

ARE PARTNERS FIDUCIARIES?

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The proliferation of partnership-type entities raises many questions about how the traditional rules of business entities will be tailored for these new contexts. This includes questions concerning default fiduciary duties in partnership-type firms. In particular, should fiduciary duties apply to manager-owners as well as to managers in firms with passive owners? In contrast to Justice Cardozo's famous dictum in Meinhard v. Salmon, Professor Ribstein concludes that partners, as such, are not fiduciaries because they do not delegate open-ended control to their co-partners. Extending fiduciary relationships beyond this specific situation would increase litigation and contracting costs, decrease the effectiveness of owners' governance rights, and dilute true fiduciaries' legal and extralegal incentives.

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Perhaps the most famous judicial expression of fiduciary duties is Justice Cardozo’s lines from *Meinhard v. Salmon*:¹

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. 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 (citation omitted). 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.

1. 164 N.E. 545, 546 (N.Y. 1928).

Meinhard's dictum still seems to be applied broadly.² Courts and commentators apply fiduciary-type duties to many different types of relationships,³ including those between franchisees and franchisors,⁴ doctors and patients,⁵ and pharmacists and customers,⁶ among others. The potential strength and breadth of fiduciary duties has led to confusion about such issues as the relationship between "good faith" and fiduciary duties,⁷ distinguishing the duties of loyalty and care,⁸ the treatment of confidential relationships,⁹ the role of disparities of influence, knowledge and sophistication,¹⁰ and whether a fiduciary can contract out of default duties.¹¹ Such questions have led one major commentator to lament the "confusion and uncertainty in applying the fiduciary principle to disparate fact situations."¹²

Nowhere is the fiduciary confusion deeper than in partnerships and partnership-type firms. These firms have developed since Cardozo's day to include a wide variety of management forms, from the direct owner-management of the traditional general partnership, the alternative owner-management and manager-management arrangements of limited liability companies (LLCs), to complete separation of ownership and

2. For example, in searches on June 14, 2003, *Meinhard's* distinctive phrase "punctilio of an honor" turned up 417 articles in Westlaw's Journals and Law Reviews database, and 410 cases in Westlaw's all-cases database.

3. See generally Deborah A. Demott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 909–10 ("[C]ourts impose fiduciary constraints whenever one person's discretion ought to be controlled because of characteristics of that person's relationship with another."); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 804 (1983) ("[C]ourts create rules for new fiduciary relations by drawing analogies with (existing) prototypes.").

4. See, e.g., *Arnott v. Am. Oil Co.*, 609 F.2d 873, 881–84 (8th Cir. 1979); Harold Brown, *Franchising: A Fiduciary Relationship*, 49 TEX. L. REV. 650 (1971).

5. See *Moore v. Regents of the Univ. of Cal.*, 793 P.2d 479, 483 (Cal. 1990); Marc A. Rodwin, *Strains in the Fiduciary Metaphor: Divided Physician Loyalties and Obligations in a Changing Health Care System*, 21 AM. J.L. & MED. 241, 247–48 (1995).

6. See *Anonymous v. CVS Corp.*, 728 N.Y.S.2d 333, 336–39 (N.Y. Sup. Ct. 2001).

7. See *infra* Part I.C.5.

8. See *infra* text accompanying note 48.

9. See *infra* Part II.D.1.

10. See *infra* Part II.D.2.

11. For articles supporting the contractual approach, see Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993); John H. Langbein, *The Contractarian Basis of The Law of Trusts*, 105 YALE L.J. 625 (1995); Larry E. Ribstein, *Fiduciary Duty Contracts In Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621 (2004). For articles favoring mandatory duties, see Alison Grey Anderson, *Conflicts of Interests: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Robert Charles Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (J. Pratt & R. Zeckhauser eds., 1985); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); DeMott, *supra* note 3; Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211 (1995); Melvin Aron Eisenberg, *The Structure of Corporate Law*, 89 COLUM. L. REV. 1461 (1989); Frankel, *supra* note 3; Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990).

12. J.C. SHEPHERD, *LAW OF FIDUCIARIES* 7 (1981).

control in the typical limited partnership. This proliferation of firms has raised new questions about when fiduciary duties arise.¹³

This article attempts to reduce the confusion by arguing for a precise definition of the relationships that give rise to default fiduciary duties. Specifically, it argues that default fiduciary duties should be confined to relationships that involve the contractual delegation of broad power over one's property. Broad delegation means management power that is not subject to limitations or constraints such as the purported owner's active monitoring or approval power, or a debtor's duty to repay, and pay interest on, a loan. Fiduciary duties are appropriate for relationships like those between directors and shareholders in public corporations. They do not fit relationships among parties who expect to be active, as in the typical general partnership. Moreover, the existence of default fiduciary duties depends solely on the structure of the parties' relationship—that is, on the terms of their express or implied contract—and not on any vulnerability arising other than from this structure.

The proposed formulation is similar to that of other major legal commentators.¹⁴ But this article's approach differs from other attempts to rationalize fiduciary law in that, rather than merely organizing numerous dicta, the analysis proceeds from the economic rationale for fiduciary duties as a particular type of constraint on agents' conduct.¹⁵ Unlike other theories, this article can show not only why fiduciary duties apply to particular situations, but also why they do *not* apply in other apparently similar situations. The power of this approach is illustrated throughout by references to puzzles identified in the traditional fiduciary literature, particularly in the extensive framework developed by J.C. Shepherd.¹⁶

There are three justifications for narrowly defining fiduciary duties. First, in many situations where fiduciary duties might seem to have benefits because of one party's vulnerability, the costs of fiduciary duties outweigh the benefits. Costs include fiduciary duties' effect on the pur-

13. For example, one commentator recently advocated broad application of fiduciary duties in limited liability companies. See Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609 (2004).

14. See *infra* text accompanying note 17.

15. Cooter and Friedman present an economic theory of fiduciary duties that is similar to the one presented here, but without many of the nuances or a detailed analysis of the cases. See, e.g., Robert Cooter & Bradley J. Friedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991). Another recent attempt that is more similar to my approach is D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002). We agree on several points, including that fiduciary duties arise from the structure of the relationship rather than from the parties' relative positions, fiduciary duties should depend on the parties' ability to protect their property in other ways, and that fiduciary duties are basically contractual. However, as noted at various points below, we disagree in many respects about the structural elements that give rise to fiduciary duties and the application of fiduciary duties in particular cases. In particular, I define the fiduciary relationship more narrowly than Smith does in an effort to delineate the relationships in which the benefits of fiduciary duties outweigh the costs. *Id.* at 1402.

16. See SHEPHERD, *supra* note 12, at 3–12.

ported fiduciary's incentives and the reduction of trust or reciprocity from substituting legal duties for extralegal constraints. The courts often ignore the costs of fiduciary duties perhaps because these costs matter most in the cases that do not get to court, and therefore seem insignificant compared to the unfairness in the case being litigated. Moreover, fiduciary duties may undermine the effectiveness of other governance rules by hampering parties' ability to protect against opportunism. Given these costs, fiduciary duties are efficient only in situations where their benefits are clear. Outside of the paradigm broad-delegation scenario, fiduciary duties may add little to other constraints on the agent's conduct.

Second, there are benefits to clearly delineating the situations in which fiduciary duties apply, including minimizing litigation and contracting costs and effectuating extralegal conduct norms. Thus, rather than comparing costs and benefits of fiduciary duties on a case-by-case basis, or providing for a continuum of relationships that involve varying levels of duties, it is better to define a specific category of cases in which a *Meinhard*-like fiduciary duty of unselfishness applies.

Third, a narrow approach to fiduciary duties inheres in the contractual nature of such duties. Contractibility requires that duties arise from the parties' deal rather than from the parties' personal characteristics. Indeed, permitting parties to contract regarding fiduciary duties assumes that parties do not need to be protected from improvident contracts. Other rules that generally apply to the contracting process, including rules regarding interpretation and unconscionability, are better suited to providing this protection. Also, this article's approach to fiduciary duties protects contracting parties' ability to delineate their rights and obligations to suit their particular relationships. Applying fiduciary duties broadly threatens to undermine parties' contracts by imposing obligations the parties do not want or expect. The law better serves parties' contracts by applying fiduciary duties only in the particular settings in which they are most appropriate, thereby clearly notifying parties of the situations where they may need to modify these duties.

Although this article's approach may seem to differ radically from courts' broad view of fiduciary duties, in fact a careful analysis of how courts have applied fiduciary duties shows that the law is largely consistent with the narrow view. The reference to fiduciary duties is often just a way to help rationalize a result the court would, and could, have reached on other grounds. This article's approach therefore would clarify rather than change the law.

This article applies its narrow view of fiduciary duties to partnership-type firms. This application of the theory is particularly valuable in guiding the formulation of fiduciary duties to suit rapidly developing alternative business forms. In contrast to the rigidly defined roles of manager and owner in the standard corporation, there is a rich mixture of re-

relationships in partnerships. Despite *Meinhard's* strong language suggesting otherwise, partnership relationships have both fiduciary and nonfiduciary aspects. Salmon owed a *fiduciary* duty (as distinguished from other duties) to Meinhard only because Salmon was a *managing* partner, and not simply because he was a partner, as Justice Cardozo suggests. Moreover, business associations are evolving from a relatively limited menu to diverse and more flexible forms, particularly including the LLC. Clarifying the theoretical boundaries of fiduciary relationships will assist the courts in adjudicating the disputes that arise among the owners of these new business forms.

The article proceeds as follows. Part I describes and explains the "paradigm" fiduciary relationship where a passive owner delegates active control to a manager and expects unselfish devotion to his interests in return. It also distinguishes fiduciary duties from other types of duties recognized between contracting parties.

Part II discusses potential bases for extending fiduciary duties beyond this situation to others that superficially resemble the fiduciary context in the sense that one party is at risk from another. It shows how these relationships differ fundamentally from classic fiduciary relationships.

Part III provides the rationale for restricting fiduciary relationships to the distinct category defined in Part I, for which the specific *Meinhard* duty of unselfishness is uniquely appropriate. In other contexts, the costs of fiduciary duties are likely to outweigh the benefits. Moreover, a more flexible definition of fiduciary duties would itself entail extra litigation and contracting costs and disable extralegal mechanisms for protecting against opportunism.

Part IV applies these insights to specific partnership settings. This article's intuitions are confirmed by cases that refuse to extend fiduciary duties beyond the narrow context of delegation of control by nonmanaging owners to managers. Part V contains concluding remarks.

I. THE FIDUCIARY RELATIONSHIP

This Part describes the classic fiduciary relationship, where imposing the standard fiduciary duty of unselfishness is appropriate. In general, this is a matter of articulating standard form terms to minimize contracting costs. It is difficult and expensive for parties to enter into customized contracts covering all of the details of a long-term agency-type relationship. But this difficulty does not help delineate the specific default rules the law ought to provide for particular situations. Section A discusses the basic function of fiduciary duties, including their contractual nature and relationship with extralegal rules. Section B identifies situations in which fiduciary duties are appropriate. Section C describes

the duties themselves, specifically by distinguishing fiduciary and good faith duties.

A. *The Function and Nature of Fiduciary Duties*

Fiduciary duties are a type of contract term that applies, in the absence of a contrary agreement, where an “owner” who controls and derives the residual benefit from property delegates open-ended management power over property to a “manager.” This relationship is referred to throughout the article as the “paradigm” case for fiduciary duties. In such a relationship the fiduciary has the incentive to use control to enrich herself rather than the owner. The owner is best protected by judicially reviewing the fiduciary’s conduct to determine whether she has engaged in self-dealing.

Although others have described fiduciary duties along similar lines,¹⁷ they usually do not clarify *why* the property manager needs to be constrained by the strong fiduciary duty. In other words, while the property owner logically would not delegate control over his property without demanding some protection from abuse of discretion, the efficiency of the particular protection provided by fiduciary law is not obvious. The short answer is that the fiduciary’s discretion cannot readily be constrained by devices other than fiduciary duties without undermining the owner’s objectives in delegating control.¹⁸

A fiduciary relationship is necessarily one of agency in the economic sense because it is characterized by separation of ownership and control.¹⁹ But it does not follow that all economic agencies are necessarily *fiduciary* relationships. A fiduciary relationship involves a specific sort of separation in which the particular constraint of fiduciary duties is appropriate. Thus, to understand the role of fiduciary duties it is neces-

17. See *id.*; Frankel, *supra* note 3, at 809; Cooter & Friedman, *supra* note 15, at 1046–47; L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 74–78 (proposing four categories of fiduciary relationships, three based on control or delegation and one based on undue influence); J.C. Shepherd, *Towards a Unified Concept of Fiduciary Relationships*, 97 LAW Q. REV. 51, 75 (1981) (receipt of power conditioned on duty to use the power in the best interests of another); Smith, *supra* note 15, at 1402 (proposing a theory based on a fiduciary’s control of a beneficiary’s “critical resource”); see also Bond Purchase, L.L.C. v. Patriot Tax Credit Properties, L.P., 746 A.2d 842, 864 (Del. Ch. 1999) (stating that “a fiduciary is typically one who is entrusted with the power to manage and control the property of another”) (citing *Wilmington Leasing, Inc. v. Parrish Leasing Company, L.P.*, CIV. A. No. 15202, 1996 WL 752364, at *19 (Del. Ch. Dec. 23, 1996)).

18. For similar reasoning, see Smith, *supra* note 15, at 1443 (stating that “[w]here 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”); *id.* at 1449 (reasoning that fiduciary duties should be based on the delegation of “discretion,” defined to include 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”). However, Smith differs from this article’s approach, particularly in applying fiduciary duties where self-help is feasible, so that the delegation of discretion is not open-ended.

19. See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Fiduciary duties are distinguished from legal agency, *infra* Part II.A.1.

sary to consider alternative constraints on agents' conduct. First, the principal might observe the manager's output, such as the profits or revenues the managed property produces, and fire the manager or reduce her compensation when that output falls below a certain amount. But the owner may be unable to determine whether the manager's failure to produce the benchmark output results from poor management or from circumstances beyond the manager's control.²⁰

Second, the principal might examine the agent's inputs, or on-the-job behavior, to determine whether the agent is working hard or faithfully enough, or review and approve the agent's job plan prior to execution. But, again, the principal delegated control to the agent precisely because she lacks the necessary skills and information to make accurate determinations.

Third, the agent might make its services more valuable by posting a "bond" which the agent forfeits if it misbehaves.²¹ This bond is often in the form of a reputation for honesty that the manager has built over the years by foregoing short-term advantage.²² But the bond is effective only to the extent that the principal or others can detect the agent's mistake, which again implicates the information problems that are inherent in fiduciary relationships.

Fiduciary duties address these problems of evaluating and controlling the manager's performance by subjecting the manager's actions to ex post judicial review. In the absence of contrary agreement,²³ managers are subject to a duty of *unselfishness*. As Justice Cardozo said in *Meinhard*, for the fiduciary, "thought of self was to be renounced, however hard the abnegation."²⁴ This means that fiduciaries have a legal duty to forego gain from the relationship exceeding agreed compensation. Measuring damages by the fiduciary's gain provides a more effective remedy than one that relies on the beneficiary's expectations, since one who delegates fiduciary-type power presumably lacks the expertise necessary to formulate precise expectations. But the strength of the gain-forfeiture remedy²⁵ suggests the need to carefully define the relationships in which the remedy is appropriate.

20. See Cooter & Friedman, *supra* note 15, at 1048–51. For a recent accessible summary of the economics literature, see Sitkoff, *supra* note 11, at 634–38.

21. See Jensen & Meckling, *supra* note 19, at 308.

22. See generally Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981) (examining the repeat-purchase mechanism of contract enforcement).

23. The effect of such agreements is discussed in more detail. See *infra* Part I.B.4.

24. *Meinhard v. Salmon*, 164 N.E. 545, 548 (N.Y. 1928).

25. See, e.g., *Triple Five of Minn., Inc. v. Simon*, 280 F. Supp. 2d 895, 909 (D. Minn. 2003) (imposing constructive trust on defendant's interest in the Mall of America for the benefit of the co-partner because defendant's purchase of the interest was a partnership opportunity).

B. Defining the Fiduciary Relationship

This Section describes the specific type of relationship in which fiduciary duties are appropriate. The nature of this relationship is determined by the particular problem that fiduciary duties are intended to deal with—the open-ended delegation of power to a manager.

As discussed in Section A, a fiduciary duty is appropriate only where the owner delegates open-ended power to the manager. This raises the question of how much delegation is necessary to create a fiduciary relationship.²⁶ The answer to that question depends on the reasons for recognizing fiduciary duties. As discussed above, fiduciary duties compensate for the owner's inability directly to observe, evaluate, and discipline the manager's performance. Requiring fiduciaries to act unselfishly, and accept potential liability, obviously deters people from becoming fiduciaries and may reduce their performance incentives. Accordingly, fiduciary duties are cost-justified only where the owner lacks cheaper methods of monitoring and controlling her agent. Classic examples where the costs are justified include the relationship between management and dispersed owners in a traditional publicly held corporation, and the relationship between the trustee and beneficiaries of a trust.²⁷ In these situations the owners' costs of obtaining information necessary to manage on a day-to-day basis are high, so that ex post judicial review of conflicts of interest is potentially valuable. On the other hand, when an owner's retention of significant control over the subject matter of the relationship sufficiently constrains the manager to act in the owner's interest, ex post liability for selfish conduct is not cost-justified.

The delegation of power implies that the fiduciary exercises the power *on behalf of* another person. The delegation *may* arise from a *legal* agency relationship, where the requirement of acting on another's behalf helps determine whether the owner can be subjected to liability for the manager's acts.²⁸ But a fiduciary relationship need not be a legal agency. For example the beneficiary of a trust lacks an agent's control, liability, consent, and power to terminate the relationship.²⁹ And a legal agency is not necessarily, or entirely, a fiduciary relationship.³⁰

This view of fiduciary duties contrasts with viewing fiduciary duties as protecting parties in supposedly unequal bargaining positions,³¹ or as arising out of the parties' status or relationship.³² These alternative views

26. See SHEPHERD, *supra* note 12, at 86 (discussing power and discretion theory of fiduciary relationships).

27. As to the fiduciary relationship in the latter situation, see Sitkoff, *supra* note 11, at 638–48; see also Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 572–82 (2003) (comparing fiduciary obligations in corporate and in trust law).

28. See RESTATEMENT (SECOND) OF AGENCY §13 (1958).

29. See *Anderson v. Abbott*, 61 F. Supp. 888, 891–93 (W.D. Ky. 1945).

30. See *infra* Part II.A.1.

31. See *infra* Part II.D.2.

32. See *infra* Part II.D.1.

would be consistent with mandatory rules intended to protect people from the consequences of their bargains. But since one can choose from among various fiduciary and nonfiduciary standard forms, an unsophisticated party can choose to enter into a fiduciary-type contract and seek the fiduciary's advice. As with other contracts, including those in the consumer setting, a party's bargain can be set aside if it is unconscionable.³³

C. *The Nature of the Duty*

This Section describes the duty that applies in the specific domain of fiduciary relationships and distinguishes obligations that do not depend on the existence of a fiduciary relationship.

1. *Contract*

The advantages and disadvantages of contractual, as distinguished from mandatory, fiduciary duties have been extensively debated.³⁴ It may be tempting to view fiduciary duties as mandatory rules that stand apart from the contract in order to protect weaker parties from improvident fiduciary waivers.³⁵ Legal constraints on fiduciary contracts also may partly respond to the parties' disparate access to information. Courts, however, are poorly situated to second-guess contract terms. Moreover, the same considerations that support not implying fiduciary duties even in some situations where there is a potential for abuse,³⁶ arguably also support enforcing fiduciary waivers despite parties' vulnerabilities.

In any event, there is less to this debate than meets the eye. Fiduciary duties are *necessarily* contractual, in the sense that no one has to become a fiduciary.³⁷ Even in a no-waiver regime, the parties agree to fiduciary duties by contracting for the particular kind of relationship in which default fiduciary duties apply.³⁸ Accordingly, the debate is not about *whether* one may contract out of fiduciary duties, but *how*—that is, whether fiduciary duties necessarily are bundled with other terms of the contract, particularly including control and how the contract is characterized.³⁹

33. See *infra* text accompanying note 100.

34. See, e.g., Butler & Ribstein, *supra* note 11.

35. See, e.g., Miller, *supra* note 13.

36. See *infra* Part III.A.

37. See Easterbrook & Fischel, *supra* note 11, at 427.

38. To say that fiduciary duties are contractual does not necessarily mean that the parties explicitly have bargained for them, but rather that fiduciary duties are a standard term that the law provides in order to minimize the parties' contracting costs. See Butler & Ribstein, *supra* note 11, at 16.

39. This arguably makes even mandatory federal rules such as those in the federal securities laws "contractual" in the sense that they apply only to certain types of intentional relationships, particularly including those that involve the sale of a "security." Indeed, I have argued that state business forms

For reasons discussed at length elsewhere,⁴⁰ I advocate broadly allowing direct contractual modification of default fiduciary duties even in paradigm fiduciary relationships. Suffice it to say for present purposes that a contractual approach lets the parties adjust the duties to suit their particular relationship. This article's approach of delineating a specific category of relationships in which fiduciary duties apply furthers the objectives of the contractual approach by providing a clear basis for contracting regarding fiduciary duties.⁴¹

Although fiduciary duties are fundamentally contractual, and there are strong arguments for permitting contractual modification, they may not be easy to waive entirely.⁴² This problem is at least partly one of interpretation. An intent to waive all duties seems inconsistent with establishing a relationship that is commonly recognized as fiduciary in nature. Also, given the need to constrain agents who have open-ended power, courts tend to strongly presume against interpreting contractual modifications as complete waivers. Thus, one implication of narrowly defining the situations in which default fiduciary duties apply is that parties who owe fiduciary duties need to negate them explicitly in order to counter the strong implication of duties that otherwise would arise.⁴³

The courts might compromise by enforcing contracts that significantly modify fiduciary duties only if they *substitute* customized constraints for default duties. This approach to interpretation would encourage fiduciaries, who are hired precisely because of their extra knowledge and expertise, to carefully consider and apply alternative con-

can and should be used as a way of, in effect, contracting out of the securities laws. See Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807, 824 (1994). But there is a difference, at least in degree, between the role of contract in state fiduciary law and that in the federal regulatory settings, most notably because of the parties' ability to choose the applicable state law in the former situation. Accordingly, while this article supports fiduciary duties in the paradigm fiduciary case, I am more skeptical of federal regulation. See Larry E. Ribstein, *Market v. Regulatory Responses to Corporate Fraud*, 28 J. CORP. L. 1, 58–60 (2002); Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77 (2003).

40. See Butler & Ribstein, *supra* note 11, at 28–32; Ribstein, *supra* note 11.

41. See *infra* Part III.D. Shepherd implicitly endorses this approach by suggesting the possibility of applying fiduciary duties based on “particular classifications of relationships.” See SHEPHERD, *supra* note 12, at 67.

42. This is analogous to the irreducible minimum of trust law duties. See Sitkoff, *supra* note 11, at 641–43; see also John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105 (2004).

43. This raises the problem that fiduciary duties may be an unwanted feature of relationships parties enter into for other reasons. In particular, parties may be able to protect themselves from personal liability for the debts of a firm only by entering into a standard limited liability business association that necessarily entails fiduciary duties. One response is to eliminate the bundling by allowing the parties to characterize their relationship. See Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 433–34 (1999). Another is to more precisely define the situations in which fiduciary duties apply, as this article suggests, so that fiduciary duties are not necessarily associated with forming a business association.

straints in order to avoid the risk of being subject to more onerous default duties.⁴⁴

2. *Relevance of Context*

This article's approach to fiduciary duties implies that the *default* fiduciary contract does *not* vary according to the nature of the relationship. Under this analysis, every fiduciary case will have the critical feature of significant delegation of managerial power. Moreover, the reasons for narrowly defining fiduciary relationships, including reducing litigation and contracting costs and enhancing fiduciary norms, support clarifying the content of fiduciary duties.

The content of fiduciary duties in the particular case, however, does depend on the parties' contract. For example, in *Meinhard*, the court took the defendant's managing role into account in determining his duty to share a partnership opportunity with his co-partner.⁴⁵ But this does not mean courts should supply contracts they think the parties ought to have made, as by calibrating fiduciary duties according to the parties' ability to self-protect.⁴⁶

3. *Duty of Care*

Fiduciary duties arguably might include unselfishness regarding the fiduciary's commitment of time and attention—that is, a duty of care. However, for several reasons a duty of care should not be regarded as fiduciary in nature.⁴⁷ First, a duty to spend time unselfishly on behalf of the beneficiary is obviously impractical. Thus, the duty of care requires the duty-holder only to expend a reasonable amount of effort.

Second, unlike a fiduciary duty, a duty of care involves liability for harm incurred by the beneficiary. It is not a duty to disgorge all benefit received by the duty-holder.

Third, a duty of care arises for different reasons than a fiduciary duty. One who undertakes to perform a task for a principal, employer, patient, or client, should have some duty to perform it carefully, even if the actor does not have open-ended power to manage another's property. Thus, the Supreme Court held that the duty of care a doctor working for a health maintenance organization owed to a patient did not

44. For an analysis of the apparent application of such an approach in Delaware limited partnership cases, see Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFF. U. L. REV. 927 (2004). This is analogous to the Ayres-Gertner analysis of "penalty defaults." Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 95–100 (1989).

45. For a more recent application of this aspect of *Meinhard*, see *Lawrence v. Cohn*, 197 F. Supp. 2d 16, 37 (S.D.N.Y. 2002), *aff'd*, 325 F.3d 141 (2d Cir. 2003).

46. See Smith, *supra* note 15, at 1482 (advocating this approach).

47. See SHEPHERD, *supra* note 12, at 49 (stating that "the duty of care has absolutely no necessary connection with fiduciary relationships").

make the doctor the patient's fiduciary, stating that labeling the doctor a fiduciary on this basis would be an "erroneous corruption of fiduciary obligation."⁴⁸

4. *Misappropriation and Business Opportunities*

Owners have joint rights in firm property and, therefore, may not appropriate the property to personal use without co-owner consent. The duty not to misappropriate is *not* a fiduciary duty, but rather arises from the nature of the owners' property rights in their firm. These rights are joint, rather than individual, in order to ensure that the owners cooperate in building an ongoing business.⁴⁹

Although owners' duty not to usurp business opportunities of the firm is often characterized as "fiduciary," it is more accurately related to the duty not to misappropriate firm property. Owners do not have a fiduciary-type duty unselfishly to share all of their opportunities with the firm—only those in which the firm has a property right as against the firm's owners.⁵⁰ Moreover, liability for usurping business opportunities is often based on defendant's use of firm information to discover the opportunity, or use of its tangible assets to develop it, as in the classic case of *Guth v. Loft*.⁵¹

The distinction between fiduciary duties and liability for usurping business opportunity duties is muddled by the fact that most usurpation cases involve fiduciaries. Careful analysis therefore requires distinguishing between fiduciary and nonfiduciary liability for usurping corporate opportunities. Fiduciary liability helps ensure that the fiduciary works unselfishly for the principal. A fiduciary accordingly may have a duty to share opportunities with the firm where a nonfiduciary owner would not. A nonfiduciary's liability, by contrast, is usually based on misuse of firm information or other assets, or on bad faith exercise of the owner's governance power.⁵²

5. *Good Faith*

The most difficult aspect of defining fiduciary duties involves distinguishing these duties from the general obligation of "good faith." Good

48. *Pegram v. Herdrich*, 530 U.S. 211, 235 (2000).

49. See Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 409–11 (2003). Although Blair sees this as a reason for the dominance of the *corporate* form, in fact this attribute is shared by partnerships. See Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 189–90 (2004).

50. This property right depends on the scope of the firm's business activities. See WILLIAM SAVITT, A NEW NEW LOOK AT CORPORATE OPPORTUNITIES (Columbia Law and Econ., Working Paper No. 235, 2003), available at http://papers.ssrn.com/abstract_id=446960 (arguing that courts have too broadly construed the scope of the firm in business opportunity cases).

51. 5 A.2d 503 (Del. 1939).

52. The good faith obligation is discussed *infra* Part I.C.5.

faith has two broad meanings. The first is a flexible way to interpret a long-term contract like a business association where the parties cannot easily foresee the circumstances in which their contract will apply.⁵³ As one court observed:

If in each contract the parties had to expressly describe and prohibit every artifice by which the parties could potentially deprive each other of the fruits of their agreement, then contracts would soon become as long as the tax code, as difficult to interpret, and (like the tax code) still contain innumerable loopholes available to a party that wished to avoid the spirit of its bargain. The better approach . . . is to treat a contract for what it is—an exchange of solemn promises—and enforce the objectively reasonable expectations of the parties. The transaction in question here is an artifice intended to thwart plaintiff's legitimate contractual expectation that it would have a right of first refusal before the partnership interest owned by CRCO could be transferred to someone outside the Cellular family of companies. As such, the Purchase Agreement violates the covenant of good faith and fair dealing that Oregon law implies in every contract [T]he doctrine of good faith is not a new material term created by the court, but rather a term implied by law in every contract to give effect to the legitimate expectations of the parties that were created by the language of their contract.⁵⁴

This view of good faith does not demand foregoing self-interested conduct, but rather only refraining from the particular sort of self-interested conduct that is proscribed by the parties' contract, broadly construed.⁵⁵ Chancellor Allen expressed the court's inquiry as follows:

[I]s it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter. If the answer to this question is yes, then, in

53. See David Rosenberg, *Making Sense of Good Faith in Corporate Law: A Contractarian Approach*, 29 DEL. J. CORP. L. (forthcoming 2004). The current draft of the Restatement (Third) of Agency blurs the distinction between good faith and fiduciary duties by characterizing this approach to interpretation as an aspect of fiduciary duties. See RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. b (Tentative Draft No. 2, 2001).

54. Or. RSA No. 6, Inc. v. Castle Rock Cellular Ltd. P'ship, 840 F. Supp. 770, 776–78 (D. Or. 1993).

55. See *McGee v. Best*, 106 S.W.3d 48, 67 (Tenn. Ct. App. 2002) (enforcing agreement providing for purchase of interest of terminated member and affirming lower court holding that there is no breach of good faith duty in performing contract according to its terms); see also John C. Coffee, Jr., *supra* note 11, at 1658 (1989) (stating that “a contracting party may seek to advance his own interests in good faith . . .”). Smith, *supra* note 15, at 1490–91, distinguishes good faith from fiduciary duties on the basis that that the former involves the exercise of discretion in performance, while the latter involves “discretion with respect to a critical resource.” However, since Smith defines “critical resource” very broadly as the subject of a fiduciary relationship, the distinction is not clear. See *id.* at 1444–47.

my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.⁵⁶

Because good faith is an interpretive rule rather than a specific default term, its existence is not subject to general contractual alteration, although its application in a particular case ultimately depends on the terms of the parties' contract.

Good faith as a gap-filler tailors agreements to their specific circumstances without subjecting them to inappropriate standard form duties. This application of good faith is particularly useful in interpreting contractual modifications of fiduciary duties.⁵⁷ The combination of fiduciary duties and good faith interpretation may explain why fiduciary duties and the interpretation view of good faith sometimes seem to blur at the edges.⁵⁸

The second view of good faith is as a distinct set of *nonfiduciary* duties that are applied to people who may, or may not, also be fiduciaries. These duties differ from the strong fiduciary duty of unselfishness that requires disgorgement of gains from dealings with other parties. Good faith may, for example, include the duty to make affirmative disclosures to the extent necessary to make actual representations not misleading—an aspect of general fraud law. Good faith also has been said to be a duty of corporate directors under recent Delaware cases that extends beyond loyalty and care to encompass an assurance that transactions are based on adequate information.⁵⁹ This closely resembles the nonfiduciary duty of care.⁶⁰

II. ALTERNATIVE BASES OF FIDUCIARY DUTIES

This Part discusses arguments for fiduciary duties outside of the paradigm case of significant delegation of management power. In each case, while there may be some argument for constraints on discretion, the specific *fiduciary* duty of *unselfishness* described above would be inappropriate. These quasi-fiduciary relationships can be placed in four general categories: *nonfiduciary* contractual delegation of power; *structural vulnerability* without contractual delegation of power; *deliberate vulnerability* (“trust”); and *party-specific vulnerability*. Part III discusses the rationale for excluding these and other relationships from the fiduciary category.

56. Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986).

57. See Larry E. Ribstein, *supra* note 44, at 938 (2004) (discussing the interpretation of fiduciary duty waivers in limited partnership agreements); *supra* Part I.C.1. (discussing the role of the contract in defining fiduciary duties).

58. See Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty and Permitted Harm*, 22 FLA. ST. U. L. REV. 955, 978–93 (1995); Easterbrook & Fischel, *supra* note 11, at 438.

59. See Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 494 (2003).

60. See *supra* Part I.C.3.

A. *Nonfiduciary Contractual Delegation of Power*

The parties' duties often cannot be fully specified in long-term contracts. This suggests that courts should fill contracting gaps with duties to constrain the exercise of power. Such general gap-filling, however, differs qualitatively from the specific fiduciary-type duty that accompanies open-ended delegation of power.⁶¹

1. *Varieties of Legal Agency*

Agency relationships have been said to be inherently fiduciary in character.⁶² A principal's delegation of power to an agent would, indeed, seem to fit the fiduciary paradigm. The principal's personal liability for the agent's acts increases the potential costs to the principal of agent disloyalty and therefore the benefits of fiduciary duties.

Some legal agency relationships, however, are not fiduciary in the sense described in this article. The principal's control over the agent, which is an important prerequisite of the creation of an agency relationship,⁶³ may be inconsistent with the kind of open-ended delegation that creates a fiduciary relationship under this article's analysis. Thus, agency-type relationships that trigger the principal's liability for the agent's acts may differ from those that give rise to fiduciary duties. Most importantly, a partnership is liable as a principal for the partners' acts⁶⁴ even if the partners' control⁶⁵ and co-ownership⁶⁶ of the partnership cut against a strong fiduciary duty of unselfishness among partners.⁶⁷

2. *Controlling Shareholders*

A majority (or controlling) shareholder may approve a corporate transaction that favors the majority holder at the minority's expense. The potential harm to the minority suggests that it is appropriate to constrain the controlling shareholder's power. But this situation, and the remedies that deal with it, differ from the paradigm fiduciary case Part I describes. Shareholders act only in well-defined circumstances such as mergers rather than, like managers, on a day-to-day basis. Accordingly, the firm can prescribe rules, such as an appraisal remedy, for dealing with

61. See Smith, *supra* note 15, at 1423–26 (noting that “abuse of power” is overly broad basis of fiduciary duties).

62. RESTATEMENT (SECOND) OF AGENCY § 1 (1958); RESTATEMENT (THIRD OF AGENCY) § 1.01, cmt. e (Tentative Draft No. 2, 2001). Both define agency as a “fiduciary” relationship.

63. See RESTATEMENT (SECOND) OF AGENCY § 1 (providing in part that “[a]gency . . . results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control . . .” (emphasis added)).

64. UNIF. P'SHIP ACT § 9 (1914), 6 U.L.A. (pt. I) 1 (2003) [hereinafter UPA]; UNIF. P'SHIP ACT § 301 (1997), 6 U.L.A. (pt. I) 275 (2003) [hereinafter RUPA].

65. See UPA § 18; RUPA § 401.

66. UPA § 6; RUPA § 202.

67. See *infra* Part IV.A.

these discrete cases rather than having to rely on an open-ended fiduciary duty of unselfishness.⁶⁸

It follows that controlling shareholders do not have a full-fledged duty of unselfishness to minority holders, but rather only a duty not to *harm* the minority. In control transactions, the majority holders are not required to forego all gain, but only to allocate gain fairly and provide procedural protections to the minority.⁶⁹ Also, controlling shareholders may, without liability, reap a control premium in selling their shares in some circumstances,⁷⁰ and parent corporations may profit from managing their partly-owned subsidiaries,⁷¹ in both cases so long as they refrain from imposing harm.

3. Creditors

Fiduciary duties may seem appropriate to deal with debtor-creditor conflicts of interest. For example, debtors may want to engage in a risky transaction where they get most of the potential gain if the transaction is successful while the creditors get most of the loss.⁷² However, as in the majority owner setting, the benefits of a general duty of unselfishness in this situation are significantly less than in the manager/owner context. Creditors care only about owners' failure to pay scheduled principal and interest. This differs from the managers' more open-ended obligation to owners to maximize profits. Accordingly, rather than subjecting debtors to a full-fledged duty of unselfishness, creditors are adequately protected by restricting the specific types of misbehavior that threaten these promised payments, such as excessive dividends and material changes in the firm's risk profile.

Courts accordingly have held that debtors do not have fiduciary duties to creditors.⁷³ As Chancellor Allen explained in *Katz v. Oak Industries, Inc.*:⁷⁴

68. See *infra* text accompanying note 100 (discussing appraisal remedy).

69. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (discussing duties of controlling shareholders in controlled mergers).

70. See generally SHEPHERD, *supra* note 12, at 359 (concluding that although fiduciary principles require majority shareholders to "have regard to" minority interests when selling control, this "regard" is subject to restriction on policy grounds); Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465 (1992) (discussing extent of duties in connection with sale of control).

71. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722-23 (Del. 1971) (holding that parent corporation did not breach duty in connection with liquidating dividend declared by subsidiary).

72. See *Jensen & Meckling*, *supra* note 19, at 334.

73. For other cases rejecting fiduciary duties to creditors, see *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1526 (S.D.N.Y. 1989); *Simons v. Cogan*, 549 A.2d 300 (Del. 1988); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Harff v. Kerkorian*, 347 A.2d 133 (Del. 1975) (reversing dismissal of fraud allegations). But see *Fox v. MGM Grand Hotels, Inc.*, 187 Cal. Rptr. 141 (Cal. Ct. App. 1982) (holding in favor of fiduciary duties to creditors in connection with spin-off to common shareholders). For general discussions of duties to bondholders, see William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92; William W. Bratton, Jr., *The Interpretation of Contracts Governing Corporate Debt Relationships*, 5

Under our law—and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature. Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders; that they may sometimes do so "at the expense" of others (even assuming that a transaction which one may refuse to enter into can meaningfully be said to be at his expense) does not for that reason constitute a breach of duty. It seems likely that corporate restructurings designed to maximize shareholder values may in some instances have the effect of requiring bondholders to bear greater risk of loss and thus in effect transfer economic value from bondholders to stockholders. But if courts are to provide protection against such enhanced risk, they will require either legislative direction to do so or the negotiation of indenture provisions designed to afford such protection.⁷⁵

As Chancellor Allen recognized in *Katz*, the appropriate way to protect the creditors is through a "good faith" duty that enforces the creditors' expectations by flexibly interpreting the specific terms of the debt agreement.⁷⁶ Thus, *Katz* carefully considered and rejected the creditors' argument that the corporation's exchange offer, coupled with solicitation of consents to waiver of covenants, was inconsistent with a good faith application of the parties' contract.⁷⁷

Fiduciary-like duties to creditors are appropriate, at most, only where the firm nears insolvency, where the creditors may be, in effect, residual claimants.⁷⁸ Thus, Chancellor Allen has held that, in this situation, directors have a duty to maximize the joint interests of creditors and

CARDOZO L. REV. 371 (1984); Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821 (1992); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988).

74. See *Katz v. Oak Indus., Inc.*, 508 A.2d 873 (Del. Ch. 1986).

75. *Id.* at 879 (citations and footnote omitted).

76. See *supra* text accompanying note 56 (discussing Chancellor Allen's definition of good faith in *Katz*).

77. For other leading examples of bond contract interpretation, see *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929 (5th Cir. 1981); *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039 (2d Cir. 1982). For a case in which Chancellor Allen found bad faith, see *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 17 DEL. J. CORP. L. 1099 (Del. Ch. 1991).

78. See Smith, *supra* note 15, at 1460 (noting that "[t]he imposition of fiduciary duties can protect creditors during the transitional period [near insolvency], when they are particularly vulnerable because the managers of the debtor would recognize the inevitability of the control transfer").

shareholders rather than exclusively those of the ninety-eight percent shareholder.⁷⁹

B. Structural Vulnerability Without Delegation

Vulnerability may arise, even without explicit delegation of power, whenever a party commits resources to a relationship such that the commitment removes market constraints on the exercise of power. The parties to many long-term contracts cannot easily discipline counterparties by simply doing business elsewhere. The value of their resources may be “asset-specific” in the sense that it depends to some extent on continued association with the other contracting party.⁸⁰ This dependence creates a risk of opportunism by that other party.

Although this theory helps explain why the parties might contract for particular devices to reduce the risk of opportunism, or might place the interdependent assets under common ownership in a firm,⁸¹ it does not support *fiduciary* duties.⁸² The abuse here is not associated with the delegation of open-ended discretion, where elimination of conflicts is necessary because the parties cannot otherwise identify breaches of duty. Rather, the problem is associated with specific contract terms. Accordingly, the parties need not act selflessly in all respects, but merely refrain from particular types of selfish conduct that contravene the spirit, if not the letter, of the parties’ contract. To the extent that any legal duty is appropriate, it is the duty of good faith, which is linked with the parties’ express contract terms.⁸³

C. Deliberate Vulnerability (“Trust”)

In general, “trust” can be said to result when the probability-adjusted gain from relying exceeds the probability-adjusted loss from the breach by the one who is relied on—that is, if $PG \times G > PL \times L$.⁸⁴ Making this calculation, the parties decide to be vulnerable to the risk of exploitation. Fiduciary duties have been said to be essential in creating the

79. Credit Lyonnais Bank Nederland, N.V., 17 DEL. J. CORP. L. 1099, at 1155. One writer argues that duties in this setting may depend on whether the corporation is liquidating or reorganizing under Chapter 11. See Jonathan C. Lipson, *Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003). Contrary to my analysis, Lipson would make the duty turn on creditors’ volition, access to information, and opportunity to exit rather than the structure of relationship.

80. See generally OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 30–32 (1985) (discussing the effects of bounded rationality, opportunism, and asset specificity on the contracting process); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978) (discussing ways parties deal with specialized assets).

81. See sources cited *supra* note 80.

82. For a contrary argument, see Smith, *supra* note 15, at 1430–38.

83. See *supra* Part I.C.5.

84. See Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 559 (2001).

necessary inequality in this equation to encourage entrustment.⁸⁵ Conversely, fiduciary duties have been said to arise in relationships in which one party trusts, or relies on, another.⁸⁶ This analysis is obviously circular, and raises the question whether trust is a meaningful concept independent of the legal duty.

Trust in a more specialized sense may, however, be useful in analyzing fiduciary duties. Trust may result from social capital, norms, or personal relationships that create “principles, and standards of behavior that have been internalized by parties to an exchange,”⁸⁷ and thereby dispose people to trust or be trustworthy. This disposition to trust is socially valuable because it reduces the need for externally enforced constraints, and therefore the costs of human interaction. Thus, a society in which trust in this sense prevails may be wealthier than one in which it is absent. Trust, in the narrow sense, is useful precisely because it *avoids* reliance on costly legal remedies.⁸⁸ In other words, one who trusts can be said deliberately to *avoid* fiduciary duties for strategic reasons. The narrow view of trust does not define a specific category of relationships, but rather argues for limiting the scope of fiduciary duties to the extent that trust makes these duties counterproductive.⁸⁹

D. Party-Specific Vulnerability

A party may be vulnerable to potential abuse by another because of the parties’ inherent characteristics rather than because of problems arising from the structure of the relationship. Any problems in these situations are best addressed by nonfiduciary remedies, including protection of information divulged in the relationship and judicial supervision of the underlying contract.

1. Confidential Relationships

Parties to family and other confidential relationships expect a higher level of conduct than in standard arms’ length transactions. Fiduciary duties in these situations arguably would help ensure that the fiduciary’s conduct matches the parties’ expectations. But just because parties expect more from those with whom they are in a confidential

85. See, e.g., William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law’s Duty of Loyalty*, in PROGRESSIVE CORPORATE LAW 139, 145 (Lawrence E. Mitchell ed., 1995); Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 429 (1993). For a critique of these arguments, see *id.* at 571–76 (2001); Smith, *supra* note 15, at 1418.

86. See SHEPHERD, *supra* note 12, at 56–60 (noting theory but questioning why reliance arises).

87. See Jay B. Barney & Mark H. Hansen, *Trustworthiness as a Source of Competitive Advantage*, 15 STRATEGIC MGMT. J. 175, 179 (1994).

88. See Lynn A. Stout, *On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can a Transplant Take?*, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS, CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS (Curtis J. Milhaupt ed., 2003) (noting this correlation of high trust, or altruism, with low enforcement of fiduciary duties).

89. See *infra* Part III.E.

relationship, the parties do not necessarily assume the law will back these expectations. Rather, the parties may rely on extralegal mechanisms like those discussed in the preceding Section. Thus, the benefits of legal duties are lower here than in less personal relationships.

A more sound basis for a fiduciary duty in family and other confidential relationships is that the parties to such relationships often do *not* trust each other but that fiduciary duties are justified by the high cost of distrust in this setting. Because the relationship requires the parties to deal with each other without reserve, they need legal protection from abuse.

A confidential relationship does not necessarily involve the sort of open-ended delegation of power that justifies the strong fiduciary duty of unselfishness. Rather, most cases in this category focus on the particular problem of entrustment with confidential information rather than constraining the discretion of one who exercises power over another's property.⁹⁰

An important example is *United States v. Chestman*,⁹¹ which reversed insider trading liability against a broker based on his client's misappropriation of information from the client's wife.⁹² The court concluded that breach of a fiduciary-like duty was necessary to support misappropriation. The majority reasoned that "[a] fiduciary relationship involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests."⁹³ This emphasis on discretionary authority resembles the paradigm fiduciary duty category discussed in Part I. However, the court concluded that the case did not involve the requisite relationship because there was no "repeated disclosure of business secrets between family members [that] may substitute for a factual finding of dependence and influence and thereby sustain a finding of the functional equivalent of a fiduciary relationship."⁹⁴ In other words, the majority conceived the fiduciary duty as arising from the parties' expectation of confidentiality based on a practice of confidential communications rather than any delegation of power.

Judge Winter, dissenting, found misappropriation when one who expects benefits from family control of a corporation and is in a position to learn confidential corporate information through family interactions

90. See SHEPHERD, *supra* note 12, at 319–38 (noting that the doctrine respecting confidential information "is analogous to but different from the law of fiduciaries").

91. *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991).

92. *Id.* at 571. *The Chestman* facts are now covered by Rule 10b5-2, which provides that confidential relationships are formed for purposes of misappropriation that constitutes insider trading "[w]henver 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]henver 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. 17 C.F.R. § 240.10b5-2 (2004).

93. *Chestman*, 947 F.2d at 569.

94. *Id.*

has a duty not to use the information for personal profit where this poses a risk of disclosure. He criticized the majority's rule on the ground that, "[u]nder such a regime, parents and children must conceal their comings and goings, family members must cease to speak when a son-in-law enters a room, and offended members of the family must understand that such conduct is always related only to business."⁹⁵ In other words, a fiduciary duty is justified even without a showing of actual confidences where the parties' relationship suggests a need to encourage such confidences by protecting them.⁹⁶

Neither *Chestman* opinion articulated an appropriate basis for a *fiduciary* duty. There are two basic problems with recognizing a fiduciary duty in this situation. First, contrary to the paradigm of fiduciary duties discussed in Part I, any duty based on the parties' family relationship would not arise out of their *contract* regarding delegation of control, but rather out of their *status* as members of a family that controlled a business, however this business was structured.

Second, and most importantly, any duty here would not be the sort of general duty of unselfishness discussed in Part I, but rather a specific duty not to steal or misuse collectively owned information, which is present in both fiduciary and nonfiduciary relationships. In other words, family members as such, apart from any other legal relationships they might have, would be legally free to act in their self-interest in any situation other than one concerning corporate information.⁹⁷ Even Judge Winter held only that the corporation's ownership rights extended to information learned in a family setting.

2. *Inherent Power Disparities*

Fiduciary duties might be said to attach to those who have more knowledge or sophistication than beneficiaries of the duty, or otherwise exert "undue influence" on such beneficiaries.⁹⁸ But, unlike fiduciary duties, such duties would not arise from the *structure* of the particular relationship. For example, sophisticated managers might be deemed to have fiduciary duties to their less sophisticated co-managers even if they all have equal management powers.⁹⁹ Since power effectively derives from knowledge and sophistication, the unsophisticated arguably are in the same position as the legally powerless.

A disparity of knowledge or sophistication does not, however, support a fiduciary duty. Consider two contexts in which a duty might be

95. *Id.* at 580.

96. See Smith, *supra* note 15, at 1466 (arguing that a fiduciary duty encourages disclosure of information).

97. See, e.g., *Landskroner v. Landskroner*, 797 N.E.2d 1002, 1013 (Ohio Ct. App. 2003) (holding that a fiduciary duty of unselfishness does not necessarily arise from family relationship).

98. See SHEPHERD, *supra* note 12, at 197-224; Sealy, *supra* note 17, at 78-81.

99. See *Konover Dev. Corp. v. Zeller*, 635 A.2d 798, 804-05 (1994).

based on such disparities. In the first context, the disparities affect the parties' relative bargaining ability. The appropriate remedy is not the imposition of a fiduciary duty of unselfishness, but rather a refusal to enforce the contract, or the substitution of more reasonable terms.¹⁰⁰ Moreover, as with abuse of confidence,¹⁰¹ this duty would not arise from the agreement, but rather would be imposed because of the parties' characteristics.¹⁰² In other words, this is an argument for a mandatory, rather than a contractual, duty. People would, in effect, be forced to buy fiduciary duties if they want to deal with people who are smarter, or more sophisticated, than they are, even when the costs of such duties in the circumstances outweighed their benefits.

In the second context, the parties have equal bargaining ability but one party needs the other's expertise regarding the subject matter of the contract. The would-be beneficiary presumably knows of the disparity and can take protective action, including entering into a fiduciary-type relationship instead of a nonfiduciary one, hiring a fiduciary to give advice, avoiding the transaction entirely, providing for nonfiduciary protection in the contract, or paying less to reflect the absence of legal protection. No mandatory duty is necessary in this situation. Even a default fiduciary duty is inappropriate unless the situation involves the paradigm fiduciary case of open-ended delegation of power.

Although a disparity in knowledge or sophistication should not be enough, in itself, to create a fiduciary relationship, it may be relevant in determining whether the parties intended to create a fiduciary relationship. For example, in *Burdett v. Miller*,¹⁰³ an accountant who held himself out as a financial advisor was held to be a fiduciary. Although noting that "we do not mean to suggest that every expert is automatically a fiduciary,"¹⁰⁴ Judge Posner reasoned that:

Miller cultivated a relation of trust with Burdett over a period of years, holding himself out as an expert in a field (investments) in which she was inexperienced and unsophisticated. He knew that she took his advice uncritically and unquestioningly and that she sought no "second opinion" or even—until the end, when at last her

100. See generally Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1 (1993) (arguing that whether a contract should be enforced fully, partially, or not enforced depends in part on whether a property rule or liability rule is at issue). Although one such reasonable term might be a fiduciary duty, that should depend on whether a fiduciary duty is appropriate based on delegation of power, and not on the disparity of knowledge or sophistication itself. If the contract did not mention fiduciary duties, the duty would exist in any event by default. The disparity of knowledge or sophistication would be relevant only if the parties explicitly waived the fiduciary duty and the question was whether to enforce the waiver.

101. See *supra* Part II.D.1.

102. The court also might use a proxy, particularly including the value of the property bought or sold by the supposed fiduciary. See SHEPHERD, *supra* note 12, at 242 (discussing "unconscionable transactions" as a category of undue influence cases where the undervaluation of the property has significant weight).

103. 957 F.2d 1375 (7th Cir. 1992).

104. *Id.* at 1381.

suspicions were aroused—any documentary confirmation of the investments to which he steered her.¹⁰⁵

A potential problem with this approach is that recognizing a fiduciary duty outside of a conventional fiduciary relationship threatens to compromise the objective of clearly defining the fiduciary category.¹⁰⁶ But this problem is mitigated by imposing an extra burden on the plaintiff who seeks to establish a fiduciary relationship in this type of case.¹⁰⁷

An analysis that focuses on the parties' intent eliminates the central problem with an "unequal relationship" theory of fiduciary duties. Although such inequality seems to justify special duties, it is difficult to determine how much or what type of inequality should be enough.¹⁰⁸ Accordingly it should be left to the beneficiary to choose whether to trust his own judgment or to place power in the hands of a fiduciary. This choice should be respected to the same extent as with other contracts.

III. THE CASE FOR A NARROW VIEW OF THE FIDUCIARY RELATIONSHIP

As discussed in Part I, fiduciary duties are justified in particular situations where other devices for controlling discretion are likely to be ineffective. However, a fiduciary-like duty is seemingly appropriate in some of the categories discussed in Part II where the owner delegates substantial control and nonfiduciary constraints are not fully effective. This suggests that it might be appropriate to have a continuum of context-specific duties to fit various situations that might collectively be termed "fiduciary."¹⁰⁹

The strong medicine of fiduciary duties is, however, appropriate only for a narrow class of cases. While parties to most contractual relationships can act selfishly, fiduciaries consent to forego self-interest. Contracting parties are unlikely to accept the high costs of unselfishness except where fiduciary duties are essentially a last resort. Understanding the fiduciary relationship requires distinguishing it from other relationships in which one party is vulnerable to misconduct by the other but in which the costs of administering the strong fiduciary medicine outweigh the benefits.

This Part discusses the costs of extending fiduciary duties beyond the paradigm case. Sections A and B discuss the relationship between fiduciary duties and other contractual and extralegal methods of enforc-

105. *Id.*

106. *See infra* Part III.D (discussing the benefits of such clear definition).

107. *See Burdett*, 957 F.2d at 1382 (holding that the trial court erred in not applying this rule, but that the error was waived).

108. *See SHEPHERD*, *supra* note 12, at 62–63 (discussing this problem in "unequal relationship" theory of fiduciary duties); *id.* at 230–32 (discussing similar problems regarding duties based on inequality of bargaining power).

109. *See generally* Easterbrook & Fischel, *supra* note 11.

ing the parties' obligations. Nonfiduciary constraints might achieve the same benefit at a lower cost. Moreover, fiduciary duties may interfere with the operation of these alternative enforcement devices. The costs of fiduciary duties may outweigh the benefits where other constraints are likely to be effective—that is, outside the paradigm fiduciary case of open-ended delegation by owners to managers. Sections C through E discuss the potential perverse effects of broad fiduciary duties on litigation costs, ex ante contracts, and the development of conduct norms.

A. *Fiduciary Duties vs. Other Governance Devices*

Fiduciary duties may be excessively costly in light of the availability of other agency cost control devices. *Replacing* these devices with fiduciary duties may be inappropriate because the devices serve functions separate from those of fiduciary duties. For example, voting enables owners to express their preferences about such things as timing of distributions and amount of risk. Fiduciary duties therefore would substitute courts' judgments for parties' preferences. *Supplementing* other devices with fiduciary duties can result in costly duplication of protection.

Imposing fiduciary duties on nonmanaging owners also may deter them from exercising governance rights. This could dilute the effectiveness of devices designed to protect the owners from abuses by managers or co-owners, including partners' powers under partnership statutes to vote on firm matters¹¹⁰ and dissociate from, or dissolve, the partnership.¹¹¹

B. *The Role of Extralegal Enforcement*

Ex post legal enforcement may be unnecessary to constrain opportunistic conduct because of the potential for extralegal constraints. For example, the dominant party, such as a franchisor or venture capitalist, may expect to engage in additional transactions and therefore must maintain a reputation for fair dealing.¹¹² Also, there is experimental evidence that people reward fair behavior and punish unfair behavior. In the Ultimatum Game, a person proposes dividing a sum of money with another party, who can either accept the division or get nothing. Though one would expect a rational self-maximizing proposer to offer close to zero because the responder would prefer something to nothing, offerees tend to reject low proposals, and proposers anticipate such rejection.¹¹³

110. UPA § 18(e); RUPA § 401(j) (same).

111. UPA §§ 29, 31; RUPA §§ 601, 801.

112. See *supra* text accompanying note 22; see also, e.g., D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 J. CORP. L. 949, 969–72 (1999) (discussing reputational incentives in venture capital).

113. Elisabeth Hoffman et al., *On Expectations and the Monetary Stakes in Ultimatum Games*, 25 INT'L J. GAME THEORY 289, 292 (1996). A possible real-world example of the Ultimatum Game in action was the highly negative public reaction to Richard Grasso's compensation by the New York

Robert Scott builds on this theory and evidence to show why parties would choose to enter into non-legally-enforceable indefinite agreements.¹¹⁴ Such contracts may be more efficient than legally enforceable agreements because the parties' ability to rely on fairness incentives lets them contract for unverifiable performance and eschew high-cost litigation. Scott infers the frequency of indefinite contracts from the large volume of litigation on this issue.

A similar analysis arguably applies to gap-filling fiduciary-type duties in firms and other contracts that have definite and enforceable terms. For example, even without an explicit legal duty, a controlling shareholder may have an incentive to prefer a transaction in which the value of control is shared with the other owners over a transaction where the controlling shareholder takes the entire premium. Indeed, it is arguably even less necessary to fill gaps in otherwise legally enforceable agreements that include some constraints on opportunistic conduct than it is to enforce indefinite agreements where there would be no legal constraints in the absence of enforcement.

The relationship between extralegal and legal constraints, however, is not obvious. Though parties have other incentives to refrain from opportunistic behavior, their potential gains from such behavior often may be large enough to swamp such incentives. This seems to be supported by the frequency of cases involving unfair behavior. Accordingly, the benefits of legally enforceable fiduciary-type duties in supplementing extralegal incentives may seem to outweigh the costs.

On the other hand, fiduciary-type duties may weaken, rather than reinforce, extralegal incentives.¹¹⁵ Experiments show that providing incentives or penalties for good or poor performance actually undermines voluntary cooperation and thereby makes such arrangements less efficient than relying on voluntary cooperation.¹¹⁶ Legal enforcement also may reduce feelings of reciprocity that enhance voluntary cooperation.¹¹⁷

Stock Exchange that ultimately led to Grasso's resignation as chairman. See James Surowiecki, *The Coup de Grasso*, THE NEW YORKER, Oct. 6, 2003, at 50.

114. Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641 (2003).

115. See Ribstein, *supra* note 84, at 580-84 (showing how legally enforceable remedies may reduce the parties' opportunities to develop trust through personal relationships, norms, and reputational constraints); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1666-67 (2001) (defending the business judgment rule on the basis that it preserves non-legally enforced rules from undermining by legal duties). Fiduciary duties may reduce extralegal enforcement not only by affecting agents' incentives, but by affecting the extralegal standards themselves. See *infra* Part III.E.

116. See ERNST FEHR & SIMON GACHTER, DO INCENTIVE CONTRACTS UNDERMINE VOLUNTARY COOPERATION? (Univ. of Zurich, Inst. for Empirical Research in Econ., Working Paper No. 34, 2002).

117. See BRUNO S. FREY, NOT JUST FOR THE MONEY (1997) (discussing how motivations such as monetary rewards and regulation "crowd out" parties' motivations based on benevolence or trust); Iris Bohnet et al., *More Order with Less Law: On Contract Enforcement, Trust, and Crowding*, 95 AM. POL. SCI. REV. 131 (2001) (discussing experiments showing that people allowed to interact in a low-enforcement environment became more trustworthy).

Parties have been shown to be more likely to cooperate voluntarily when the incentive is a positive bonus for good behavior than when it is a negative fine for bad behavior.¹¹⁸ Thus, parties who see themselves as adversaries, or who are expected to behave selfishly, may behave accordingly.¹¹⁹ Introducing contractible fiduciary duties into close-knit relationships like families, for example, requires the parties to negotiate over future litigation, hire lawyers, and draft formal documents, as if they were in an arms' length relationship. This encourages them to behave in other respects as parties in such a relationship. Planning for litigation becomes a self-fulfilling prophecy.

To be sure, parties' incentives to behave fairly are not necessarily stronger in all situations than their incentives to behave self-interestedly. Experiments comparing incentive arrangements with pure trust do not measure the *marginal* effects of fiduciary duties in a contract that includes incentives. On the other hand, the benefits of fiduciary duties cannot be measured by observing conduct in reported cases because extralegal incentives help most in reducing disputes.¹²⁰

The theories and evidence summarized above at least counsel caution as to whether fiduciary duties improve incentives. This makes fiduciary duties particularly inappropriate outside the paradigm case, where extralegal constraints and weaker legal duties may be adequate to constrain opportunistic conduct.

C. Litigation Costs

Litigation may entail substantial expense in, among other things, parties' time, attorneys' fees, and business disruption. Clear delineation of when fiduciary duties apply reduces the need to litigate to determine the application of these duties, and increases the benefits of settling without trial.¹²¹ Narrowly defining fiduciary relationships also reduces the potential fiduciary's exposure to opportunistic litigation.¹²² Where the costs and benefits of ex post litigation are asymmetrical a broad remedy gives a party the power to use litigation to extract more from the deal than the parties bargained for. In other words, the power to litigate creates a moral hazard.¹²³ This, in turn, forces the parties to contract for

118. See FEHR & GACHTER, *supra* note 116, at 30–31.

119. See *Triple Five of Minn., Inc. v. Simon*, 280 F. Supp. 2d 895 (D. Minn. 2003) (noting that, “[w]hen you foster an atmosphere of mistrust by threatening litigation for every perceived wrong, you reap what you sow. A person who is mistrusted will often give you reason to mistrust.”).

120. See Scott, *supra* note 114, at 1658–60 (cautioning that policymakers should not generalize about the benefits of legally enforceable duties from litigated cases because in those cases extralegal incentives have broken down).

121. See George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 13–17 (1984).

122. See Ribstein, *supra* note 84, at 576–77.

123. See Scott, *supra* note 114, at 1655–57.

constraints on litigation that decrease this vulnerability. The problems entailed in such contracts are discussed in the next Section.

D. Default Rules and Contracting Costs

The costs and benefits of fiduciary duties arguably could be efficiently balanced by allowing parties to opt out of fiduciary duties where the costs of such duties exceed the benefits. A broad, but contractible, definition of fiduciary relationships would encourage the party who seeks to avoid fiduciary duties to devise more cost-effective protection.¹²⁴ This would be especially important in situations where the duty is based on knowledge, sophistication or bargaining asymmetries.

This approach, however, may entail higher contracting costs than does a narrower structural approach. If fiduciary duties apply broadly and vary significantly across relationships, the parties will not easily be able to determine which duties apply to their particular relationship, and therefore the costs and benefits of contracting for different duties.

E. Norm-Creation and Standards of Conduct

Applying fiduciary duties outside the paradigm relationship may create precedents that weaken fiduciary duties' role in creating norms and standards of conduct even within the paradigm case.¹²⁵

Norms can be defined as internalized standards whose violation produce shame or guilt.¹²⁶ Thus, firms could employ agents with good character who are most likely to adhere to the firm's normative standards.¹²⁷ The law can assist norm-creation by expressing society's condemnation of untrustworthy behavior, thereby triggering internal sanctions for norms violations.¹²⁸ For example, the law can apply "shaming" sanctions to corporate wrongdoers.¹²⁹

124. This discussion presents another analogy to the Ayres-Gertner default rules analysis. See *supra* note 44 and accompanying text.

125. The norm and standard-creating function of fiduciary duties might be further enhanced through specific "sub-rules" of fiduciary conduct. See Sitkoff, *supra* note 11, at 682-83 (discussing such sub-rules in trust relationships); Sitkoff, *supra* note 27, at 577-79.

126. See Rock & Wachter, *supra* note 115, at 1619, 1642-44. Norms as used here is narrower than the concept inherent in Edward Rock's "NLERS." See generally Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 339-43 (1997). NLERS apparently can include owners' use of governance procedures, although these might be viewed as involving legal enforcement of the governance procedure itself.

127. See Robert Cooter & Melvin A. Eisenberg, *Fairness, Character, and Efficiency in Firms*, 149 U. PA. L. REV. 1717, 1723 (2001).

128. See Simon Deakin & Frank Wilkinson, *Contract Law and the Economics of Interorganizational Trust*, in TRUST WITHIN AND BETWEEN ORGANIZATIONS: CONCEPTUAL ISSUES AND EMPIRICAL APPLICATIONS 153-54 (Christel Lane & Reinhard Bachmann eds., 1998) (arguing that, because regulation may influence the development of trust norms, law's overall impact depends on more than just its coercive effect); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1254-55 (1999); Elizabeth S. Scott & Robert E. Scott, *Parents as Fiduciaries*, 81 VA. L. REV. 2401, 2425 (1995) (stating that "[b]y establishing a standard of performance that emphasizes

Most importantly for present purposes, fiduciary duty rules, and the strong language in judicial opinions such as *Meinhard*, arguably help create extralegal norms. Margaret Blair and Lynn Stout argue that normative judicial fiduciary language influences managers' preferences and behavior by "framing" their roles as either self-interested (low-trust) or other-regarding (high-trust).¹³⁰

Assuming the validity of this theory, lawmakers must carefully choose the conduct they stigmatize. The law may be ineffective if it tries to develop a norm that is too far removed from existing perceptions of good behavior. Courts squander their moral authority by condemning conduct that people widely regard as being in the ordinary course of business.¹³¹ Thus, applying the fiduciary characterization to ordinary contract breaches may cause parties to act according to contract, rather than fiduciary, norms.

Commentary supporting the law's role in creating norms, including Blair and Stout's framing theory, accordingly supports this article's theory. Applying fiduciary duties outside the paradigm case, where the fiduciary character of the conduct is unclear, blurs the boundaries between self-interested and other-regarding behavior and thereby interferes with the creation and enforcement of norms.

IV. APPLYING THE ANALYSIS: PARTNERS AS FIDUCIARIES

This article has shown that fiduciary duties should apply only in situations involving open-ended delegation of managerial power. These duties should not apply merely because the contract or the parties' characteristics create vulnerability, to encourage "trust," or because the parties are in a close-knit confidential relationship.

This Part applies this article's analysis in answering the question posed in the title—to what extent do partners and members of other partnership-type firms act as fiduciaries? Partners are often said to have fiduciary duties to each other and the partnership.¹³² However, partners do not have fiduciary duties when they act simply as owners of the firm. Although partners generally have significant governance powers, includ-

heightened obligations of loyalty and integrity, and by the use of hortatory moral rhetoric, the law invokes a personal sense of moral obligation in the performance of fiduciary duty" (citing *Meinhard*); see also Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649, 1666 (2000) (discussing how law can provide a focal point around which norms can form).

129. David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1812 (2001).

130. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1741–42, 1744 (2001) (noting that a separate question exists as to why liability is necessary for appropriate framing); Ribstein, *supra* note 84, at 566–67.

131. See Robert Cooter, *Expressive Law & Economics*, 27 J. LEGAL STUD. 585, 601–06 (1998).

132. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG & RIBSTEIN ON PARTNERSHIP* § 6.07(a) (Supp. 2004-2) (stating that "partners owe fiduciary duties to each other and to the partnership"); Smith, *supra* note 15, at 1458 (stating that "courts predictably impose fiduciary duties in the partnership context").

ing the power to dissolve the firm, and may exercise these powers opportunistically, they do not have fiduciary-like open-ended management power to manage the firm on behalf of passive members. Only *managing* partners in partnerships with centralized management and partners who act as *agents* should be deemed to have fiduciary duties.

Section A discusses general partnerships. Section B discusses limited partnerships, in which managerial and nonmanagerial roles are clearly defined and fiduciary duties have been confined to the former category. Section C discusses limited liability companies, which blend different types of partnership formats, and therefore raise questions about the appropriate analogy.

A. General Partnerships

This Section distinguishes the duties of partners who act solely as owners of the firm from those of partners who act as agents or as managers of centrally managed firms.

1. Partners Acting Solely as Owners

Arguments for imposing fiduciary duties on nonmanaging/nonagent partners focus on the partners' vulnerability to contractual opportunism and the confidential relationship that often arises between owners of very closely held firms. However, Part II shows that these are insufficient grounds for creating a fiduciary relationship.¹³³ For example, the mere fact that a partner's power to withdraw from the firm might be opportunistic does not trigger *fiduciary*, as distinguished from *good faith*, duties.¹³⁴ Partners' powers are insufficient to create the paradigm fiduciary relationship because their co-partners also have significant rights to participate in and object to partnership decisions. The partners of a default partnership, when exercising their governance rights, inherently lack the open-ended delegation of power that would make them fiduciaries.

Consider the following specific aspects of partners' power. First, partners have *equal* rights to participate in management.¹³⁵ This means partners can vote on every transaction, not merely the sort of important transactions on which corporate shareholders can vote.¹³⁶

Second, partners have strong information rights. They are entitled at least to demand all information affecting the partnership,¹³⁷ and have

133. See *supra* Parts II.B, II.D.1.

134. See *infra* text accompanying notes 166–71.

135. See UPA § 18(e), (h); RUPA § 401(f), (j).

136. See, e.g., DEL. CODE ANN. tit. 8, §§ 242 (charter amendments); 251 (mergers); 271 (asset sales).

137. See UPA § 20; RUPA § 403(c)(2).

some additional rights to information even without demand.¹³⁸ They may also be able to demand a full accounting for all partnership transactions even without dissolution.¹³⁹

Third, partners have a strong default right at least to dissociate from the firm and be paid for their interests, and possibly also to cause the partnership to dissolve and liquidate.¹⁴⁰ Although shareholders of publicly held firms easily can sell their shares, they must accept the value the market gives to a minority share. Partners' default dissolution power gives them the leverage to insist on being paid their pro rata share of the asset value of the firm as the price of permitting the other partners to continue the firm. Even where partners can insist only on buyout,¹⁴¹ RUPA provides for valuation on a liquidation basis, which precludes a minority discount.¹⁴²

To be sure, the partnership agreement may negate some, or all, of these rights. For example, the partners may delegate management power to co-partners.¹⁴³ They may also weaken their exit right by providing for a minimum term or undertaking, which implies penalties for early withdrawal,¹⁴⁴ contract for continuation of the firm notwithstanding dissociation, and agree to receive less than the fair market value of their interest upon dissociation.¹⁴⁵ One might argue that fiduciary duties should apply to partners as owners where the agreement leaves them vulnerable to their co-partners.

The application of fiduciary duties should, however, depend on the *default* structure of the relationship, subject to the discussion in the next Subsection concerning centrally managed partnerships. If partners contractually negate their powers, they have an opportunity to contract for alternative protections, including fiduciary duties. Moreover, because of the myriad possible combinations of customized contractual rights, statutes cannot provide default rules, including fiduciary duties, for each feasible set. Ad hoc judicially imposed fiduciary duties would be an even worse alternative because of the need for clear rules to minimize litigation and contracting costs and provide a basis for norm-formation.¹⁴⁶

138. See RUPA § 403(c)(1); BROMBERG & RIBSTEIN, *supra* note 132, § 6.06.

139. See UPA § 22; RUPA § 405(b); BROMBERG & RIBSTEIN, *supra* note 132, § 6.08.

140. See UPA §§ 31, 38; RUPA §§ 601, 603, 701, 801.

141. This includes where the agreement provides for continuation notwithstanding withdrawal but does not specify a buyout price or where the partnership is for an unexpired term or uncompleted undertaking. In the latter situation, a partner who withdraws wrongfully is entitled to the buyout price less damages. See RUPA §§ 602(c), 701(b). However, a partner may withdraw rightfully and not be liable for damages if another partner has dissociated by death or analogous cause. See *id.* § 602(b).

142. See *id.* § 701(b). UPA is unclear. Compare *Shopf v. Marina Del Ray P'ship*, 549 So. 2d 833, 840 (La. App. 1989) (holding that appraiser should apply minority discount), with *Hewitt v. Hurwitz*, 592 N.E.2d 213, 216 (Ill. App. Ct. 1992) (rejecting expert testimony based on sale price of minority interest).

143. See UPA § 18 (lead-in); RUPA § 103.

144. See UPA §§ 31(2), 38(2); RUPA § 602.

145. See BROMBERG & RIBSTEIN, *supra* note 132, §§ 7.11, 7.13(i).

146. See *supra* Parts III.C–E.

Similar observations apply to joint ventures and other business alliances, which are essentially partnerships for a limited period and scope.¹⁴⁷ Here, too, fiduciary duties are thought to be inherent in the relationship.¹⁴⁸ However, the limited scope of the relationship implies even narrower delegation of power than in standard partnerships. As in confidential relationships,¹⁴⁹ the duty is a more limited one regarding misappropriation of information and other jointly owned property.¹⁵⁰

2. *Partners as Managers or Agents*

Partners have fiduciary duties when they act as managers of centrally managed firms. Although the partnership default rule calls for equal participation in management, partners may vary the default. For example, in *Meinhard*, Salmon was a fiduciary because he managed the firm on behalf of Meinhard, the passive investor. Though partners have a strong incentive to participate in management because of their personal liability for partnership debts,¹⁵¹ if they nevertheless delegate management power, their personal liability arguably increases the need for fiduciary duties. Nor is the need for fiduciary duties negated by partners' default rights to demand information and compel dissolution and accounting. Partners' dissolution power is a blunt instrument for constraining managers' day-to-day exercise of discretion. Partners' access to information is unlikely to be effective because partners who delegate broad management power may not know what information to request.

Even if fiduciary duties have significant benefits in centrally managed partnerships, default fiduciary duties arguably are inappropriate in this situation. Because partnership statutes do not provide for managing partners, such partners' powers are not standardized as they are for corporate managers. Applying fiduciary duties therefore would conflict with the need to define clear fiduciary categories. This suggests that it would be more efficient to put the burden on partners to contract for the appropriate level of fiduciary duties even when they contract for centralized management.

On balance, however, as long as courts are wary of the need for clear rules, they should be able to delineate the sort of centralized-management general partnership for which fiduciary duties are appropriate. This would include substantial delegation of management to one or more partners coupled with passivity by the other partners. It would not include mere delegation of some management functions. For example, in

147. See BROMBERG & RIBSTEIN, *supra* note 132, § 2.06 n.3.

148. See, e.g., George W. Dent, Jr., *Gap Fillers and Fiduciary Duties in Strategic Alliances*, 57 BUS. LAW. 55 (2001).

149. See *supra* Part II.D.1.

150. See Smith, *supra* note 15, at 1477; see also Ribstein, *supra* note 43 (discussing the problems of avoiding fiduciary duties in these quasi-firm situations).

151. UPA § 15; RUPA § 306.

Walter v. Holiday Inns, Inc.,¹⁵² the plaintiffs claimed they were owed a fiduciary duty of affirmative disclosure because the defendant was “the managing partner with exclusive control over all financial information concerning the casino.”¹⁵³ However, the court rejected this argument, stating:

[A]lthough the day-to-day operations of the casino were under Holiday’s control . . . the most important decisions regarding the planning and financial management remained with the partnership’s Executive Committee on which plaintiffs served equally with defendants . . . The documents and testimony cited by Holiday overwhelmingly demonstrate the active role played by plaintiffs in every aspect of the partnership’s business.¹⁵⁴

Partners also may have fiduciary duties to the extent that they act as agents of the firm in transactions with third parties, even in a non-centrally managed firm. In this situation partners step out of their governance role. As agents, they are not supposed to be acting on their own behalf, but rather solely on the firm’s behalf.

3. *Analysis of Cases*

Meinhard indicates that the courts have recognized fiduciary duties at least of managing partners. The important point for present purposes is that the duties arguably exist in *Meinhard* solely because Salmon was a *managing* partner, and not simply because he was a *partner*. On the other hand, partnership cases generally do not recognize fiduciary duties in other situations. Despite general statements to the contrary,¹⁵⁵ partners acting solely in their capacity as the firm’s owners have not been subject to fiduciary duties as those duties are defined in this article. Rather, courts generally hold that, in exercising their rights and powers under partnership agreements and partnership statutes, partners can look to their own interests rather than those of the firm or the other owners. The only qualification is that this conduct must comport with the parties’ contract, including the contractual allocation of partnership property, interpreted in light of the good faith interpretation principle.¹⁵⁶

Four categories of cases illustrate the limits of partners’ duties in their capacity as owners. First, partners as owners have a duty to honor the sharing relationship implicit in partnership. It follows that they have a duty not to appropriate firm property, including information and opportunities,¹⁵⁷ for their own benefit.¹⁵⁸ This duty includes not using part-

152. 985 F.2d 1232 (3d Cir. 1993).

153. *Id.* at 1240.

154. *Id.*

155. See *supra* note 132 and accompanying text.

156. See *supra* Part I.C.5.

157. The nonfiduciary nature of liability for usurping business opportunities is discussed *supra* Part I.C.4.

nership information to exploit opportunities that the firm otherwise could utilize.¹⁵⁹ The partner's duty to share partnership information also includes disclosing such information to co-partners,¹⁶⁰ particularly where the informed partner is buying out the other partner.¹⁶¹ This is not, however, a *fiduciary* duty of unselfishness. Thus, a nonmanaging partner's duty to disclose does not include information the partner has generated or that was equally accessible to both partners.¹⁶²

Second, partners have no duty to take affirmative action to protect the firm from harm, or to refrain from contractually authorized action that may harm the firm, even if the action or failure to act benefits themselves at the firm's expense. For example, a nonfiduciary partner need not refinance his loan to the partnership,¹⁶³ make mortgage payments to save partnership property from foreclosure, or refrain from buying the property in the foreclosure sale.¹⁶⁴ Also, a hospital need not continue to employ its doctor partner.¹⁶⁵

Third, partners generally may exercise their power to withdraw from or dissolve the firm in their own interests, subject to their duty not to misappropriate the firm's property or information.¹⁶⁶ This situation may involve structural vulnerability arising from the partnership relationship, as distinguished from the sort of delegated power that gives rise to fiduciary duties.¹⁶⁷ For example, partners may abuse their power unilaterally to dissolve the firm by taking property from the firm, or using

158. See BROMBERG & RIBSTEIN, *supra* note 132, § 6.07(c). For examples of cases in the dissolution situation, see *Leff v. Gunter*, 658 P.2d 740 (Cal. 1983) (partner who prepared bid for lease while associated with partnership could not withdraw and make competing bid); *Rosenfeld, Meyer & Susman v. Cohen*, 194 Cal. Rptr. 180 (Cal. Ct. App. 1983) (law partners may not appropriate major antitrust case simply by withdrawing from firm). See also *Page v. Page*, 359 P.2d 41 (Cal. 1961) (although partner could exercise power to dissolve partnership at will, dictum indicated that a partner may not use the power to appropriate business belonging to a partnership after dissolution); *Wilensky v. Blacklock*, 414 S.E.2d 1 (Ga. 1992) (holding that dissolution in such circumstances is wrongful).

159. See BROMBERG & RIBSTEIN, *supra* note 132, § 6.07(d).

160. See UPA § 20 (1914) (duty to "render on demand true and full information of all things affecting the partnership"); RUPA § 404(c) (1997) (specifying disclosure duties with, and without, demand).

161. See BROMBERG & RIBSTEIN, *supra* note 132, § 6.06.

162. See *Walter v. Holiday Inns, Inc.*, 985 F.2d 1232 (3d Cir. 1993) (applying New Jersey law; duty to disclose not breached in light of plaintiffs' access to records, involvement in the business, and sophistication); *TSA Int'l Ltd. v. Shimizu Corp.*, 990 P.2d 713, 729, 731-32 (Haw. 1999) (duty to disclose not breached where plaintiff had complete access to the partnership records); *Gen. Elec. Real Estate Equities, Inc. v. Bell Realty Mgmt., Inc.*, 738 N.Y.S.2d 318 (N.Y. App. Div. 2002) (affirming summary judgment for defendant on claim of nondisclosure of environmental problems where plaintiff was an experienced real estate development and management company that did its own inspection); *Stuart Silver Assocs., Inc. v. Baco Dev. Corp.*, 665 N.Y.S.2d 415 (N.Y. App. Div. 1997) (holding that general partners had no fiduciary duty to disclose appraisal to limited partners in a real estate venture where limited partners could have obtained information from their legal and financial advisors and could have asked the general partner for more information about the project).

163. See *Riveredge Assocs. v. Metro. Life Ins. Co.*, 774 F. Supp. 892 (D.N.J. 1991).

164. *Jones v. Wagner*, 108 Cal. Rptr. 2d 669, 674 (Cal. Ct. App. 2001).

165. *St. Joseph's Reg'l Health Ctr. v. Munos*, 934 S.W.2d 192, 198 (Ark. 1996).

166. See BROMBERG & RIBSTEIN, *supra* note 132, § 7.02(c)(2). As to misappropriation in this situation, see *supra* note 140 and accompanying text.

167. See *supra* Part II.B.

the leverage the power confers to extract extra benefits from the firm.¹⁶⁸ This is appropriately redressed through the good faith interpretation principle¹⁶⁹ rather than a *fiduciary* duty of unselfishness.¹⁷⁰ Thus, *In re Estate of Rubloff*¹⁷¹ held that a partner had a right to dissolve where the agreement gave the partner a power to do so, and that the partner had no duty to continue the long prior practice of cooperation between the parties.

Fourth, even partners who have controlling voting power are not fiduciaries solely by virtue of that power. This follows from co-partners' significant default exit right, information rights, and the availability of other contractual constraints on partners' voting power. This issue normally arises when partners exercise a contractual expulsion power,¹⁷² where the expelled partner's default exit and information rights are often inadequate protection. The courts generally do not apply a fiduciary analysis in this situation. Although expulsion almost always redistributes firm value to the expelling partners, and therefore would be inconsistent with a strict duty of unselfishness, courts generally have permitted expulsion in accordance with the agreement.¹⁷³ Courts sometimes suggest that partners must have a business purpose for the expulsion rather than exercising it solely for personal gain.¹⁷⁴ But this simply questions whether partners have acted in bad faith by using the expulsion power in a way that the parties never intended.¹⁷⁵ A court might, alternatively, impose liability where the expulsion was triggered by the self-interested exercise

168. See Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999).

169. See *supra* Part I.C.5.

170. See *Bohatch v. Butler & Binion*, 977 S.W.2d 543, 546-47 (Tex. 1998) (upholding expulsion of partner on ground that there is no fiduciary duty to remain someone's partner); *Welder v. Green*, 985 S.W.2d 170, 177 (Tex. App. 1998) (holding that a partner may dissolve a partnership at will even if he benefits from doing so).

171. 645 N.E.2d 370 (Ill. App. Ct. 1994).

172. This should be distinguished from an attempt to expel the partner in the absence of an expulsion power in the agreement, which could trigger statutory damages for wrongful dissolution. See *Cadwalader, Wickersham & Taft v. Beasley*, 728 So. 2d 253 (Fla. Dist. Ct. App. 1998).

173. See *Lawlis v. Kightlinger & Gray*, 562 N.E.2d 435 (Ind. Ct. App. 1990); *Levy v. Nassau Queens Med. Group*, 476 N.Y.S.2d 613 (N.Y. App. Div. 1984); *Gelder Med. Group v. Webber*, 363 N.E.2d 573, (N.Y. 1977); BROMBERG & RIBSTEIN, *supra* note 132, § 7.02(f); Robert Hillman, *Misconduct as a Basis for Excluding or Expelling a Partner: Effecting Commercial Divorce and Security Custody of the Business*, 78 Nw. U. L. REV. 527, 559-81 (1983); Larry E. Ribstein, *Law Partner Expulsion*, 55 BUS. LAW. 845 (2000); Allan W. Vestal, *Law Partner Expulsions*, 55 WASH. & LEE L. REV. 1083 (1998).

174. See *Waite ex rel. Bretton Woods Acquisition Co. v. Sylvester*, 560 A.2d 619 (N.H. 1989).

175. See *Ehrlich v. Howe*, 848 F. Supp. 482, 491 (S.D.N.Y. 1994) (construing expulsion agreement in light of the general contractual duty of good faith); UPA § 31(1)(d) (referring to expulsion bona fide in accordance with the partnership agreement). The expulsion power under RUPA § 601(3) is implicitly subject to the good faith duty under RUPA § 404(d).

of management power, which would be a breach of fiduciary duty under this article's analysis.¹⁷⁶

Not all partnership cases, however, comport with this article's analysis. *Konover Development Corp. v. Zeller*¹⁷⁷ illustrates the perils of expanding fiduciary duties in partnerships beyond the paradigm case. The court subjected a partner's decision to withdraw from a partnership to a fiduciary duty of fairness to the limited partner based on the parties' relative sophistication and bargaining power, disclosure and the adequacy of consideration. The fiduciary duty analysis was inappropriate for several reasons. First, the partner acted as an individual rather than exercising open-ended management power. Second, any potential for opportunism in this situation could have been constrained other than with fiduciary duties, including by adjusting the payout to the withdrawing partner. Third, basing the partner's fiduciary duty on the limited partner's sophistication and bargaining power erroneously looks to partners' characteristics rather than the structure of the relationship.¹⁷⁸ Fourth, a fiduciary duty reduces the value of the withdrawal right in constraining co-partner opportunism.¹⁷⁹ Indeed, the general partner's exit power seems to have been designed to let the partner make a judgment as to the firm's continued financial viability.¹⁸⁰ As the *Konover* court noted, the general partner might be held "hostage" by the other partners.¹⁸¹ The court therefore should have enforced the parties' explicit deal unconstrained by fiduciary duties.

4. *Statutory Provisions*

The narrow construction of partners' duties is consistent with the UPA, which has given rise to most of the partnership fiduciary case law. The UPA requires a partner to "account . . . for any *benefit*, and hold as trustee for it any profits *derived by him without the consent of the other partners*" from transactions connected with the partnership.¹⁸² Although the UPA section is titled "Partner Accountable as a Fiduciary," it does not impose a general fiduciary duty of unselfishness. Rather, the rule requires a partner to share gains from partnership business with the other partners and the partnership, consistent with the partners' joint financial

176. See *Winston & Strawn v. Nosal*, 664 N.E.2d 239, 245–46 (Ill. App. Ct. 1996) (finding a triable issue of bad faith where the expulsion apparently triggered by plaintiff's threat to seek records that would have indicated wrongdoing by the managing partner who was instrumental in the expulsion).

177. 635 A.2d 798 (Conn. 1994).

178. See *supra* Part II.D (criticizing this approach).

179. See *supra* Part III.A.

180. The partnership agreement in *Konover* allowed the defendant to withdraw and demand payment for development expenses if it decided in its sole discretion that the project was not feasible. *Konover*, 635 A.2d at 801.

181. *Id.* at 810.

182. UPA § 21 (emphasis added).

rights¹⁸³ and co-ownership of partnership property¹⁸⁴ and duty not to misappropriate.¹⁸⁵

RUPA provides that partners have “only” a “duty of loyalty” and a “duty of care.”¹⁸⁶ The duty of loyalty includes a UPA-like duty to account for property “derived by the partner in the conduct and winding up of the partnership business,”¹⁸⁷ as well as a duty “to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership.”¹⁸⁸

RUPA is inconsistent with this article’s analysis in at least two respects. First, it characterizes a duty of care as a fiduciary duty owed by all partners. As discussed above, the duty of care is not a strict fiduciary duty of unselfishness.¹⁸⁹ Moreover, partners have a duty of care only when they act as agents or managers, and not when they are acting solely as co-owners. Second, and most importantly, RUPA applies the fiduciary duty of unselfishness—that is, the duty to refrain from dealing adversely with the partnership—to *all* partners, and not only managing or agent partners.

Courts might minimize RUPA’s effect by continuing to apply pre-RUPA case law permitting partners to act in their own interests. This approach is supported by a RUPA provision providing that a partner does not violate a duty “merely because the partner’s conduct furthers the partner’s own interest.”¹⁹⁰ A partner acting as a fiduciary *does* breach his duty if he “furthers [his] own interest.” Courts should interpret the provision as applying the duty of unselfishness only where the partner is acting as a fiduciary, and not in all cases where a partner acts in his own interest.

5. *Limited Liability Partnerships*

Limited liability partnerships (LLPs) opt into limited liability through a corporate-type filing.¹⁹¹ Fiduciary duties arguably are less important in LLPs than in non-LLP general partnerships because, all other things equal, limited liability for partnership debts reduces the costs of

183. *See id.* § 18(a).

184. *See id.* § 25(1).

185. *See supra* text accompanying notes 50–51.

186. RUPA § 404(a).

187. *Id.* § 404(b)(1).

188. *Id.* § 404(b)(2).

189. *See supra* Part I.C.3.

190. RUPA § 404(e); *see Jones v. Wagner*, 108 Cal. Rptr. 2d 669 (Cal. Ct. App. 2001) (holding that partners did not breach fiduciary duty by failing to make mortgage payments to save property from bankruptcy when not required to do so by the agreement, or by bidding on and buying the property in foreclosure sale, relying in part on § 404(e)).

191. *See generally* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT (2001) (2005).

abuse of discretion as compared with a standard form general partnership.

All things are not equal, however, since the presence or absence of limited liability is likely to affect other aspects of the entity's structure. In particular, given limited liability, partners in LLPs are more likely to delegate management power. The allocation of power among the parties, and not limited liability, should control.

B. *Limited Partnerships*

Limited partnerships involve the same underlying principles as general partnerships for purposes of the fiduciary analysis except for the clear delineation of managing and nonmanaging partners.

1. *Limited Partners*

The rules regarding fiduciary duties of general partners discussed in the previous Subsection technically apply not only to general partners, but also to *limited* partners under the Revised Uniform Limited Partnership Act (1985) (RULPA), which defines them as "partners."¹⁹² Consistent with this article's analysis, given limited partners' lack of management power, they do not have fiduciary duties solely as such.¹⁹³ However, a limited partner who participates in control may take on fidu-

192. See REVISED UNIF. LTD. P'SHIP ACT § 101(8) (amended 1985), 6A U.L.A. 223 (2003) [hereinafter RULPA].

193. See *In re Villa West Assoc.*, 146 F.3d 798, 807 (10th Cir. 1998) (holding no fiduciary duty in absence of evidence showing that partners held positions of confidence with, or exercised control over, the partnership); *In re Kids Creek Partners, L.P. v. Leighton Holdings, Ltd.*, 212 B.R. 898, 936-37 (Bankr. N.D. Ill. 1997) (holding that defendant was not shown to have had management role as limited partner or in other roles related to the partnership's development project as investment manager for foreclosing lender, one percent owner of grandparent of corporate general partner, and general partner of a general partnership that owned thirteen percent of the grandparent of corporate general partner and 32.88% limited partnership interest); *Becknell v. Quinn*, 592 F. Supp. 102, 118-19 (E.D. Ark. 1983) (holding that limited partner had no fiduciary duty in buying co-limited partner's interest in foreclosure sale); *Tupper v. Kroc*, 494 P.2d 1275, 1275 (Nev. 1972) (holding that limited partner had no duty to justify price paid for interest at public sale pursuant to charging order); *Crawford v. Ancira*, No. 04-96-000078-CV, 1997 WL 214835, at *5 (Tex. App. Apr. 30, 1997) (holding that limited partner had no fiduciary duty in selling to another limited partner); BROMBERG & RIBSTEIN, *supra* note 132, § 16.07(a)(1); see also *Bond Purchase, L.L.C. v. Patriot Tax Credit Props., L.P.*, 746 A.2d 842 (Del. Ch. 1999) (holding that minority holders of beneficial interests that were equivalent to limited partnership interests had no fiduciary duty in making mini-tender offer for 4.9% of the beneficial interests).

ciary duties.¹⁹⁴ Also, a limited partner may have fiduciary duties to the extent that she acts as an agent for the firm.¹⁹⁵

Limited partners also have *nonfiduciary* duties, as where they may abuse rights to partnership property, including partnership information.¹⁹⁶ For example, *Tri-Growth Centre City, Ltd. v. Silldorf, Burdman, Duignan & Eisenberg*¹⁹⁷ held that a limited partner whose law firm had represented plaintiffs' partnership breached his duty by bidding on property in competition with the partnership using confidential financial information bearing on the partnership's ability to buy the property. The court reached the right result, though it mischaracterized the partner's duty as fiduciary in nature.

2. General Partners

In determining the duties of a general partner in a limited partnership, it is necessary to further distinguish the relationship among the general partners from that between the general partners as a group and the limited partners. In the former situation, the general partners probably are acting as owners, and therefore do not have fiduciary duties under this article's analysis. In the latter situation, a general partner in a standard form limited partnership is more clearly a fiduciary than is a managing general partner in a general partnership. That is because the limited partnership "control" rule, which imposes partner-like liability on limited partners who participate in management,¹⁹⁸ effectively blocks their participation in management.

3. ULPA (2001)

ULPA (2001) clarifies that a limited partner, acting solely as such, does not have fiduciary duties.¹⁹⁹ However, the clear division between general and limited partners' powers and duties is threatened by the demise of the limited partnership control rule in ULPA.²⁰⁰ Where limited partners exercise significant management powers under the agreement

194. See *S. Atl. Ltd. P'ship of Tenn., L.P., v. Riese*, 284 F.3d 518, 533–34 (4th Cir. 2002) (holding that limited partner who was permitted to be a contractor, employee, consultant, or surety and to handle firm's accounting had fiduciary duties though agreement also provided that limited partners should take no part in the management or conduct of business); *Goldwasser v. Geller*, 684 N.Y.S.2d 210, 210 (N.Y. App. Div. 1999) (holding that limited partners breached fiduciary duty to co-limited partner when they took over control of the partnership and settled limited partners' claim against the general partners). The result in *Goldwasser* arguably followed from the terms of the partnership agreement rather than from default fiduciary duties.

195. See UNIF. LTD. P'SHIP ACT § 305 cmt. a (2001), 6 U.L.A. 51 (2003) [hereinafter ULPA (2001)].

196. See *supra* Part II.D.1.

197. 265 Cal. Rptr. 330 (Cal. Ct. App. 1989).

198. See RULPA § 303.

199. ULPA (2001) § 305 (2001).

200. See *id.* § 303; Larry E. Ribstein, *Limited Partnerships Revisited*, 67 U. CIN. L. REV. 953 (1999).

analogous to those of general partners,²⁰¹ they might become, in effect, general partners, with those partners' duties.

An early draft of ULPA (2001) suggested as one alternative that limited partners' fiduciary duties depend on the level of power delegated to the partners, along the lines of members' duties under some LLC statutes.²⁰² This flexible test poses two problems. First, a statute cannot easily specify the many gradations of power that may be provided for in partnership agreements.²⁰³ Accordingly, it makes sense to let the partners draft for the level of fiduciary duties that is appropriate to their firms. Second, it may be important to provide for clear categories of fiduciary relationships even if these categories do not perfectly fit policy objectives in every case.²⁰⁴

Finally, the comment to ULPA's fiduciary provision suggests that the different approaches to limited and general partners' duties reflects a difference between fiduciary duties arising out of a partner's "status" as such and those arising out of contract. The issue here, however, is one of choosing the default rule that provides the parties' agreement in the absence of a customized term. The comment accordingly is misleading in suggesting that default fiduciary duties that arise from a partner's "status" are categorically different from duties that arise by customized "contract."

C. LLCs

LLCs differ from both general and limited partnerships in that, under most statutes they can adopt either one of two *default* structures—general-partnership-type decentralized management or limited-partnership-type centralized management. This has led one court to observe that: "Limited liability companies are neither general corporations nor general or limited partnerships. They are a specially recognized form of entity. . . ." ²⁰⁵ Another court said that, because LLCs are "hybrid" entities, courts should interpret LLC characteristics according to "the foundational business form from which that characteristic originated."²⁰⁶

201. If management power were shared among limited partners, these partners, like general partners in a general partnership, would not have fiduciary duties to each other under this article's analysis.

202. See *infra* Part IV.C.

203. See *infra* Part IV.C (discussing LLCs).

204. See *supra* Part II.

205. *In re Lake Country Invs.*, Nos. 99-20287, 00-6064, 2001 WL 267475, at *10 (Bankr. D. Idaho Mar. 19, 2001) (footnote omitted).

206. *Anderson v. Wilder*, No. E2003-00460-COA-R3-CV, 2003 WL 22768666, at *4 (Tenn. Ct. App. Nov. 21, 2003) (quoting David M. Hastings, Annotation, *Construction and Application of Limited Liability Company Acts*, 79 A.L.R.5TH 689, 698 (2000)); see also *Credentials Plus LLC v. Calderone*, 230 F. Supp. 2d 890, 898-99 (N.D. Ind. 2002) (applying both corporate and partnership principles in holding that office-member breached duty by soliciting the LLC's customers).

The management structures of LLCs are further complicated by the fact that, like general and limited partnerships, they can vary each default structure by allocating management power to individual members. Accordingly, an LLC may be centrally managed for purposes of limiting the agency power of individual members to bind the firm, but give substantial power to members for internal purposes. Conversely, an LLC can formally adopt decentralized management but delegate power to managing members.

Under this article's approach, fiduciary duties in LLCs should depend on the allocation of management power. Thus, as in limited partnerships and corporations, managers of manager-managed LLCs should have default fiduciary duties. Members should not have fiduciary duties solely on account of their membership status. They may be fiduciaries, however, to the extent that the agreement creates centralized management, or to the extent they act as agents.

Consistent with this analysis, several cases have held that members, as such, do not have fiduciary duties.²⁰⁷ On the other hand, LLC managers have been held liable for breach of fiduciary duty.²⁰⁸ Where courts have held that members had duties, these have been nonfiduciary under this article's analysis. Some of these cases involve member usurpation of the firm's business opportunities.²⁰⁹ As discussed above, these cases are based on a combination of the firm's property rights in the opportunity as against the members, and members' use of information belonging to the firm—theories that apply to both managing and nonmanaging members.²¹⁰ Liability also has been based on misappropriation of LLC as-

207. See *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 708–09 n.7 (Bankr. E.D. Va. 2000) (applying Virginia LLC statute); *In re Lake County Invs.*, 2001 WL 267475 (holding that members had no fiduciary or other duty to advance funds beyond specific requirements set forth in agreement); *Suntech Processing Sys., L.L.C. v. Sun Communications, Inc.*, No. 05-99-00213-CV, 2000 WL 1780236 (Tex. App. Dec. 5, 2000) (holding that members have no duties to each other, relying on close corporation cases, and applying rule to eighty percent owner of LLC); see also *McGee v. Best*, 106 S.W.3d 48 (Tenn. Ct. App. 2002) (holding no breach of good faith duty in performing buyout agreement according to its terms).

208. See *Blue Chip Emerald LLC v. Allied Partners Inc.*, 750 N.Y.S.2d 291 (N.Y. App. Div. 2002) (manager of joint venture LLC breached duty in connection with purchase of co-venturer's interest to disclose negotiations to sell the firm's property to third party at higher price); *Flippo v. CSC Assocs. III, L.L.C.*, 547 S.E.2d 216 (Va. 2001) (manager transferred firm assets to joint venture to effectuate personal estate planning goal contrary to LLC's interests). *Blue Chip* arguably should be characterized as involving bad faith or misappropriation of information because the parties had specifically disclaimed fiduciary duties in the buyout agreement. *Flippo* was based partly on bad faith reliance on advice of counsel, but it is appropriately characterized as a duty of loyalty case because the bad faith issue arose only as to whether the defendant could rely on statutory exculpation provision.

209. See *Anest v. Audino*, 773 N.E.2d 202, 211 (Ill. App. Ct. 2002) (finding breach of duty by member in member-managed LLC where opportunity was developed with firm's assets and not properly tendered or disclosed, despite firm's financial inability to develop opportunity); *Jundt v. Jurassic Res. Dev.*, 656 N.W.2d 15, 25 (N.D. 2003) (finding no breach of duty where there was no showing that the LLC had the financial ability to take the opportunity).

210. See *supra* Part II.C.2.

sets.²¹¹ Other cases involve bad faith abuse of governance powers in the operating agreement.²¹² Such conduct often also constitutes an abuse of agreed powers because it effectuates misappropriation of firm assets and opportunities,²¹³ or involves a manager's breach of a duty of loyalty.²¹⁴

To be sure, the courts do not always articulate the appropriate rationale for recovery. For example, *Anderson v. Wilder*²¹⁵ questionably applied corporate fiduciary principles to the bad faith expulsion of a co-member. This confusion is expectable in light of the courts' uncertainty as to how to characterize limited liability companies. *Anderson*, in particular, struggled to find the appropriate analogy for LLC duties.²¹⁶ This article's analysis should assist courts in rationalizing duties in the relatively new LLC context.²¹⁷

Finally, with respect to statutory specification of LLC duties, the Uniform Limited Liability Company Act (ULLCA) adopted the approach, later rejected in ULPA (2001),²¹⁸ of attempting to specify when members of manager-managed LLCs would have fiduciary duties. As in

211. See *Credentials Plus, LLC v. Calderone*, 230 F. Supp. 2d 890 (N.D. Ind. 2002) (holding that member and officer breached duty in soliciting the firm's customers).

212. See *Fine v. Bork*, No. CV010808586, 2002 WL 207538 (Conn. Super. Ct. Jan. 16, 2002) (manager of an LLC may have breached duty by unilaterally amending operating agreement to remove two-member requirement and thereby avoid dissolving the LLC when he dissolved a member in connection with a plan to seize the firm's property); *Solar Cells, Inc. v. True N. Partners, LLC*, No. Civ. A. 19477, 2002 WL 749163 (Del. Ch. Apr. 25, 2002) (enjoining secret attempt to merge LLC into subsidiary of firm that had appointed three of the LLC's directors); *VGS, Inc. v. Castiel*, No. C.A. 17995, 2000 WL 1277372 (Del. Ch. Aug. 31, 2000) (managers diluted power of co-manager who owned controlling share interest in LLC by persuading director appointed by controlling member to switch sides; breach of loyalty and good faith by failing to give plaintiff advance notice of merger plans, though no notice explicitly required by operating agreement); *Walker v. Res. Dev. Co., Ltd., L.L.C.*, 791 A.2d 799 (Del. Ch. 2000) (members breached operating agreement by attempting unilaterally to remove plaintiff as member); *Anderson v. Wilder*, No. E2003-00460-COA-R3-CV, 2003 WL 22768666 (Tenn. Ct. App. Nov. 21, 2003) (triable issue of bad faith in controlling members' expulsion of minority members from an LLC in order to increase expelling members' interests in the firm and enabling expelling members to resell the expelled members' interests for a higher price, and in wrongful use of LLC funds to buy the expelled members' interests). For a comparison of good faith and fiduciary duties, see *supra* Part I.C.5.

213. See *Fine*, 2002 WL 207538; *Solar Cells*, 2002 WL 749163; *VGS*, 2000 WL 1277372; and *Anderson*, 2003 WL 22768666, discussed *supra* note 212.

214. See *VGS*, 2000 WL 1277372.

215. 2003 WL 22768666, at *4.

216. See *supra* text accompanying note 206.

217. An article that appeared for the first time as this paper was being completed suggests that courts should adopt a "broad approach to fiduciary duties" in LLCs in preference to a narrower good faith or entire fairness test in order to balance contractual freedom with "legitimate expectations of fair and equitable conduct . . ." Miller, *supra* note 13, at 1654. Miller concludes that broad fiduciary duties better reflect "society's norms of ethical conduct," would combat "subtle freeze-out schemes," and would recognize that the parties' relationship may not be "governed by a highly negotiated and well-conceived contract." *Id.* However, Miller does not articulate precisely when fiduciary duties would apply under her approach in contrast to good faith interpretation. Nor does she disclose how broad fiduciary duties might lead to a better result in any particular case or category of cases, including the LLC freeze-out and other cases she discusses. By contrast, this article has shown how broad fiduciary duties may be costly in several respects. In particular, tighter fiduciary duties may be antithetical to establishing "norms of ethical conduct." See *supra* Part III.E.

218. See *supra* Part IV.B.3.

the limited partnership context,²¹⁹ this type of provision causes problems in attempting to anticipate myriad contractual arrangements. Although clarity and predictability in defining the fiduciary relationship is desirable, that clarity will have to come from courts' understanding of the nature of fiduciary duties and relationships.

V. CONCLUDING REMARKS

Fiduciary duties are a valuable tool, but they are subject to misuse. Courts often have been beguiled by Justice Cardozo's colorful language in *Meinhard* into using fiduciary analysis whenever they are confronted with an issue that is not easily resolved in other ways. But this article shows that there are significant costs in extending fiduciary relationships beyond the specific paradigm situation involving clear separation of management powers and ownership. Overuse of fiduciary duties increases litigation and contracting costs, decreases the effectiveness of owners' governance rights, and dilutes true fiduciaries' legal and extralegal incentives.

This delineation of the structure of the fiduciary relationship can be useful in several ways, including guiding courts, legislators, and lawyers in adapting traditional rules for new types of partnership-based business entities. It also broadly comports with the holdings of cases. Its significance, therefore, lies mainly in increased clarity rather than a radical reduction in legal protection.

The article has applied this analysis to partnership-type firms. In general, neither partners nor owners of partnership-type firms have fiduciary duties solely in their capacity as such. Rather, partners or equivalent parties have such duties only as agents or as managers of centrally managed firms. Courts have recognized this dichotomy, and should continue to do so despite some ambiguities in the underlying statutory provisions.

219. See *supra* text accompanying note 202.

