Fiduciary Relationship in the United States Today

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1. INTRODUCTION

This paper discusses recent movements in American fiduciary law. One movement, adopted by the courts, is toward adding members to the family of fiduciaries, specifically, psychiatrists and doctors. Academics are calling for applying fiduciary law to priests who have abused their parishioners and it is likely that the courts will extend the law in that direction. But not all academics' recommendations to change fiduciary law are embraced by the courts. Other recommendations to increase, reduce or eliminate fiduciary duties applicable to corporate managements have had far less effect on judicial decisions. On three related issues concerning corporate management courts have declined to change drastically the status quo. Essentially, they refused to extend fiduciary law to a non-fiduciary relationship of corporate management with bondholders.1 Similarly, they refused to characterize the employees' relationship with corporate management as fiduciary.2 The courts also showed no inclination to adopt as legal doctrine the economic definition of a corporation as a nexus of contract relationships. Such a definition would substitute contract law for fiduciary law applicable to the relationship between the

management and its corporation and shareholders. While legal scholars are now debating many issues arising from this definition, the courts do not seem inclined to exclude corporate managements from the category of fiduciaries although they have sometimes increased the judicial deference to managements’ decisions duties.

In sum, the courts have usually maintained the status quo regarding corporate management — a traditional member of the fiduciary family — but have reached out to admit into the family new and different members. Why these different results? This paper offers an explanation and tests or conditions that will help predict when courts are likely to expand or refuse to expand the group of fiduciaries (“Basic Conditions”).

In my opinion, trends in American fiduciary law can be explained by the judges’ perception of the state of the Basic Conditions. Judicial decisions are fairly consistent with this test, and the different results in the decisions make sense in light of this consistency.

Before discussing the topic I would like to address a threshold question: What difference does it make if someone, such as a psychiatrist or a priest, is declared a fiduciary? What difference does it make to the defendant, the plaintiff, and the judicial system? Here are some of the main differences.

First, fiduciaries are subject to far more judicially-created rules than contract parties or tortfeasors. Judicial activism is one of the main emblems of fiduciary law. Judging can rarely, if ever, be passive, but the degree of judicial activism by fiduciary law is relatively great.

Second, judges create rules of behavior that not only fill gaps in the general terms of the agreement between fiduciaries and their entrustors, but also supersede and establish norms of behavior that are higher than the norms prevailing in the market place and trade associations. Therefore, a serious moral stigma attaches to those fiduciaries who breach their duties. This moral stigma is far greater than the stigma attached to those who breach a contract. Unfaithful fiduciaries are “the criminals from the right side of the tracks”.

The moral behavior required of a fiduciary is particularly important when otherwise the criteria for conduct are the morals of the market place and that is especially important in some contexts, such as professional licensing standards.

A third difference for the parties to a relationship from the application of fiduciary law relates to the civil remedies available to the entrustors. These civil remedies, which generally are not available to contract or tort claimants, include accounting for the fiduciary’s illegitimate profits and other equitable remedies. The remedies are available to entrustors in addition to any remedies under contract and tort law.

Fourth, from the perspective of the courts’ system, the imposition of fiduciary duties on a new class of defendants or the exclusion of old-timers from the group of fiduciaries affects the judicial work-load and the courts’ resources; that may be a factor in determining whether to expand or restrict the applicability of fiduciary law. Therefore, it makes a great difference to the parties and the judicial system whether the parties are in a fiduciary relationship.

The first part of this paper describes the conditions which I believe trigger the applicability of fiduciary law and those conditions which may deter the

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5 See section 2 infra, discussing Basic Conditions.

6 I hasten to make two disclaimers. First, my assertions do not purport to offer a general theory of legal change, which is far beyond the scope of this paper; broader implications are left for another day. The other disclaimer relates to the paper. This paper focuses on doctrine. There are political, economic, philosophical, and other reasons for reducing or increasing courts’ activism by fiduciary law. For example, in corporate law, these reasons involve the role of the corporation and its board of directors in society, whose interests the corporation and the board should serve, how the gains and losses of the corporate enterprise should be divided among the competing stakeholders and the extent to which corporations should internalize the externalities that they impose on society (e.g. laying off employees and shutting down company towns).


8 Arguably, law, and fiduciary law especially, is inherently indeterminate. Many fiduciary relationships vest in the fiduciary broad discretion, often long-term. For both parties, the cost of specifying the details of performing discretionary, expert, or long-term services is great or prohibitive. Therefore, the courts spell out the terms of the relationship, post facto, after conflicts arise. Because fiduciary relationships are so varied, detailed judicial rules are also very costly. To adapt to different circumstances, fiduciary law rules must remain flexible and less determinate.

Moreover, since the parties’ agreement contains large gaps that the court must fill, the courts are less bound to the text of these agreements in contrast to contract texts. The courts reconstruct the parties’ reasonable expectations, exercising broader judicial discretion to resolve conflicts. In sum, the high costs of determinacy for the parties and the courts, necessitate broad judicial discretion in fiduciary law.
2. THE BASIC CONDITIONS

(a) When Courts are Likely to Apply Fiduciary Law

Interest in fiduciary law has increased in the past two decades. About ten years ago I joined the group of scholars that examined this area of law, and suggested the conditions under which courts are likely to apply fiduciary law. In this paper I call them "Basic Conditions." Now I would like to refine the list of conditions under which the courts are likely to refrain from applying fiduciary law.

In a 1983 article I suggested that courts will apply fiduciary law when:

1. One party, "a fiduciary," performs some service for another party, "an entrustor"; and
2. In order to perform the service effectively, the fiduciary must receive power from the entrustor; and
3. The relationship is open to so many variables that the parties cannot specify outcomes in different circumstances, except generally; and

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10Frankel, supra, note 7.

11Traditionally, the power related to property in various intensities, such as transfer of title, possession, or providing investment advice.
4. The fiduciary's power enables him to violate the reasonable expectation of the entrustor either by incompetent or negligent performance or by disloyal performance in conflict of interest.
5. If the entrustor were to monitor and control the fiduciary, the very benefit from the relationship would be undermined; and
6. No effective alternative monitors and controls over the fiduciary exist.

(b) When Courts are Likely Not to Apply Fiduciary Law

I believe that judges are likely to refuse to extend fiduciary law to new situations when the new situations do not involve property rights. The reason is that historically fiduciary duties were designed to protect property owners. Hence, courts develop fiduciary law by drawing an analogy to new relationships to property relationships; if the model does not fit, courts are likely to refrain from applying fiduciary law to the new situations. Judges are also likely to refuse to extend fiduciary law when the application of the whole of that law will present doctrinal problems. I believe that the courts are unlikely to apply selective rules of fiduciary law to relationships in other categories; courts tend to apply fiduciary law as a whole rather than pick a rule from one category and transport it to another. I also believe that courts are unlikely to shift situations selectively from one legal category to another. When such applications are problematic, the courts will probably maintain the status quo. An example for the proposition that courts are unlikely to apply selective rules of fiduciary law to relationships in other categories involves the status of insurance companies’ reserves. During the 1920s insurance companies invested premiums and reserves in speculative investments. When they failed, policyholders argued before the courts that these investments constituted a breach of trust because insurance companies held the reserves as trustees for the policyholders. These arguments were rejected. The courts classified insurance policies as contracts (deeds). Ownership of the reserves vested fully in the companies. Therefore, the companies were free to invest the reserves as

14 See Coster and Freedman, supra, note 11 at 1046-47.
15 A beneficiary entrusts a fiduciary with control and management of an asset. Ideally, for the beneficiary, this relationship would be governed by specific rules that dictate how the fiduciary should manage the asset in the beneficiary’s best interests. In fact, however, the fiduciary’s obligations are open-ended. Because asset management necessarily involves risk and uncertainty, the specific behavior of the fiduciary cannot be dictated in advance. Moreover, constant monitoring of the fiduciary’s behavior, which would protect the beneficiary, often is prohibitively costly.
16 When judges do not have the expertise in the supervised area, such as medicine (even though courts can be helped by expert witnesses), they may adopt the hands-off attitude. This issue relates to the extent of supervision, not to whether fiduciary law should apply at all.

17 210 U.S. 206 (1908).
18 Old Dominion Copper Mining & Smelting Co. v. Biglow, 203 Mass. 159 at 176, 89 N.E. 193 at 201 (1909).
Neither imposed on the selling promoters a fiduciary duty of prior disclosure to
crude investors so as to negate the rule of caveat emptor, applicable to contract.
There are counter-examples to my proposition that the courts are unlikely to
apply selective rules of fiduciary law to relationships in other categories and to
the proposition that the courts refuse to shift situations from one legal category to
another. However, generally such counter-examples are more apparent than real
and some are borderline cases.

(i) Remedies

One counter-example to the proposition that courts do not shift rules or mix
categories involves remedies; there are cases in which courts shift remedies
transferred from one category to another. For example, constructive trust can be
viewed as a counter-example to judicial practice not to transport rules from one
category to another. Constructive trust, accounting and restitution are remedies
under fiduciary law that are stronger than common law remedies. The courts
import these strong remedies into contract and other subcategories of law in
egregious cases by creating an irrebuttable presumption that a wrongdoer is
holding property as a trustee for the victim, and requiring the wrongdoer to
transfer the property to its rightful beneficial owner. The remedy enables the court
to right a wrong without voiding the transaction which vested in the wrongdoer
the title to property (by transfer, or by a will, or by any other legal way).
Also, a constructive trust can be imposed on the profits gained by the party in breach
of contract, even if the breach did not result in damages. In Sney v. United
States, the Supreme Court awarded the government such a remedy by imposing
a constructive trust on profits that a CIA agent made in violation of his contract
with the government. The court reasoned that information gathered by the agent
in the course of his employment belonged to the government. Since the agent
misappropriated the information by writing a book about the CIA, the profits
from the book belonged to the government. Due to this remedy, the agent lost
most, if not all, of the incentive to write or publish the book.
Thus, the remedy of constructive trust is a remedy that mixes legal categori-
es, but does not result in a conflict among the categories; rather, it preserves the
values and policies of each category. Perhaps the reason for this exception is that
remedies are greatly affected by the facts of the case; their application is therefore
more situation-specific. In addition remedies are less likely to affect the basic

23 Trust can be viewed as an exception to the proposition that courts do not mix legal categories
because it combines contract, property, and fiduciary law. However, the trust does not conflict with
the values and policies of contract with respect to the interpretation of the trust instrument.
Fiduciary law also complements property category because it accommodates and enforces the
desires of the property owner, which cannot be effected under contract. In addition, as against
third parties, a fiduciary is bound by a contract and property law.

24 Cohabitation resembles marriage in purpose (not necessarily its anticipated duration), but lacks
the formal blessing of the State. Cohabitation also resembles partnership, since both parties
work to create wealth, but it is not established for the purpose of carrying on a business. In fact,
cohabitation is a new "mixed" relationship with ingredients from both categories.

25 “Notes: A More Perfect Union: A Legal and Social Analysis of Domestic Partnership
Ordinances”, 92 Colum. L. Rev. 1164 at 1168-86 (1992). Other doctrines that were applied
include implied contract for services, quasi-contract, irrecoverable gift, resulting trust and
similar remedies. (Cf., e.g., Amos v. United States, 444 U.S. 707 at 815 (1980); see also Frankel, supra, note 7.)

law of marriage to the extent that the rules in these two categories are not identical. The choice of partnership category allows the courts to follow the public policy which favors marriage over cohabitation by imposing higher costs of uncertainty on cohabitants. Therefore, the classification of cohabitation does not reclassify cohabitants and does not shift the relationship from another category; it adds a new relationship of cohabitation to the existing partnership category.26 Therefore, the classification of cohabitation does not provide a counter example to the proposition that courts tend to refrain from mixing categories or transferring rules from one category to another.

(iii) Landlord-Tenant Relationship

I concede to one real counter-example in landlord-tenant law. Courts have introduced property rights to protect tenants against the landlords' contract rights.27 In general, however, the mixing of categories and rules from different categories is effected by the legislatures.

3. FIDUCIARY DUTIES OF MEMBERS OF THE MEDICAL PROFESSION AND THE CLERGY

(a) The Medical Profession: Four Scenarios

I start by describing four scenarios arising from the relationships of psychiatrists and physicians with their patients. Then I apply the Basic

(Akans, 1985); Schlapp v. Schlapp, 380 So.2d 573 (Fla. App. 1980); 318 A.2d 421 (1974); Raymond S. Roberts, Inc. v. White, 117 VI, 573, 97 A.2d 245 (1953); Adderhold v. Adderhold, 426 So.2d 457 (Ala. App. 1983); Presotti v. Presotti, 270 Md. 193, 310 A.2d 791 (1973); Griscom v. Beamson, 527 S.W.2d 81 at 87 (Mo. 1974); Simond v. Schonander, 3 Ohio App. 3d 357, 445 N.E.2d 734 (1982); Conrad v. Judson, 465 S.W.2d 819 (Tex. Civ. App. 1971), cert. denied, 405 U.S. 104 (1972). Similarly, cohabitation is established informally (although with differing degrees of recognition by different social groups), it can be a "creeping" relationship starting as short-term and ending in marriage (or termination), and its purposes may be diverse, from full sharing of life to a more discrete arrangement for mutual satisfaction of various needs. Third, because partnerships vary greatly, the partnership category is suitable for developing new rules for a new relationship. Since cohabitation comes in many flavors, partnership rules give courts more discretion to fashion appropriate rules for this new relationship on a case by case basis. Fourth, like partnership conflicts, conflicts between the cohabitants concern property.

Another counter example to the proposition that courts do not mix categories or transpose rules among them is claims on harassment in the work place. This counter-example is also weak because to start with the claims can be based on a number of categories: tort, employment, contract and violations of constitutional rights. Therefore, issues in this area cannot pose a choice of an appropriate category, in which courts engage often.


27 Conditions to these scenarios in search of a principled and consistent explanation for the courts' decisions.

In the first scenario a psychiatrist obtains information from his patient, the spouse of an executive in a large publicly held corporation, that is confidential and material to the corporation's future and consequently would affect the market price of its shares. The psychiatrist trades on the basis of this information.28 Under the American securities laws, he is likely to be liable for "insider trading" if he received the information as a fiduciary of his patient. For a fiduciary, the rule is: "disclose or abstain."29 If the fiduciaries are not allowed to disclose, they must abstain from trading. The courts held that the psychiatrist was a fiduciary in this context.30 As is shown below, this result comports with the Basic Conditions.

The psychiatrist performed service for another party. In order to perform the service effectively he had to receive power from the entrustor in the form of confidential and truthful information.31 The relationship is open to so many variables that the parties cannot specify outcomes in different circumstances, except very generally. The psychiatrist's power enables him to violate the reasonable expectation of the entrustor either by incompetent or negligent performance or by disloyal performance in conflict of interest. In this case he was able to use the confidential information for his own benefit, although the patient expected him to keep the information confidential and use it only for the patient's benefit.

If the patient monitored and controlled the psychiatrist, the very benefit from the relationship would be undermined. The patient cannot obtain therapy while withholding information which might be abused or ensuring that the information will not be abused. Thus, in the context of the Securities Acts there is reason to view the psychiatrist as a fiduciary whose duty is to keep confidential the information received from the client.32

As stated, one Basic Condition to classifying a relationship as a fiduciary is that there exist no adequate alternative monitors and controls over the service giver. In the past, the perception was that effective alternative controls existed as medical associations supervised their members. Members of the profession

29 Ibid.
argued, helps her). 37 This question is more readily answered by the professional experts than by the courts. If fiduciary law applied, the doctor may not benefit from the relationship with the patient regardless of whether the benefit to him is harmful to the patient. In this case the issue is easily resolved because most members of the profession agree that a sexual relationship between a member of the medical profession and the patient is unacceptable and undesirable even after the relationship terminates. The real issue, however, is whether the courts should regulate the relationship by fiduciary law, and I predict they would because the past alternative controls over the profession have been watered down. The courts’ expertise would not be necessary in this case to determine difficult questions of appropriate treatment.

In the third scenario a physician determines to operate on a patient. 38 He does not explain to the patient about the illness or the alternative options available. 39 Is the physician a fiduciary? Applying the Basic Conditions, the physician offers service that requires the patient to relinquish control over his body to the physician. One issue here is: what control did the patient relinquish to the physician by seeking the physician’s service? At one extreme, it is inconceivable that the physician should ask the patient’s consent to every treatment. At the other extreme, it is inconceivable that the physician could apply drastic treatment without discussing it with the patient and seeking his consent.

A contractual relationship would require far more specific transfer of control to the physician. A fiduciary relationship would require far less explicit consent by the patient, but would subject the physician to higher judicial scrutiny of the treatment. Unless the patient consented immediately before the treatment, and that consent was independent and informed, the courts would exercise their discretion to determine the expected degree of control which the physician acquired in the particular case. The courts are likely to view the physician as a fiduciary, mainly because possible treatments are varied, and the contract between the parties can be open ended.

In the fourth scenario a physician refers the patient for medicine or therapy to a pharmacy or a clinic in which the physician has proprietary interests.

38 Supra, note 30.
39 Such situations are governed by the doctrine of “informed consent”. Although originally derived from tort law, this doctrine also has fiduciary elements. See, generally, F.A. Roszowski, Consent to Treatment: A Practical Guide, 2nd ed. (1990); M. Fajfar, “Notes: An Economic Analysis of Informed Consent to Medical Care”, 89 Geo. L.J. 1321 (1981); 42 C.J.S. 1321 (1984); A.H. McCoid, “A Reappraisal of Liability for Unauthorized Medical Treatment”, 41 Minn. L. Rev. 381 (1957); Cobb v. Grunt, 502 F.2d 1 at 9 (Cal. 1972); In re Practitioners in Kline, 350 F.2d 603 at 1101-1102 and 1106 (Kim 1960).
ownership, without disclosing his property interests to the patient. Is the physician a fiduciary of the patient and, if yes, has he violated his fiduciary duties to the patient? If the physician discloses his ownership, has he discharged his duties and obtained protection if the medicines are expensive or unnecessary? Would he be liable if the medicines or treatment are harmful? I suggest that the courts are more likely to impose strict fiduciary duties on the physician in this case. The analogy to the traditional fiduciary relationship involving property interests is very strong. The conflict of interest of the physician is a classic conflict in fiduciary relationship. By full disclosure the physician could exonerate himself from liability, depending on the quality of the disclosure and the ability of the patient to understand the implications of the disclosure, and if he evaluated correctly the ability of the physician to provide the patient with unbiased treatment despite the conflicts. Since fiduciary law fits fairly well in these cases, I believe that the courts will impose it.

In sum, although the courts have spoken of physicians' fiduciary duties, they have found such duties only in relatively narrow circumstances. Whether the courts will extend their supervision over the medical profession may depend, first, on the existence of alternative regulatory systems: how the profession will police itself in the future, whether legislation will enter the field whether third parties like hospitals or employees or colleagues at work or guarantors will monitor the professionals' performance.

(b) Future Application of Fiduciary Law to Clergy

The future application of fiduciary law to clergy is an example of anticipated judicial activism through fiduciary law. I believe that by applying


the Basic Conditions we can predict that the courts would extend fiduciary law to the clergy.

Recently, the American public was shocked at allegations by an increasing number of adults that, in their childhood, they were sexually abused by the clergy of their church. It has been suggested that the duties of clergy to their parish members were fiduciary duties, and it may well be that this classification of clergy will be adopted by the courts. Like physicians, the clergy is supervised by the church, a powerful organization that commands the loyalty of millions. But the courts seem to have concluded that the church has failed to exercise strict supervision. Although the revelations of abuses are recent, it seems that the abuses happened long ago. The church hierarchy has attempted to avoid public disclosure and to shield its reputation as well as the reputation of the offending clerics. It is this type of protection that may trigger judicial intervention.

4. BASIC CONDITIONS UNDER WHICH THE COURTS WILL NOT EXPAND FIDUCIARY LAW

In recent years the American courts were pressed to expand fiduciary law in two areas concerning corporate managements. One area involves the relationship of corporate management to bondholders. The other area involves the relationship of corporate management to employees. Generally, the courts declined to do so in both cases, and this judicial refusal is explained by applying the Basic Conditions.

(a) Corporate Management and the Bondholders

Historically, the relationship between the bondholders and the corporation has been viewed as contractual; the bondholders did not complain about their status. However, during the recent wave of takeovers, bondholders sought the status of entruors vis-à-vis the corporation and its management. The reason for the claim is not hard to find. In most cases takeovers resulted in liquidation and transfer of corporate assets to the shareholders as premiums over the market price of the shares. Alternatively or in addition to liquidation, these corporations issued large amounts of subordinated debt ("junk bonds") to pay the shareholders' premiums. Even though the junk bonds were subordinate, the existing bondholders were affected by the issuance of the junk bonds. Junk bonds are a


close alternative to equity, with two differences. Corporate directors have discretion to declare or refrain from declaring dividends; they do not have such discretion with respect to payment of interest on junk bonds. Shareholders vote; junk bondholders do not vote. In fact, junk bondholders can be viewed as shareholders who exchanged voting power for high fixed dividends and the power to put the corporation in bankruptcy (in case of non-payment). Thus, junk bonds imposed fixed high payments that rendered the financial condition of the issuers precarious.

Corporate recapitalization in takeovers had a devastating effect on their prior unsecured corporate bondholders because they became creditors of enterprises with substantially less assets and substantially higher fixed payment obligations. The bonds' collateral was depleted, their risks were increased and the value of the bonds decreased accordingly. Arguably, the shareholders received their premiums at the expense of the bondholders. Since the bonds were sold when the modern version of takeovers were not yet contemplated, the trust indentures and bond documents provided no protection for them. Further, commentators argued that "[c]ontrary to popular belief, indentures do not have numerous, detailed covenants that regulate the bondholder-stockholder conflict ... Such covenants are costly. Other constraints on stockholder gain at bondholder expense are ineffective. Since fiduciary duties are a substitute for costly contracts, directors should have fiduciary duties to bondholders as well as to stockholders." Arguably, so long as the shareholders and bondholders' interests in the viability of the corporation were aligned, management of the corporate business for the benefit of the shareholders protected the bondholders who had priority over the shareholders. But bondholders are at high risk if their interests conflict with those of the shareholders who plan to benefit at the bondholders' expense.

The courts, however, rejected these arguments; rarely if ever did they view bondholders as enticrators. I believe that the court's decision was based on a number of reasons. First, the courts were not convinced that bondholders could not provide alternative protections for themselves. Second, the courts refused to re-classify bondholders as beneficial owners of the corporation.

(b) Corporate Management and Employees

Even though Congress has provided an elaborate system for regulating the labor management relationship, employees' relationship to the corporation has been historically and remained contractual rather than proprietary, like their relationship to bondholders, neither the corporation nor its management owe employees a fiduciary duty.

In the past few years, as the financial condition of many large corporations has worsened during the recession, corporations closed plants and laid off employees. Employees sought judicial redress from the personal hardship off employees. Employees sought judicial redress from the personal hardship

44 In addition, such contractual protection is difficult because the circumstances of similar reorganizations may differ greatly. Specification of the conditions under which such a reorganization is permissible is not possible. Other solutions are not easy. A veto power by the bondholders on such transactions may be too strong a remedy. Arbitration may be too weak a remedy.

45 See M.W. McDaniel, "Bondholders and Corporate Governance," 41 Bus. Law. 413 (1986). If the leveraging of the corporation can be related to its demise, then bondholders have remedies in bankruptcy law (stalking horse conveyances), and corporate policies which may be fashioned along the same principles. However, such remedies do not impose on corporate management a duty to manage the corporation for the benefit of the bondholders as well as the shareholders.


47 McDaniel, supra, note 45 at 416-417.


50 Varallo and Finkelstein, ibid. at 245-50.

51 See section 2(a), supra.
of plant closing and scholars looked for doctrines on which to base judicial interference on the employees' behalf.\textsuperscript{52} It should be noted that, under state law corporation statutes, management has the discretion to take into account the interests of constituencies other than the shareholders.\textsuperscript{53} However, the power to consider these interests does not imply the duty to consider these interests; it seems to me that courts have rarely imposed such a duty on management.

The reasons for their refusal can be explained by an application of the Basic Conditions discussed above. The employees do not entrust management with property or power over their bodies, and entrusting human capital to others does not seem to give rise to fiduciary duties. The corporation does not provide the employees with service but the other way around. Most employees, whether organized or not, can discover management's plans for corporate restructuring better than outsiders. Unless employees contributed property to the corporation (other than human capital), the imposition of fiduciary duties on management towards them as employees conflicts with the traditional classification of the relationship.\textsuperscript{54}

52 See J.W. Singer, "The Reliance Interest in Property"., 40 Stan. L. Rev. 611 (1988) (dealing with local 1230, United Steel Workers of America, 631 F.2d 1264 (6th Cir. 1980), that denied relief to employees who sought to purchase a plant designed for closing and demolition. The court refused to recognize a contract claim or a proprietary estoppel claim. Professor Singer argued that the employees had a reliance interest which entitled them to enforce the sale of the plant to them.) See also M.A. O'Connor, "Restructuring the Corporation's Nexus of Contracts: Recognizing A Fiduciary Duty to Protect Displaced Workers", 69 N.C.L. Rev. 1189 at 1247-54 (1991) (arguing for recognition of a fiduciary duty to employees to alleviate the impact of corporate restructuring upon labor, and citing Jordan v. DuPont & Phelps, 81 S.F. 2d 429 (9th Cir. 1978) (same).\textsuperscript{55}

53 See O'Connor supra, note 52 at 1258-59, 1229-30 and footnote 289. The author argues that a legislative alternative solution to plant closing has disadvantages. Detailed and inflexible regulation on plant closing will impede management's ability to respond to problems, especially if they are unique to the corporation (its business or culture or financial structure); regulations could impose unnecessary costs and will not remedy management's opportunistic behavior. In contrast, judicial supervision is flexible and provides fact specific solutions, courts have dealt traditionally with "relational contracts"; and although judicial

54 5 PROPOSALS TO LIMIT FIDUCIARY DUTIES OF CORPORATE MANAGEMENT

(a) Corporate Management Relationship with the Corporation and Its Shareholders

In recent years, academics and lawyers have made proposals that would result in excluding corporate decisions from the family of fiduciaries or relaxing their fiduciary duties. The main motivation for these proposed doctrinal changes is to reduce judicial interference in corporate governance and corporate affairs. This motivation is based on the belief that, left alone, the markets spontaneously will create the best business organization (whatever "best" might be). For example, one way to reduce active judicial supervision of corporate management is to reclassify the relationship as contractual. A number of American academics have advocated the incorporation of economic concepts and terms into corporate law, and some have also advocated the adoption of economists' definition of a corporation as an aggregation of contracts (similar to markets), rather than a hierarchical institution (similar to a planned and managed economic institution). In economics, these distinctions are very fruitful, and can help predict when people will interact in the markets and when they will organize under a directed centralized control. In law, if the corporation is defined as a nexus of contracts and the relationship of management and the corporation and its shareholders is redefined as contract, then judicial interference in these relationships will be governed by contract rather than fiduciary law and judicial supervision of management will become far more limited.

In general, the courts refused to make the change and have continued to supervise corporate management. These decisions and their permutations can be explained by the Basic Conditions and especially the condition that fiduciary status will be imposed when no adequate alternative regulation exists to supervise fiduciaries.

Implicitly, one strand of academic scholarship has argued that there exists a need for an alternative regulation of management. This strand of scholarship has argued that corporate management is being monitored and controlled by the market for corporate control (controlling shares), the market for corporate executives, the capital markets, and the markets for the corporations' products. Arguably, these markets provide alternative regulation of management, and thereby judicial supervision of management superfluous. Further, the model market of the corporation can be a plausible model to explain its organization and the relationships among its constituents.

As the Basic Conditions suggest, I believe that the courts respond to perceived changes in external monitoring of fiduciaries. These changes affect the extent of judicial activism. Also, judges may design fiduciary rules in light of current literature as to management's predictable behavior. For example, a recent case upheld the corporate managers' decision to award themselves "golden parachutes" in the wake of a takeover. The court reasoned that substantial severance pay will reduce managers' hostility to takeovers which are likely to benefit the shareholders.57 But as management flexed their powerful muscle against powerful shareholders in takeover contests, the courts have generally taken a very active role in guiding and supervising management to protect small shareholders against both warring parties. The courts have not adopted the hands-off attitude, either on defensive tactics or management, "golden parachutes," or on any other action which management took in response to the market monitoring mechanism of takeovers.

Since the courts continue to supervise management under fiduciary law (including management's activities in takeover and reorganization situations), it seems that the courts do not consider the markets to be adequate alternative controllers of managers. I suspect that arguments for substituting contract for fiduciary law will not persuade the courts without a showing of fundamental changes in management's environment. A plausible explanatory model is not enough to convince the courts to relinquish their supervision of management.

Another strand of academic scholarship has argued that corporate management should be supervised by institutional investors that hold large blocks of shares. However, institutional investors' supervision of management would require substantial amendments in the law. Right now, these institutional investors are passive investors and limit their holdings to avoid the burdens and constraints of active controlling shareholders.58 Apart from changes in the law, I doubt whether these institutional investors desire the role of corporate management controllers. The only change in the posture of institutional investors has occurred in the area of shareholder proposals. Rule 14a-8 promulgated under the Securities Exchange Act of 1934 requires management to distribute shareholders' proposals with proxy materials. Before October 1992 it was unclear whether institutional investors could consult and combine their efforts to introduce such proposals. The October amendment to the Rule makes it clear that such a combined effort is not solicitation of proxies that triggers the requirements of filing proxy materials, and that management compensation is a proper subject matter for shareholder proposals.59 In any event, courts have not ceased to treat management as fiduciaries.

The recent amendments in the proxy rules do, indeed, provide additional alternative supervisory mechanisms over management compensation. I doubt whether the courts will view such shareholder proposals under new Rule 14a-8 as sufficient alternative controls to release corporate fiduciaries of their fiduciary duties. It is conceivable that the courts may limit their interference in the particular areas subject to shareholder proposals, such as management compensation. But, then, the courts were not historically active supervisors of management compensation in large corporations.

In short, I do not foresee judicial re-classification of corporate management as contract parties nor substantial relaxation of judicial supervision of management until the courts are convinced that the markets or other regulatory systems offer effective substitutes for the courts.


6. CONCLUSION

Even though fiduciary law is less determinate than other areas of law, I believe that the Basic Conditions listed in this paper can help predict future judicial approaches. The discussion here is explanatory. Yet some explanations can become also normative. The Basic Principles can provide the justifications for designing, applying, limiting and changing fiduciary law. I believe that the courts were right in extending fiduciary law to the helping professions, in light of the evidence of abuse and the changing environment in which professionals function. I believe that the courts are right not to impose fiduciary law on corporate management in relation to bondholders and employees but for different reasons. With respect to bondholders, there are good reasons to impose fiduciary duties on managements towards them when managements act to transfer wealth from bondholders to shareholders. In my opinion, the main reason for the courts’ refusal to interfere by fiduciary law is doctrinal. They refuse to re-classify creditors as entrustors (beneficial owners). To some, this reason seems formalistic and not justified. I believe, however, that legal classifications are very important to maintain coherence, and consistency in law; and the courts are the guardians of legal coherence. Further, shifting select rules from fiduciary law to contract may expand judicial discretion that may lead to arbitrariness.

The better doctrinal method would be to protect bondholders by expanding the interpretation of the indenture to include the implied duty of fair dealing in contract law. Although this implied duty leaves the courts a broad discretion to fashion the terms of the relationship among the parties ex post, this method is not as broad as the judicial creation of fiduciary duties. The burdens on the party asserting the implied duty are heavier than the burdens on the entrustor against his fiduciary. Further, the courts exercise their discretion within the category of contract. Similar, the problems with respect to the employees’ plight in cases of plant closing would be better resolved by others than the courts. Further, I believe that the courts have done well not to relinquish their supervisory power over corporate management and to leave that power as flexible as they have. If new environments subject corporate managements to new restrictions on abuse of power, or, better still, if corporate managements demonstrate new self-discipline and self-limitations in their dealing with other peoples’ money, the courts can relax their supervision accordingly. In sum, the Basic Conditions show why the courts have extended fiduciary duties in some areas but not in others, and we can use the Conditions as a predictor of the courts’ direction in the future.

60 Such a duty was implied and imposed on broker dealers in their relationships with customers (the “shingle theory”). By hanging his shingle the broker dealer is representing that he will deal fairly with his customers. See L. Loss, Fundamentals of Securities Regulation, 2d ed. (1988) at 811-20.