNETT, LIFE ON THE ENGLISH MANOR: A STUDY OF PEASANT CONDITIONS 1150-1400, 41-60 (1937/1962).

or volition to attaining a fiduciary role. The contract-versus-status discourse extends a literature spanning more than three decades that debates the linkage between contract and fiduciary relations. The seminal contributions that have defined the contours of this debate were made by Easterbrook and Fischell,[78] who advanced a pure contractarian view of fiduciary duties, and Cooter and Freedman,[79] who took a more reserved, nuanced position. Many other scholars have elaborated on these basic positions, taking more or less polar stances along the continuum between them.[80]

Briefly, Easterbrook and Fischel perceive the fiduciary principle as a flexible principle - a punitive implied term in a standard contract approximating a hypothetical agreement. Making the fiduciary principle a legal rule serves to save on transaction costs due to multiple negotiations, on the assumption that most parties would adopt it. It follows that this is a default rule, devoid of any essential content that must be preserved, around which the parties should be free to contract.[81] Cooter and Friedman, in contrast, argue that instances of taking by the agent are more difficult to prove than cases of neglect such that the law should be stricter with regard to breaches of loyalty. They insist that fiduciary relations also have an institutional (legal) element that is beyond the reach of the parties.

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[78] *See* Easterbrook & Fischel, *supra* note 5.

[79] *See* Cooter & Freedman, *supra* note 5.

[80] *See*, e.g., Getzler, *supra* note 69; Sikoff, *supra* note 5; Sitkoff, *supra* note 48; Langbein, *supra* note 44; John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995); John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105 (2004) ("Mandatory"); Larry E. Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899 (2011); Smith, *supra* note 75; D. Gordon Smith, *Firms and Fiduciaries*, in CONTRACT, STATUS, AND FIDUCIARY LAW (forthcoming Andrew Gold and Paul Miller eds. 2016); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303 (1999); Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67 (2005); Robert Flannigan, *The Economics of Fiduciary Accountability*, 32 DEL. J. CORP. L. 393 (2007); Anthony Duggan, *Contracts, Fiduciaries and the Primacy of the Deal*, in EXPLORING PRIVATE LAW 275 (Elise Bant & Matthew Harding, eds., 2010)/

[81] On default versus mandatory rules *see generally* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); IAN AYRES, OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS (2005).

A noteworthy branch of this debate has developed in corporate law, where the metaphor of the corporation as a "nexus of contracts" has made a tremendous impact. A sub-branch of this literature has debated "contractual freedom in corporate law" with regard to general public corporations.[82] Delaware allows for contracting around the duty of care but not with regard to the duty of loyalty or conduct not in good faith.[83] Another sub-branch exceeded the law review pages, taking shape in legislative reforms throughout the United States that created or revised contract-based business entities, most notably, the limited liability company (LLC).[84] Members of such entities can design the regime governing them in the basic documents, including by eliminating the duty of loyalty.[85] Delaware courts, however, have treated such waivers restrictively and with great reluctance.[86] Strine and Laster, observing that contractual freedom in alternative entities has increased transaction costs, propose that the governing agreement would presumptively retain the traditional fiduciary duty of loyalty, while for publicly-traded entities the duty of loyalty would be non-waivable, again, for transaction cost reasons.[87]

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[82] A seminal symposium with this title was published in Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); *see also* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV 595 (1997); Robert C. Clark, *Agency Costs versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard J. Zeckhauser eds., 1985).

[83] Delaware General Corporation Act § 102(b)(7).

[84] *See generally* LARRY RIBSTEIN, THE RISE OF THE UNCORPORATION (2010).

[85] *See*, e.g., Delaware Limited Liability Company Act § 18-1101(c), providing that fiduciary duties "may be expanded or restricted or eliminated by provisions in the limited liability company agreement", subject to provisos. The Delaware Revised Uniform Limited Partnership Act § 17-1101 includes a similar provision.

[86] *See Sutherland v. Sutherland*, 2009 Del. Ch. LEXIS 46 (2009); *see also Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160 (2002).

[87] *See* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11 (Mark Lowenstein & Robert Hillman eds., 2015).

A drawback of the debate discussed above is that it takes place at a high level of generality in that it usually treats the fiduciary office as a whole, without inquiring into its components. At this level of generality, reasonable minds can differ on the contractibility of fiduciary loyalty should they focus on different components of it. For example, Strine and Laster's position, which focuses on negotiation costs, might appear unpersuasive to adherents of Langbein's position, which dismisses the argument from costly information due to advances in technology and procedure. To sharpen the analysis one needs to identify particulars parts that may or may not be susceptible to negotiation. Such an analysis of negotiability of fiduciary obligations in non-U.S. jurisdictions has been taking place primarily under the title of the "irreducible core".

B. Disclosure and the Core of Fiduciary Loyalty

The concept of an irreducible core of a legal institution originated in contract law, where Wedderburn argued that certain features of contractual liability cannot be eliminated by exemption clauses if the contract is to retain its nature.[88] Hayton implemented this concept in trust law, arguing that "a settler cannot… oust the accountability of the trustee that is fundamental to the very existence of the trust"; such a move would be "repugnant to the trust intended to be created."[89] In *Armitage v. Nurse*, Lord Millet echoed this approach by examining whether a contested exemption clause was "so repugnant to the trusts or contrary to public policy that it is liable to be set aside," holding that "there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the

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[88] *See* K.W. Wedderburn, *Contract-Exemption Clauses-Fundamental Breach-Main Objects of Contract*, [1957] CAMB. L.J. 16; K.W. Wedderburn, *Contract-Exceptions Clause-Fundamental Breach-Agents*, [1960] CAMB. L.J. 11.

[89] David Hayton, *The Irreducible Core Content of Trusteeship*, in TRENDS IN CONTEMPORARY TRUST LAW 47, 53 (A.J. Oakley ed. 1996).

concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts."[90] In tandem, *Armitage* holds that the "duty of the trustees to perform the trusts honestly and in good faith for the benefit of the beneficiaries is the minimum necessary to give substance to the trusts, but in my opinion it is sufficient."[91] Breaches in good faith, including negligent and even grossly negligent ones, can be waived.[92]

Stated positively, the core consists of features that are absolutely necessary for the trust to be regarded as such. Several scholars have addressed this core, identifying different sets of these features.[93] Arguing that without these features a purported trust would be "unreal", Fox points to the need of the trust to *function* as such, with the core ensuring this "minimum functionality".[94]

In considering the components of the irreducible core of trust it is useful to classify them into two groups: first, elements that constitute the trust as a unique proprietary legal device, and second, obligational elements that constitute the governance mechanism of the trust.[95] It is the latter category that is of interest here, as it applies generally to all types of fiduciaries.[96] According to Hayton, "the fundamental core duties to disclose information and trust documents and to account to

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[90] *Armitage v. Nurse* [1998] Ch 241, 253-254; *see also Welker v. Rinehart (No 2)* [2011] NSWSC 1238, [24].

[91] *Armitage, ibid*.

[92] *See* sources cited *supra* note 93.

[93] *See* Nicholas J. McBride, *Trustees' Exemption Clauses*, [1998] 57 CAMB. L.J. 33; Langbein, Mandatory, *supra* note 80; Andrew Butler & D.J. Flinn, *A Modern Law of Trusts: What is the Least That We Can Expect of a Trustee? Exclusion of Trustee Duties and Exemption of Trustee Liability*, [2010] N.Z. L. REV. 459; Daniel Clarry, *The Irreducible Core of a Guernsey Trust: The Offshore Trustee* en Bon Père de Famille, 17 JERSEY & GUERNSEY L. REV. 5 (2014); .

[94] David Fox, *Non-Excludable Trustee Duties*, 17 TRUSTS & TRUSTEES 1, 9 (2011).

[95] *See* James Penner, *Exemptions*, in BREACH OF TRUST 253 (Peter Birks & Arianna Pretto eds., 2002).

[96] On the proprietary elements *see*, e.g., Penner, *ibid.*; John H. Langbein, *Burn the Rembrandt? Trust Law's Limits on the Settlor's Power to Direct Investments*, 90 B.U. L. REV. 375 (2010).

the beneficiaries for the trustee's stewardship of the trust property, so as to be liable for losses or profits in relation thereto, cannot be excluded."[97] The U.S. Restatement of Trusts similarly provides: "A provision in the terms of a trust that relieves a trustee of liability for breach of trust… is enforceable except to the extent that it purports to relieve the trustee of accountability for profits derived from a breach of trust."[98] An offshore court addressed aggressive attempts by trust settlors to deny beneficiaries of any access to information on how their fiduciaries discharge their obligations.[99] Striving to give efficacy to the regime desired by the settlor, the court upheld such provisions in principle, yet insisted that the court retains an inherent supervisory jurisdiction over the disclosure of information in order to ensure the trustee's accountability. This view is consistent with the Privy Council's opinion in *Schmidt v. Rosewood Trust Limited*, which recast the trustee's duty to disclose trust documents as a manifestation of accountability and the court's supervisory role rather than as a proprietary aspect.[100] Fox further argues that accountability before an alternative dispute resolution institution may suffice in terms of preserving the irreducible core.[101]

The upshot is that fiduciary law may go a very long way towards respecting the regime negotiated by the parties in particular fiduciary relations. However, inasmuch as the parties intend their relations to be regarded as fiduciary in nature,

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[97] Hayton, *supra* note 89, at 57.

[98] RESTATEMENT (THIRD) OF TRUSTS, §96(a)(2) (2007).

[99] *See Application for Information about a Trust*, [2013] CA (Bda) 8 Civ. One wanders if the Bermuda court has not struck the balance too much in favor of confidentiality. *Compare B Family Trust* [2013] JRC 136; *see also* Charles Mitchell, *Disclosure of Information to Discretionary Beneficiaries* 115 L.Q. REV. 206 (1999); Lusina Ho, *Trustee's Duties to Provide Information*, in EXPLORING PRIVATE LAW 275 (Elise Bant & Matthew Harding, eds., 2010).

[100] [2003] UKPC 26 (Isle of Man); *see* also *Hancock v. Rinehart* [2015] NSWSC 646; *Breakspear* v *Ackland* [2008] EWHC 220 (Ch); Richard Nolan, *"The Execution of a Trust shall be under the Controul of the Court": A Maxim in Modern Times*, 2 CAN. J. COMP. & CONTEMP. L. 469 (2016).

[101] *See* Fox, *supra* note 94, at 9.

they must accept law's insistence on full disclosure about the good faith performance of the fiduciary's obligations. These two elements - especially the former - correspond conceptually with the two factors that facilitate opportunism in fiduciary relations, namely, information asymmetry and self-interestedness. As courts reiterate time and again, fiduciary relations without accountability are meaningless, "unreal"; and for ensuring accountability, full disclosure to the beneficiary - or, at the very least, to an adjudicating body - is crucial and cannot be ousted by contract or consent.

Unsurprisingly, these features of fiduciary law resemble insurance law's stance towards full disclosure and good faith, as detailed above. Notwithstanding substantial differences between the two contexts, in both cases complete contractual freedom is unacceptable for public policy reasons, as it is likely to engender market failure. That is, while particular arrangements between parties - either fiduciary or insurance - may be optimal at the individual level in terms of allocating risk and return inter se, irreconcilable information asymmetries lead to suboptimal "market for lemons" equilibrium at the societal level. Undertakings to (utmost) good faith and full disclosure therefore should be mandatory in both cases.[102]

V. CONCLUSION

In the debate over contractual freedom or enabling versus mandatory rules in fiduciary law, those who do not adhere to an unbridled contractatian/enabling approach tend to justify fiduciary law's strict posture by appealing to transaction cost reasoning. For example, Strine and Laster with regard to limited liability business

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[102] *See* Tom Baker & Kyle D. Logue, *Mandatory Rules and Default Rules in Insurance Contracts*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW 390 (Daniel Schwarcz & Peter Siegelman eds., 2015). In insurance law, other societal-level considerations such as consumer protection may militate for derogating from this strict approach.

associations[103] and Sitkoff more generally with regard to fiduciary relations[104] thus underscore the efficiency of legal rules that approximate the private regime that most parties likely would opt for. Getzler points to the economic analysis of "penalty default rules" to explain fiduciary law's position.[105] In this view, the law sets forth rules that most parties likely would *not* adopt, thus incentivizing them to reveal private information.[106] Drawing on new institutional economics and information economics, this paper advances another theory on the appropriate scope of contractibility with regard to fiduciary loyalty. The present account highlights information asymmetries that are more tenacious than those stemming from information production costs - to wit, asymmetries due to unobservable and unverifiable information. These asymmetries provide a compelling justification for a strict, full-disclosure-based accountability regime. At least since Lord Eldon's jurisprudence, courts (more than legislatures) in common law jurisdictions have exhibited keen awareness of this phenomenon. Fiduciary law thus preserves an irreducible core of accountability to ensure fiduciary loyalty.

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[103] *See* Strine & Laster, *supra* note 87.

[104] *See* Sitkoff, *supra* note 48.

[105] *See* Getzler, *supra* note 69, at 61.

[106] *See* Ayres & Gertner, *supra* note 81; AYRES, *supra* note 81.

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