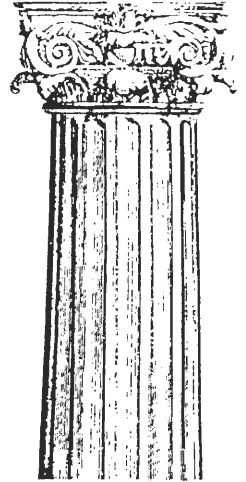
The 1993 Isaac Pitblado Lectures



FIDUCIARY DUTIES/ CONFLICTS OF INTEREST

Co-Chairs:
Mr. Justice Alan MacInnes
Manitoba Court of Queen's Bench
Barbara M. Hamilton, Q.C.
Aikins, MacAulay & Thorvaldson

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Faculty of Law

not settled as the majority did not explore the matter and allowed for consideration of it in "an ordinary doctor-client case".[34] Where a physician/patient relationship does exist, counsel should carefully review McLachlin J.'s reasons.

Misuse/abuse of the relationship is not restricted to sexual improprieties. As noted earlier, the current economic stress on our health insurance schemes has resulted in an increasing number of services being paid for by patients. In Manitoba, cosmetic surgery, psychoanalysis, *in vitro* fertilization, breast implants and unproven sex changes are among a growing number of noninsured services. A breach of a fiduciary obligation may entitle a patient to recover the fees paid to the physician per ***Henderson*** v. ***Johnson.***[35] As well, if a physician obtains a collateral benefit for services rendered to a patient, counsel should review ***Ralston*** v. ***Tanner***[36] which provides that the fiduciary nature of the relationship may give rise to a presumption of undue influence. Standby fees which are often the subject of patient complaints may be characterized as collateral benefits.

As a result of the significant information and discussion which was generated by the *Task Force on Sexual Abuse of Patients*,[37] instigated by College of Physicians and Surgeons of Ontario, sweeping changes have been proposed by Canadian medical licensing bodies and some provincial governments for the governance of the healthcare professions. As an example, on November 20, 1992 the Attorney-General of Ontario introduced an amendment to *The Limitations Act*[38] which amendment, if passed, will entirely eliminate the limitation period for civil suits for sexual assault by a person in a position of trust. The apparent tendency of the courts to view fiduciary obligations in a closed, commercial context is in stark contrast to the ethical precepts enunciated by medical licensing bodies. The medical licensing authorities in Canada are unanimous in their position that any sexual involvement between a physician and patient is a serious breach of trust by the physician. The significant increase in disciplinary actions for breach of trust will likely result in many appeals to the courts. One may also anticipate a corresponding increase in the number of civil actions by patients. It is only a matter of time until the Supreme Court considers and determines the issue of fiduciary obligation in the context of what it regards as "an ordinary doctor-client case."

34 *Ibid.* at 457.

35 *Supra*, note 8.

36 (1918), 43 O.L.R. 77.

37 An Independent Task Force commissioned by the College of Physicians and Surgeons, 1991.

38 R.S.O. 1990, c. L15.

FIDUCIARY LAW: THE JUDICIAL PROCESS AND THE DUTY OF CARE*

TAMAR FRANKEL

In this paper I discuss the judicial process regulating the duty of care of fiduciary managers In particular, I discuss the recent developments with respect to the managers' duty of care. These developments present a puzzle. Increasingly, American courts have broadened the functions and attendant powers and discretion of managers. Usually, as the powers of fiduciaries broaden, so do their duties. Yet, with respect to fiduciary managers' duty of care, the recent movement has been the reverse. While the courts have recognized **broader functions** and discretionary powers for managers, be they trustees or corporate managements, courts and legislators have **relaxed** their **supervision** of fiduciary managers' substantive decisions under the duty of care. Courts have resorted to procedural guides, statutes have allowed shareholders to waive their fiduciaries' duty of care (not the duty of loyalty), and the American Law Institute's *Principles of Corporate Governance* has permitted corporations to put a dollar cap on managements' liability for breach of the duty of care.[1]

These incongruous trends appear with respect to the duty of care of fiduciary managers but not the duty to provide skillful services, or to the duty of loyalty; nor do these trends appear with respect to other types of fiduciary services, such as lawyering and health care.

To discuss these particular trends, I would like to put them in context. Judges have long exercised broad powers in designing fiduciary law. Fifty years ago, Justice Frankfurter described the judicial mandate as follows:

> [T]o say that a person is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary?

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1 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations, Proposed Final Draft (March 31, 1992)* (Philadelphia: American Law Institute, 1992) at § 7.19 [hereinafter *Principles of Corporate Governance*]; J.C. Coffee, Jr., "The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role" (1989) 89 Colum. L. Rev. 1618.

What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[2]

Traditionally, the courts have pursued these inquiries and have undertaken to answer all of them. Thus, the courts take three main steps in adjudicating fiduciary matters: they first define the functions which fiduciaries were expected to serve; they then determine the powers which fiduciaries needed in order to perform these functions, and, finally, on the basis of the functions and powers the courts design the regulatory scheme for the particular situations.[3] Because fiduciary relationships can arise under various legally binding relationships (contracts, trust instruments, wills, statutes, charters, elections, appointments) as well as under non-binding agreements or unilateral consents of a fiduciary to serve, courts determine the fiduciaries' functions by drawing on the instruments, facts and circumstances under which the relationships arose. The principles which guide the courts in determining the fiduciaries' functions are similar to those that guide the courts in ascertaining the parties' intent, but the sources from which the intent is garnered are far more varied (written documents, the parties' actions, the actions of third parties and other circumstantial evidence).[4]

To determine the fiduciaries' powers attendant to their functions, the courts draw on the parties' intent and on the nature of the functions. Once they establish the fiduciaries' powers in the particular relationship, the courts design rules to regulate their exercise of those powers. Thus, in the area of fiduciary law, the courts engage in three lines of inquiry, and draw on somewhat different sources, models and processes to guide and answer the inquiries.

Fiduciary law regulates the providers of very special services. These services can be divided into two groups. The first group consists of services that require entrustment of property or power to the fiduciary. Without such entrustment the services cannot be rendered at all, or they can be rendered with less than maximum efficiency. The second group consists of services requiring skills that are very costly to master; for example, lawyering, and some kinds of investment management.

2 ***SEC* v. *Chenery Corp.***, 318 U.S. 80 at 85-86 (1943).

3 To reduce the itemized analysis of each situation the courts have developed categories such as trust, agency and partnership. The analysis may therefore start with categorizing the relationship and then, within that category, refining the components of functions, powers and required regulation.

4 *See* at § 1(b) *infra*.

5 W R. LaFave & A. W. Scott, Jr., *Criminal Law*, 2d ed. (St. Paul, Minn: West, 1986) at § 8.6.

Because the relationship poses for one party ("the entrustor") substantial risks of misappropriation and monitoring costs and because public policy strongly supports both groups of services, fiduciary law interferes to reduce these risks and costs. The law aims at deterring fiduciaries from misappropriating the powers vested in them solely for the purpose of enabling them to perform their functions ("duty of loyalty"). The principles that guide the courts in regulating fiduciaries to deter them from misappropriation are similar to those underlying the crime of embezzlement[5] and the tort of conversion.[6]

Further, fiduciary law aims at reducing the entrustors' costs of monitoring the quality of the fiduciaries' services ("duty of care"). The guiding principles in reducing monitoring costs are drawn from the tort of negligence.[7] In general, the greater the risks, the higher the costs to entrustors, the stricter the rules regulating the fiduciaries will be. As the fiduciaries' discretion is more broadly defined, their regulation will be stricter.

The recent trends discussed above pose two questions. First, what are the reasons for the recent expansion of fiduciary managers' powers and discretion? My hypothesis is that the recent expansion of managers' functions and discretion is responsive to recent changes in the global business and economic environment in which most such managers operate. This environment is becoming less predictable and more chaotic. Such instability requires that the power and discretion of the fiduciaries be extended so that they can respond to unexpected developments.

The second question is: why is the duty of care of such managers shrinking instead of expanding? The extension of fiduciary power should have been accompanied by tighter judicial controls, but it was not. As discussed in this article, a number of explanations come to mind.

First, the managers' duty of care has progressively weakened for quite some time. Second, investment management services are not easily

6 W L. Prosser & W P. Keeton, *Prosser and Keeton on the Law of Torts*, 5th ed. (St. Paul, Minn: West, 1984) at § 15. For an example of the viewing conversion and breach of fiduciary duty as inter-changeable see ***Moore* v. *Regents of the University of Cal.***, 51 Cal. 2d 120, 793 P.2d 479, 271 Cal Rptr. 146 (1990) (claim by a patient against his physician for taking without the patient's consent and converting to his own research and commercial use the patient's blood, skin, and sperm. While the Court rejected the claim for conversion it allowed an action for breach of fiduciary duty and lack of informed consent to the taking. The dissent argued for imposing the tort of conversion on the physician's taking); see "Recent Developments" (1991) 104 Harv. L. Rev 808

7 Prosser & Keeton, *ibid*.

amenable to judicial standards. To the extent that such standards are available, they are, indeed, imposed. In addition, public policy encourages some kinds of fiduciaries, such as corporate management, to take entrepreneurial risks, rendering any possible regulatory standards even "thinner." Third, as the courts often state, the fiduciaries rather than the courts were chosen by the entrustors to perform the services. Therefore, the courts restrain themselves from making business judgments on the merits, or determining the risk levels of investments. Fourth, as their discretion broadens and the unpredictability of the environment increases, fiduciaries may be exposed to liabilities that far exceed the benefits they receive from the services. Consequently, managers may refuse to serve. This last reason has loomed large as litigation and judgments have increased and the cost of insurance coverage for managing fiduciaries has sky-rocketed.[8]

I predict that the current trends will continue. Managers' discretion will be broadened but their duty of care (that one would expect to increase) will continue to shrink. I do not expect our business and economic environment to become more predictable in the near future. In fact, I believe that, with the melting of the cold war and the emergence of powerful global communications technologies, the business and economic environment will continue to fluctuate, perhaps at greater speed Therefore, managers will continue to be vested with more discretion to deal with unanticipated changes that require immediate decisions. Nonetheless, we can expect that the law as set forth by legislatures and expounded by the courts will continue to limit the managers' duty of care and reduce direct judicial supervision.

This paper is divided into four parts. Part 1 discusses the purpose of fiduciary law. Part 2 examines the multi-dimensional form of adjudication in fiduciary law. Part 3 illustrates the expansion of the functions and powers of managers in trust law and corporate law. Part 4 describes the techniques which courts have used to relax the duty of care regulating these managers. I conclude with an explanation of these developments.

1. THE PURPOSE OF FIDUCIARY LAW

(a) The Fiduciary Relationships

Fiduciary relationships are unique. They involve service relationships. In general such relationships are backed by a fundamental and strong

8 See note 28 *infra*.

policy in our society to encourage division and specialization of labour. However, service relationships result in dependence of both parties on each other, and such dependence conflicts with strong American public policy and culture to encourage people to be independent. American society is a "do-it-yourself" society.[9] When people can easily acquire the skills to perform services, it is likely that they will do so, for example, fix their cars, mow their lawns, and assemble newly-bought furniture. Therefore, in the United States the policy of encouraging division of labour and specialization is not equally strong with respect to all types of services. There seems to be no strong public policy to encourage Americans to hire others to render services that most Americans can usually do themselves.

Fiduciary relationships do not involve these kinds of services. They involve services that require special skills. These are skills that require a substantial investment in education; the kind of services that machines cannot yet perform (at least not as well as humans, in this day and age). It would be wasteful for every person to learn medicine, law, or investment management and sound public policy encourages people to engage others to perform fiduciary services rather than "do it themselves."

However, those who engage others to perform these special services not only become dependent on the service givers, but also cannot judge the quality of the services precisely because these services are not easily acquired or understood. The cost of monitoring and evaluating such services would undermine the very utility of the arrangement. Low quality services could cause substantial losses to entrustors. Thus, the strong public policy to encourage specialization with resect to these services is likely to be defeated.

Another aspect of fiduciary services poses further substantial risks for entrustors and provides disincentives for engaging fiduciaries. Many fiduciary relationships involve entrustment. They require that the fiduciary receive power over the entrustor, or over property or interest belonging to the entrustor; without such power the fiduciary would not be able to perform his or her services effectively.[10] This entrustment exposes entrustors

9 Anyone who has lived abroad is struck by the strong inclination of Americans to service themselves. One reason may be the high cost of labour and relatively low cost of machinery to help perform the services. Another important reason may be that Americans prefer not to be dependent on the service givers.

10 The power may be entrusted by statute (public officials), or by statute and entrustors (corporate directors and officers), or it can be vested by the entrustor (agents), or it can be vested by a third party (trustees under trusts or wills).

to the risk that the fiduciaries will appropriate the entrusted property or interest or misuse the power entrusted to them. Such appropriation or abuse of power can result in a loss that far exceeds the potential gain from the fiduciaries' services. Thus, the strong public policy to encourage specialization with respect to fiduciary services is likely to be defeated.

In sum, there is a strong public policy to encourage service relationships that require skills involving substantial investment and services that require entrustment. Yet these relationships are highly risky to entrustors because the services are either costly to monitor, or because they pose the risk of misappropriation, or both. Both low quality services and misappropriation can result in severe losses to entrustors.

(b) Fiduciary Law

Fiduciary law addresses the two unique aspects of the relationship. To reduce the risk from low quality services fiduciary law vests in entrustors the legal right to rely on the adequate quality of their fiduciaries' services – it imposes on fiduciaries a duty of care and skill. To entice entrustors to enter the relationship the bulk of fiduciary law is designed to reduce the entrustors' risk of loss of their entrusted property or injury from abuse of entrusted power; it vests in entrustors the right to rely on the honesty of their fiduciaries – it imposes on fiduciaries a duty of loyalty.[11]

It is notable that fiduciary law is triggered when the relationship arises, regardless of whether it arises under contract, trust, will, statute, charter, election or without any legally binding arrangements. If Smith agrees to represent me in a legal transaction as an act of friendship and without remuneration, fiduciary law is triggered by his consent, and he becomes my fiduciary. If he is negligent in his representation, he will be liable to me for my losses.

2. THE MULTI-DIMENSIONAL FUNCTIONS OF THE COURTS IN FIDUCIARY LAW

In applying fiduciary law, the courts follow three steps. First they define the functions which fiduciaries were expected to serve. Second, in light of these functions, the courts determine the powers that the fiduciaries needed to perform these functions. Third, the courts design the regulatory regime for the particular situations before them. The functions, powers

[11] In addition, fiduciary law imposes specific preventive duties designed to deter misappropriation of entrusted property or interests, such as trustees' duty to earmark and segregate trust property.

and regulations are related. When the fiduciaries' functions are determined, the powers necessary to perform these functions follow from the parties agreements, or are implied from the functions, as a matter of logic or experience.[12] Even though the courts do not always explicitly distinguish among them, it is useful to analyze the three lines of inquiry separately because the courts use somewhat different forms of analysis in making the determination in each of these steps.

(a) Determination of Fiduciaries' Functions

Because the sources that may trigger fiduciary relationships are so many and varied, and because these sources may cover many other legal arrangements that do not relate to the fiduciary relationship (e.g., sale), the judges' first function is to ascertain the terms of the relationship – the fiduciaries' functions and attendant powers. It is only after these have been ascertained that the fiduciaries can be regulated.

To determine the fiduciaries' functions judges draw on the various sources that gave rise to the relationships: agreements, contracts, trust instruments, wills, statutes, charters, elections, or appointments. The principles which guide the courts in determining the fiduciaries' functions are principles of interpretation derived both from written documents and parties' actions. Examples of judicial interpretation of instruments are abundant in trust law, wills, partnerships, and agency. When fiduciary relationships arise under written instruments, the courts are likely to follow these instruments.

Difficult issues arise when the written instruments state one thing, but the parties acted differently. It is interesting to note that when they interpret contracts, judges are more likely to follow the classification that the parties designed for their relationship as stated in the instruments, while in fiduciary law they are less inclined to do so. Applying fiduciary law, judges may look to what the parties did rather than only to what they said. Presumably judges consider predictability in contract relationship to be far more important than predictability in fiduciary law. For example, in ***Fowler v. Pennsylvania Tire Co.***,[13] the issue was whether an agreement constituted a consignment or a sale. The majority of the court gave effect to the parties' classification of their relationship as an

[12] One commentator objected to the grant of management power because, he argued, the cost of regulating the power would be too high, and presumably, exceed the benefit from the exercise of the power. L.E. Ribstein, ''Takeover Defenses and the Corporate Contract'' (1989) 78 Geo. L.J. 71, at 108-111, 118.

[13] 326 F.2d 526 (5th Cir 1964).

assignment as stated in their written agreement while the dissenting judge argued for classifying the relationship mainly according to the parties' actions. In contrast, in ***Martin*** v. ***Payton,***[14] the issue was whether an agreement constituted a loan or a partnership. The court stated:

> Partnership results from contract, express or implied. If denied, it may be proved by the production of some written instrument, by testimony as to some conversation, by circumstantial evidence. If nothing else appears, the receipt by the defendants of a share of the profits of the business is enough . . . And we are to remember that although the intention of the parties to avoid liability as partners is clear, although in language precise and definite they deny any design to then join the firm of K.N.& K.; although they say their interests in profits should be construed merely as a measure of compensation for loans, not an interest in profits as such; although they provide that they shall not be liable for any losses or treated as partners, the question still remains whether in fact they agree to so associate themselves with the first as to 'carry on as co-owners a business for profits.'

When fiduciary relationships arise without writing, or under instruments that do not define the fiduciaries' functions and powers in detail, the courts exercise broad discretion to determine the fiduciaries' functions. One striking example can be drawn from corporate law, at the beginning of this century. During that period, the courts allocated to management the function and power to determine the size of the corporation's enterprise. The case of the Ford Motor Company demonstrates this transition.

In the early 1900's, the majority of the shares of Ford Company was owned by Henry Ford and most of the minority shares were owned by the Dodge brothers.[15] Ford controlled the company as majority shareholder and manager. The company did spectacularly well and paid "extraordinary dividends" in addition to the "usual" dividends of 5% a month. In 1916 Ford declared that the company will cease to pay the extraordinary dividends and continue to pay only the regular dividends. He justified his decision on the ground that the company was earning too much and should return some of what it received to society. He wished to reduce the price of cars so that more people could own cars, even though the company had a back-log of over five years. Whereupon the Dodge brothers sought a court order requiring Henry Ford to distribute all profits to the shareholders except for necessary working capital.

[14] 246 N.Y. 213, 158 N.E. 77 (N.Y.C.A., 1927) at 78-79. See also ***Kaufman-Brown Potato Co.*** v. ***Long***, 182 F.2d 594 (9th Cir. 1950).

[15] ***Dodge*** v. ***Ford Motor Company***, 204 Mich. 459, 170 N.W. 668 (1919).

The holding in the case centred around the legitimate purpose of a business corporation: whether such a corporation may be managed for the benefit of the public while reducing profits. However, an ancillary issue involved the criteria for dividend distribution. Behind that issue lurked a much larger question of who should determine the size of the corporate enterprise. On this point, the lower Court held that management's discretion in declaring dividends is limited to determining the amount of working capital necessary to maintain the enterprise.

The higher Court held that the management of the corporation had discretion to reinvest dividends in the corporate enterprise and expand the size of the enterprise. The Court's views were influenced by the phenomenal success of Ford Company and Ford's contributions to this success. The Court vested in corporate management the function and power to determine the size of the economic enterprise.[16]

In sum, courts establish the functions of fiduciaries by interpreting and enforcing the intent as manifested in the parties' agreements and actions. In absence of such agreements and actions, as is the case in defining corporate managers' functions, the courts seem to be guided by what they considered desirable functions and powers for managers and the appropriate relationship between the managers and their entrustors.

(b) Determining the fiduciaries' powers

Fiduciaries' powers are attendant to their functions, but the powers do not follow automatically from the functions. A fiduciary may be expected to serve as trustee, but the trust instrument may constrain his or her powers, for example, to invest trust assets only in government securities. An agent has the power to purchase on behalf of the principal, but the amounts involved, the expertise required, and the discretion granted to perform these functions may vary greatly. Courts ascertain the fiduciaries' powers from the express or implied language of the instruments that created the relationship or from the actions of the parties and

[16] The Court recognized the conflict of interest between management and shareholders, especially the minority shareholders. Management can receive its income from salaries while the minority shareholders depend for income on dividends.

circumstances of the relationships. In this respect, courts adopt an analysis similar to the one they follow for determining the fiduciaries' functions.[17]

(c) Design of Rules

Once they determine the powers of a fiduciary in the particular relationship, the courts design rules to regulate the fiduciary in the exercise of these powers. Two main purposes drive the regulatory regime. One is to reduce the entrustors' risk from misappropriation of entrusted property and power. These rules are deterrent rules, and come under the umbrella of the duty of loyalty. The principles that guide the courts in regulating fiduciaries to deter them from misappropriation are similar to those underlying the crime of embezzlement[18] and the tort of conversion.[19]

The other purpose that drives the regulatory system is to reduce the costs of monitoring fiduciaries to ensure quality fiduciary services. This regulation comes under the umbrella of the duty of care. The guiding principles in reducing monitoring costs are drawn from the tort of negligence. This regulation is the subject of the discussion here.

Historically, courts determined the duty of care by setting forth the degree of attention that the fiduciary must pay in performing his functions. Courts also determined the duty of skillful performance, establishing a standard of skills – the degree of proficiency that fiduciaries must possess in order to perform their functions. In some cases, such as investment management services, courts established the level of risk which managers may take in investing for their entrustors. For example, trustees were required to exercise prudence while corporate directors were allowed to take greater risks.

In sum, historically, the regulation of the quality of fiduciaries' services required a minimal level of attention to performing the service, minimal proficiency in performing the service, and an acceptable level of exposure to risk in connection with the services.

17 Courts also determine the degree of skill that the fiduciaries must possess in performing their functions. These skills are rarely, if ever, explicitly stated in the documents creating the relationships. The degree of required skill is derived from the type of expected services and the circumstances surrounding the relationships, such as the responsibility involved in providing the services, the skills which the fiduciaries professed to posses, and the fees paid to them.

18 LaFave & Scott, Jr., *supra*, note 5

19 Prosser & Keeton, *supra*, note 6

20 American Law Institute, *Restatement of the Law, Trusts (Prudent Investor Rule): Proposed Final draft April 6, 1990*. (Philadelphia: American Law Institute, 1990).

3. THE EXPANSION OF MANAGERS' FUNCTIONS AND POWERS

Recently, the functions and powers of trust managers and corporate managers have been greatly expanded. Today, most trust documents vest in trustees broad investment discretion. The American Law Institution Prudent Investor Rule[20] has granted trustees (subject to the trust instrument) almost unlimited discretion to choose the particular investments in the trust portfolio, and substantial freedom to determine the level of risk of the whole portfolio in light of the needs of the specific trust beneficiaries. The rule imposes on trustees the duty to diversify the trust portfolio according to the level of risk appropriate for the particular trust.[21] This rule was substituted for the old rules that required diversification in a limited manner and specified which particular investments were risky (second mortgages and stock) and which investments were safe (first mortgages).[22] The new rule allows trustees to take into account inflation and other economic circumstances, and encourages trustees to delegate some of their managerial authority to others by investing in mutual fund shares, when appropriate.

Similarly, corporate management is increasingly invested with discretion not only to operate and manage the corporate enterprise but also in negotiating with hostile raiders and blocking hostile takeovers.[23] When takeovers became prevalent, the functions and powers of management were not clearly defined in legislation or in the corporate constitutional documents. The courts undertook to define the managements' functions and powers in order to determine what type of regulation is appropriate for these functions. An avalanche of scholarly advice was soon available to the judiciary, ranging from denying managements any function or power to react to hostile takeovers to vesting in management the discretion to negotiate with hostile raiders, representing the shareholders or the

21 *Ibid.*

22 A.W. Scott & W. F. Fratcher, *The Law of Trusts*, 4th ed. (Boston: Little, Brown, 1987) at §§ 227.5, 227.6, 227.12, 228 (1988). The level of risk regarding corporate assets was left to the determination of corporate managements in recognition of the public policy to encourage corporate entrepreneurial risk taking.

23 For examples of early cases see ***Cheff*** v. ***Mathes***, 199 A.2d 548 (Del. Supr. 1964) ***Kors*** v. ***Carey***, 39 Del Ch. 47, 158 A.2d 136 (1960).

shareholders and other stakeholder, to intermediary positions.[24] The courts experimented; they changed their views about corporate managements' functions and powers to react to hostile takeovers in light of the changing environment and new legislation None of the courts deprived corporate managements of discretion in the face of hostile takeovers.[25] Legislatures provided substantive and procedural

[24] For examples of scholarly literature on managements' role in the case of hostile takeovers see L. E. Ribstein, "Takeover Defenses and the Corporate Contract", *supra*, note 12; Choi, Kamma & Wintrop, "The Delaware Courts, Poison Pills, and Shareholder Wealth" (1989) J. Law Econ. & Org. 375; F.H. Easterbrook & D.R. Fischel, "The Proper Role of a Target's Management in Responding to Tender Offer" (1981) 94 Harv L. Rev. 1161; R.J. Gilson, "Seeking Competitive Bids Versus Pure Passivity in Tender Offers Defense", (1982) 35 Stan. L. Rev 51; R.J Gilson "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers" (1981) 33 Stan L. Rev. 819. There are numerous state corporate and securities statutes that deal with the subject by imposing various conditions in hostile takeover situations. For a similar issue see ***Moore* v. *Regents of the University of Cal.***, *supra*, note 6 (attempting to determine limits to the patient's ownership rights to his blood cells, skin and sperm as against the public policy of encouraging physician to conduct research and benefit from it commercially. This issue is similar to the issue of determining intellectual property rights); D.D. Haddock, J.R Macy & F.S. McChesney, "Property Rights in Assets and Resistance to Tender Offers" (1987) 73 Va. L. Rev. 701; J.C. Coffee, Jr., "Shareholders versus Managers: The Strain in the Corporate Web" (1986) 85 Mich L. Rev. 1. See also Easterbrook & Jarrel, *Separate Statement to Report of Recommendations of the SEC Advisory Committee on Tender Offers* 16-18 reprinted in Fed. Sec L. Rep. (CCH) at 70 (special edition no. 1028) (July 15, 1983).

[25] See e.g. ***Edgar* v. *Mite Corp.***, 457 U.S. 624 (1982); ***CTS Corp.* v. *Dynamics Corp. of America***, 481 U.S. 69 (1987); ***Paramount Communications, Inc.* v. *Time Inc.***, 571 A.2d 1140 (Del. Supr. 1989); ***Unocal Corp.* v *Mesa Petroleum Co.***, 493 A.2d 946 (Del. Supr. 1985) (determining whether and under what circumstances management can make a tender offer of the corporation's shares as a defensive tactic and requiring management to use its discretion to maximize the shareholders' value); ***Moran* v. *Household Int'l, Inc.***, 500 A.2d 1346 (Del. Supr. 1985) (determining the validity of a defensive tactic by "rights offerings"); ***Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.***, 506 A.2d 173 (Del. Supr. 1986) [hereinafter ***Revlon, Inc.***] (expressing concern about the potential conflicts of interest between the shareholders and the managers; determining the functions of the management and its range of discretion before it determines to maintain the corporation's independence and after the loss of independence is a foregone conclusion). For a detailed description and bibliography on this subject see L.E. Ribstein, *Business Associations* at § 12 (1990).

empowerment to corporate managements.[26] In fact, they allowed numerous forms of defense tactics, and provided few guidelines.[27]

4. MANAGERS' SHRINKING DUTY OF CARE

(a) The Duty of Care

Fiduciary services involving expertise and skills expose entrustors to high cost of monitoring. Yet, the fiduciaries offering such services must have broad discretion because they are the best judges of how their services should be performed. One of the purposes of fiduciary law is to reduce the monitoring costs of such services and ensure their quality performance.

(b) The Relaxation of the Managers' Duty of Care

While investment managers were, and still are, regulated in respect to negligence in performing their duties, this regulation has been relaxed. The recent movement to relax the strictness of the duty of care did not apply to expert performance of skillful fiduciary services. Lawyers, accountants, and physicians have been subject to staggering liabilities for lack of skillful and careful performance of these services.[28] The history of

[26] For descriptions and analyses of, and arguments about, state legislatures' reaction to hostile takeover movement see R. Romano, "The Political Economy of Takeover Statutes" (1987) 73 Va. L. Rev. 111; H. N. Butler, "Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters" (1988) Wis. L. Rev. 365; J.W Hackl & R. A. Testani, "Second Generation State Takeover Statutes and Shareholder Wealth: An Empirical Study" (1988) 97 Yale L. J. 1193; M. Ryngaert & J. M. Netter, "Shareholder Wealth Effects of the Ohio Antitakeover Law" (1988) 4 J.L. Econ. & Org. 373; R. A. Booth, "The Promise of State Takeover Statutes" (1988) 86 Mich L. Rev. 1635.

[27] The Delaware court did hold that if management anticipated that the corporation will lose its independence, then management's discretion became more limited and it had to put the corporation on the auction block to maximize the shareholders' value. *Revlon, Inc.*, *supra*, note 25 at 182.

[28] See e.g., B. K. Kirby, T L. Davies, "Accountant Liability: New Exposure for an Old Profession", (1991) 36 S.D. L. Rev 574 n.3 citing Medick, "Accountant's Liability: Coping With the Stampede to the Courtroom" (1987) J. Acct. 118 at 119 ("a collection of the largest accounting firms have paid more than $250 million in accountant audit-related lawsuits since 1980").

corporate managers' duty of care reveals that the process of relaxing the duty of care started long ago.[29] The quality control of fiduciary managerial services has been diluted in a number of ways.

First, the courts created a presumption that, if the process is adequate, a decision on the merits is not negligent, provided no breach of the duty of loyalty has occurred. This business judgment rule, which shields managers from liability, has been continuously expanded.[30]

Second, the courts have reduced their supervision of the fiduciaries' substantive decisions by resorting to procedural guidelines that demonstrate the managers' attention to the decision.[31]

Third, the courts are more inclined to allow entrustors to reduce or waive the duty of care in advance.

Fourth, the courts and the legislatures allowed entrustors to waive or reduce the liability of their managers for the breach of the duty of care, by informed and independent consent, provided the duty of loyalty has not been breached.[32] Although it is debatable whether shareholders can give such consent,[33] capable, independent and informed principals, partners and trust beneficiaries can, and the courts will enforce that consent. Thus, trustors and testators may waive the requirement that their trustees and executors will provide a bond, and that waiver will be enforced.

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29 H. Marsh, Jr., "Are Directors Trustees? Conflict of Interest and Corporate Morality" (1966) 22 Bus. Law. 35.

30 *Ibid.*

31 In ***Smith* v. *Van Gorkom***, 488 A.2d 858 at 893 (Del. Supr. 1985) the Court held that the board of directors of a corporation failed to perform its duties with care when: it made a crucial decision about future of the company (the sale of the company), during an approximately two-hour meeting, without in-depth study of the value of the company's shares, and without written reports which the board could scrutinize in advance. There are those who argue that such procedural requirements result in empty "paper trails" and do not have a substantive impact on the quality of the board's decision. I disagree. I believe that process and ritual have a great impact even if attention is not always focused. Those people who pray daily or weekly in the synagogue are greatly impacted by repeated words and the meaning of these words are inculcated within them.

32 American Law Institute, *Principles of Corporate Governance, supra*, note 1 at §7.19; J. C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, supra*, note 1

33 See generally, Coffee, *ibid.*

Fifth, in some cases the courts and legislatures reduced the judicial supervision over the managers' duty of care by providing for results explicitly, for example, in takeover situations. These rules have indirectly limited the managers' discretion, but in most respects they have strengthened the managers' remaining discretion.[34]

Thus, the managers' increased discretion was not accompanied by increased legal accountability. In fact, fiduciary managers' level of liability for injuries resulting from taking inappropriate risks (without bad intent) was lowered.

(c) Re[illegible]ns for relaxation of the managers' duty of care

Th[illegible] managers' duty of care may have been relaxed lately for a number of reaso[illegible]

Fi[illegible] historically, investment managers' duty of care has never been very st[illegible]. Although their services require a measure of skill, managers' services [illegible]e regulated as fiduciary essentially because they involve entrust[illegible]t. Neither trustees nor corporate managers are required to posses[illegible]ecial qualifications; minimal qualifications suffice.[35] The fact that in[illegible]ment and business managers are not regulated on the basis of their s[illegible]ut rather on the basis of entrustment may explain why the duty of car[illegible]nposed on these managers is not considered paramount to regulat[illegible]; their services.[36] In fact, commentators have long argued that

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34 See e.g., Act No. 36, Apr. 27, 1990 amending 15 Pa. Cons. Stat. (Business Corporation Law) revising §§102, 511-512, and 2502, and adding §§ 2561-2567, 2571-2575, 2581-2583 and 2585-2587. For descriptions and analyses of, and arguments about, state legislatures' reaction to hostile takeover movement see Romano, *supra*, note 26; Butler, "Corporation-Specific Anti-Takeover Laws and the Market for Corporate Charters, *supra*, note 26; Hackl & Testani, *supra*, note 26; Ryngaert & Netter, *supra*, note 26; Booth, *supra*, note 26. Note that some legislation has limited judicial interference in managements' activities by direct regulation of some aspects of hostile takeovers.

35 Only when they profess to have special skills, and they do so falsely, or when they do not perform their services with the expected skills, will they will be held liable.

36 Under the *Advisers Act*, 15 U.S.C. §80b-1 to §80b-22, investment advisers with respect to securities are not required to have any qualifications. See T. Frankel, *The Regulation of Money Managers* §7 at 21 (1978, 1980).

the duty of care should not apply to these fiduciaries.[37] One commentator also argued that when courts have imposed liabilities on corporate managers for breach of duty of care they suspected breach of the duty of loyalty, but there was no clear proof of such breach.[38]

The historical weakness of the managers' duty of care can be also explained by the fact that many managerial functions are not amenable to the imposition of judicial standards. Managerial services have remained an art rather than a science. There are numerous investment strategies and techniques, and most are based on intuition and unproven theories. Courts cannot and should not dictate the strategies that investment managers should adopt. So long as these theories are acceptable to some people, or so long as they are disclosed to entrustors and they choose the particular investment managers, courts should not judge their techniques.

Third, there are good arguments for the proposition that entrustors rather than the courts should establish the level of desirable risk for their managed properties. The future appropriate level of risk of investments cannot be anticipated when the economic environment is volatile. For example, investments in low income, fixed return debt instruments may represent low credit risk. However, in times of inflation, such investments are risky because the buying power of the currency is eroded to the extent that even the capital is not preserved. If the beneficiaries do not expect to draw on the trust fund for many years, and inflation may nibble at the value of the assets, an investment in stocks will be far wiser and less risky than investment in debt instruments. It is recognized that these issues should be left to the trustee, so long as the trustee can rationalize the choice of risk level for the particular trust.

By far the most important reason for the further relaxation of managers' duty of care is that the number of cases brought against

37 J. D. Cox, "Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures" (1984) 52 Geo. Wash. L. Rev. 745.

38 D. M. Phillips, "Principles of Corporate Governance: A Critique of Part IV" (1984) 52 Geo. Wash. L. Rev. 653.

managers and the amounts involved have increased dramatically.[39] As their discretion broadens, and the unpredictability of the environment increases, managers may be exposed to liabilities that far exceed their benefits from the services. Fiduciary law is designed to encourage the parties to engage in the relationship. Its main thrust is to regulate fiduciaries because they pose substantial risks for the entrustors. However, if the burdens on managers exceed the expected benefits from the relationship the managers will refuse to engage and provide their services. Corporate directors' fees do not begin to cover the enormous amounts for which directors might be liable. To the extent that they will not be indemnified or insured, one can expect capable people simply to refuse to serve on corporate boards. Similarly, even though corporate officers are highly compensated, there are limits to the potential liability that they will tolerate. Thus, the main explanation for reducing or eliminating the duty of care of managers seems to be the concern that high burdens of liability deter capable potential directors from serving.[40]

39 Similar problems have appeared with respect to other fiduciary services, such as medical services, and we in the United States are grappling with the problems of enormous judgments and higher mal practice insurance premiums. See W. F. McDonough, "Does the Punishment Fit the Crime? How Federal and State Civil RICO Statutes transform Accountant Liability" (1992) 26 Suffolk L. Rev. 1107, 1108 (litigation costs accompanying these suits and the risks associated with insuring accountants have resulted in higher malpractice insurance costs with premiums rising and coverage falling. Accountant malpractice insurance costs have tripled in the last three to four years); see also P. M. Danzon, "The Frequency and Severity of Medical Malpractice Claims: New Evidence" (1986) 49 Law and Contemp. Probs., 58 at 69-70 (citing rising frequency and severity of malpractice claims as causing increased insurance premiums); H. F. Mooney & L. S. Bloom, "Anatomy of a Legal Malpractice Claim" (1988) 55 Def. Couns. J. 400 (same).

40 For admonitions that people will decline to serve as directors see D. J. Block, S. A. Radin & J. P. Rosenzweig, "The Role of the Business Judgment Rule in Shareholder Litigation At the Turn of the Decade" (1990) 45 Bus. Law. 469 at 475, citing ***Bach* v. *National Western Life Ins. Co.***, 810 F.2d. 509 at 511 (5th Cir. 1987); ***Joy* v. *North***, 692 F.2d 880 at 888 (2d Cir. 1982) (demonstrating the courts' concern with the directors' burden of liabilities affecting their readiness to serve), M. P. Dooley and E. N. Veasey, "The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared" (1989) 44 Bus. Law. 503 ("the threat of personal liability on corporate directors might make directors unduly risk averse or less willing to serve"); B. G. Helldorfer, ed., "Recent Literature" (1988) 43 Bus. Law. 1157 at 1162 (many qualified individuals are reluctant to serve on corporate boards due to a fear of the perceived resurgence of the duty of care and the difficulty in obtaining liability insurance). C. Hansen, "The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, a Commentary" (1986) 41 Bus. Law. 1237 at 1239 ("[i]f the directors are to be second-guessed as to the substance of their decisions,

For all these reasons the courts have sought to reduce the level of fiduciary managers' liabilities for lack of care (negligence).

CONCLUSION

I believe that the trends described in this paper will continue: on the one hand, the functions of managerial fiduciaries will be broadened and their discretion will expand. On the other hand, judicial supervision of these fiduciaries with respect to negligence in the performance of their services will be reduced and alternative mechanisms will be sought to deal with the problem.

The recent developments expanding managers' functions and discretion are greatly influenced by changes in the business and economic environment in the United States. As the instability of the environment grew, the power and discretion of the fiduciaries had to expand. The courts enforced the conditions negotiated by the parties and the legislative initiatives in granting fiduciaries expanded discretion. To be effective,

continued...

with accompanying liability, few will serve''); *Delaware General Corporation Law* §7(b) as amended, effective July 1, 1986 permitting a Delaware Corporation to provide in its certificate of incorporation or amendment thereto a limit or to eliminate altogether directors' personal liability to their corporation or its shareholders for breach of care as a director under certain circumstances; J. W. Groessl, ''Delaware's New Section 102(b)(7): Boon or Bane For Corporate Directors?'' (1988) 37 DePaul L. Rev. 411 (stating that the passage of §102(b)(7) was the result of increasing scarcity of qualified disinterested directors in 1985. This scarcity resulted from decline in scope of coverage and availability of directors and officers insurance, ''staggering personal liability'' in litigation involving breaches of fiduciary duties, and increased likelihood of such litigation against directors); L. A Whited, ''Note: Corporate Directors – An Endangered Species? A More reasonable Standard For Director And Officer Liability in Illinois'' (1987) Ill. L. Rev. 495 (expressing similar sentiments: ''corporations will find it increasingly difficult to attract onto their boards men and women of achievement as the liability risks and the work burden of directorship overwhelmingly outbalance the marginal benefits of directorship''); R. F. Belotti & M. J. Gentile, ''Elimination or Limitation of Director Liability for Delaware Corporations'' (1987) 12 Del. J. Corp. L. 5 (the section was ''intended to assist Delaware corporations attract and retain highly qualified individuals to serve as directors. Many corporations have since taken advantage of this section by adopting amendments which limit or eliminate director liability . . .''); S. R. Cohn, ''Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule'' (1983) 62 Tex. L. Rev. 591; D. J. Block & H. A. Prussin, ''The Business Judgement Rule and Shareholder Derivative Actions: Viva *Zapata*?'' (1981) 37 Bus. Law. 27 (increased directorial discretion and elimination of judicial second-guessing encourages competent individuals to assume directorships).

fiduciaries need the freedom to act, and greater power to make quick decisions.

At the same time, the courts and the legislatures have reduced judicial supervision over the level of care that managers exercise in the performance of services for the reasons described above, even though an increase in the entrustors' risks usually results in stricter rather than more lax fiduciary duties.

I do not expect our business and economic environment to become more predictable in the foreseeable future. In fact, with the disappearance of the cold war and the appearance of powerful global communications techniques, the business and economic environment is likely to fluctuate and change, perhaps at greater speed. Therefore, managers will continue to acquire greater discretion to deal with unanticipated changes that require immediate decisions, and the courts will continue to recognize this greater discretion.

I expect that the law as set forth by legislatures and expounded by the courts will continue to reduce their monitoring of the quality of managerial services and their direct judicial supervision over the negligent performance of these services. Perhaps other mechanisms and market competition will substitute for the managers' quality services. However, we can expect continue[illegible]al limitations and caps on the responsibility of managers for negligent performance of their services.