Philosophical Foundations of Fiduciary Law

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Managing Our Money

The Law of Financial Fiduciaries as a Private Law Institution

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Introduction

Courts and commentators invoke fiduciary duties in rather divergent contexts, that is, with respect to a diverse range of relationships, from the most intimate (parents and children) to the most commercial (directors and corporations), with numerous other categories in between (think lawyers, physicians, agents, trustees, guardians, etc).[1] This chapter focuses on one type of fiduciary: those who manage our money.[2] The typical example of a financial fiduciary is the professional trustee, but some financial fiduciaries are neither professional nor trustees.[3] Financial fiduciaries are responsible for people's savings, pensions, and bequeathable fortunes. Their relationships with the beneficiaries of these enormous amounts of money—it is estimated that as much as $14 trillion are managed by the trustees of the US pension funds system alone[4]—warrant special attention even if our conclusions turn out to be inapplicable to the other (also important, to be sure) types of fiduciary relationships.

Like other fiduciaries, financial fiduciaries are bound by a duty of loyalty, which is oftentimes (justifiably) treated as a (if not the) defining characteristic of fiduciary law overall.[5] If they are found in breach of this duty, they are required to disgorge their profits, a remedy that is also viewed as characterizing this area of law.[6] But while both the core

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[1] See, eg, Paul B Miller, "Justifying Fiduciary Duties," 58 *McGill LJ* 969, 971 (2013).

[2] As the text implies, we narrowly circumscribe the ambit of our inquiry around money managers and invoke corporate fiduciaries only for purposes of comparison.

[3] Examples of financial fiduciaries who are not trustees are executors, conservators, receivers, and trustees in bankruptcy (who are not trustees despite their title). *Restatement (Third) of Trust* § 5 (1992).

[4] See Federal Reserve Statistical Release, Flow of Funds Accounts of the United States 113 (6 Dec. 2012), available at <http://www.federalreserve.gov/releases/z1/Current/z1.pdf>. We acknowledge that a subset of these pension account holders make some of their own investment decisions. But on the other hand, while the funds managed by pension trustees are probably the largest component of all funds held by trustees, there are other funds managed by financial fiduciaries, the composition and amounts of which are much less transparent. In any event, we note by comparison that the value of all corporate shares held directly by US households stands at about $9 trillion, and the market value of US households' real estate is estimated at $17 trillion against which there are $9.5 trillion in mortgages.

[5] See, eg, Ernest J Weinrib, "The Fiduciary Obligation," 25 *U Toronto LJ* 1, 16 (1975).

[6] See, eg, Hanoch Dagan, *The Law and Ethics of Restitution* (2004) 237.

content of the fiduciary relationship and its potential remedial implications are undisputed, the normative underpinnings of this body of law as well as many specific doctrinal issues, including the precise contents of the duty of loyalty, are far from being settled. (Another controversy, which we set aside here for reasons that will be clarified shortly, is whether we should think of fiduciary law as property-like, contract-like, or *sui generis*.)

We contend that the law of financial fiduciaries is a private law institution aimed at enhancing people's autonomy by allowing them to safely delegate to others (typically specialists) authority over a significant aspect of their welfarist interests.[7] In this chapter, we hope to explain why we find this conception of the relationship normatively attractive, to show how it accommodates the most convincing insights of other approaches to the field, and to explore the ways in which our account both elucidates important aspects of doctrine and offers some critical bite, namely: it reaffirms certain disputed rules and suggests the reform of others.

Section I sketches briefly the conceptual and normative framework of our inquiry: the construction of private law as a diverse set of institutions designed to empower people's ability to be the authors of their lives. Section II extracts some building blocks for our theory from the existing literature on fiduciary law: private law formalists helpfully insist that we understand fiduciary law as part of private law and that we focus accordingly on the parties' relationships and their rights and duties; lawyer economists, in turn, helpfully remind us that the main good people seek in having other people manage their money is utilitarian in nature; and moralists helpfully highlight both the material and expressive roles of the duty of loyalty in cultivating the intricate relationship such a delegation of authority entails.

Armed with these insights, we proceed, in Section III, to develop our own theory: we articulate and defend an animating principle of the law of financial fiduciaries, consider its prescriptions, and discuss its doctrinal implications. We argue that enabling the safe delegation of management of our money is autonomy enhancing because it allows people to enlist others for this increasingly complex task and focus their time and attention on their intrinsically valuable projects. We further explain how the *telos* of enabling the reliable delegation of money management entails a delicate balance between material effects (emphasized by lawyer economists) and expressive ones (highlighted by moralists). Financial fiduciaries law must be attuned to the complicated incentive structure generated by the peculiar mission of managing other people's money, which implies a discretionary authority that is particularly susceptible to both carelessness and abuse. But in addition to tailoring optimal incentives, the law of financial fiduciaries should also aim at ingraining a moral vocabulary epitomized by the loyalty injunction, for the cultural perception of financial fiduciaries as the quintessential figures of the ethical subject as economic subject[8] has a significant, if instrumental, role in the functioning of this private law institution.

[7] To be sure, unlike private law purists, we do not claim that concerns that are external to the pertinent parties are never legitimate considerations for private law. See Hanoch Dagan, *Reconstructing American Legal Realism & Rethinking Private Law Theory* (2013) ch 5. Considering whether the macroeconomic or distributive consequences of financial fiduciaries law pass the threshold of legitimacy in this respect is beyond the scope of this chapter. Cf Joshua Getzler, "'As If:' Accountability and Counterfactual Trust," 91 *BUL Rev* 973, 975–6 (2012).

[8] See Ritu Birla, *Stages of Capital: Law, Culture, and Market Governance in Late Colonial India* (2009) 71.

Translating these prescriptions into legal technology can explain and justify the traditional structure of loyalty doctrine in fiduciary law, composed as it is of the strict sole interest rule and a long list of exceptions and exemptions. More critically, our analysis demonstrates that in order to properly shape financial fiduciaries' investment policies, and thus the content of their duty of care, lawmakers should reexamine the traditional fiduciary fee structure and, we further insist, fiduciary pay should be treated as an exception to the duty of loyalty and be carefully scrutinized and periodically reassessed. Finally, under our account, although rules of financial fiduciaries law should not be mandatory, they should be shaped as sticky defaults that are tilted towards serving relatively weak and unsophisticated beneficiaries (or settlors).

I. Structural Pluralism in Private Law[9]

Private law theorists typically strive to formulate broad and unified normative theories of property, contracts, torts, and restitution. These structurally monist accounts suggest that there is one regulative principle—one value or one particular balance of values—that underlies (or should underlie) the various doctrines in these complex legal fields. Structural pluralism challenges this dominant paradigm; it embraces the vast heterogeneity of private law and celebrates the multiple forms characterizing its landscape. Multiplicity, under this approach, is neither a symptom of disorder nor a source of confusion. Quite the contrary: what looks like a random mess from a monist viewpoint, which struggles to pigeonhole the entire terrain of a heterogeneous field (property, contracts, and the like) into one regulative principle, is a rich mosaic from the perspective of structural pluralism. And this mosaic is indispensable for people's autonomy.

To see why, consider the conception of autonomy as self-authorship, under which people should, to some degree, be the authors of their own lives, choosing among worthwhile life plans with the ability to pursue those choices. As Joseph Raz explains, autonomy requires not only appropriate mental abilities and independence, but also "an adequate range of options." Whereas a wide spectrum of sets of social forms is available in societies pursuing the ideal of autonomy, autonomy "cannot be obtained within societies which support social forms which do not leave enough room for individual choice." For autonomy to be meaningful (other things being equal), there must be "more valuable options than can be chosen, and they must be significantly different," so that choices entail "tradeoffs, which require relinquishing one good for the sake of another." Thus, because autonomy underscores "the value of a large number of greatly differing pursuits among which individuals are free to choose," valuing autonomy inevitably "leads to the endorsement of moral pluralism."[10]

Given the variety of acceptable human goods from which autonomous people should be able to choose, the state must recognize a sufficiently diverse set of robust frameworks through which people can organize their lives. And because many of these goods

[9] This section draws on Hanoch Dagan, "Pluralism and Perfectionism in Private Law," 112 *Colum L Rev* 1409 (2012). For an application in property law and a preliminary one in contracts, see Hanoch Dagan, *Property: Values and Institutions* (2011); Hanoch Dagan, "Autonomy, Pluralism, and Contract Law Theory," 76 *Law & Contemp Probs* 19 (2013) [hereinafter Dagan, "Contract Theory"].

[10] Joseph Raz, *The Morality of Freedom* (1986) 372, 381, 395, 398–9.

cannot be realistically actualized without the active support of viable legal institutions, private law should ensure a wide range of such facilitative institutions.[11] Hence, private law should incorporate more than one set of principles and, consequently, more than one set of coherent doctrines; it should include, for each major category of human activity or interaction, sufficiently diverse types of institutions, each governed by a distinct regulative principle (namely, a different value or different balance of values); the boundaries between these institutions must be open to enable people to freely choose their goals, principles, forms of life, and associations.

Proactively facilitating the multiplicity of private law through such structural pluralism curbs law's power without undermining its normativity. The combination of the seemingly mundane ability of the law's carriers to recruit the state's monopolized power to enforce their judgments and the institutional and discursive features that tend to downplay law's coercive power mandates wariness of assigning much power to lawmakers who, as human beings, can make mistakes and, at times, even prefer their self-interest to the public good. A commitment to structural pluralism follows this injunction, because it opens up alternatives for choice rather than channeling everyone to the one possibility privileged by law. A pluralist private law regime thus allows individuals to navigate their course so as to bypass certain legal prescriptions, avoiding their implications and, hence, the power of those who have issued them.

Structural pluralism's acute attention to the power of law does not lead it to neglect law's normativity.[12] Quite the contrary: a structurally pluralist private law is profoundly normative. Each one of its categories encompasses a set of precise rules and informative standards that are shaped by a distinct regulative principle. Although many of these rules and standards function—as they should in an autonomy-based private law regime—as defaults, the frameworks of social interaction and cooperation that private law facilitates are necessarily limited in number and their contents relatively standardized. These features enable private law not only to consolidate people's expectations regarding the core types of human relationships, but also to express the law's normative ideals for these types of social interaction.

Structural pluralism advocates a major shift in private law theory, which informs this chapter: that rather than searching for unifying normative accounts of property, contracts, torts, restitution, and, for that matter, fiduciary law in their entirety, we should redirect our efforts towards reviving the inquiry of the specific private law institutions. Accordingly, the main task of private law theory is to distil the distinct human ideals embodied in the various private law institutions and elucidate how each of those institutions contributes to human flourishing. To be sure, with many private law institutions, the law often falls short of the human ideals their regulative principle purports to represent. But rather than challenging structural pluralism, these discrepancies highlight its practical significance as a source of critique and reform that can force private

[11] Indeed, while structural pluralism is animated by private law's commitment to one value—personal autonomy—this value requires law to not only tolerate, but rather actively facilitate, the institutional infrastructure necessary for the pursuit of a variety of values. See text accompanying n 74.

[12] This accommodation of law's power and normativity is one manifestation of structural pluralism's reliance on the legal realist conception of law. See Dagan (n 7) at chs 1, 8, 9.

law institutions to live up to their implicit promises and push lawmakers to craft innovative private law institutions.

II. New Lessons from the Received Wisdoms

Our understanding of fiduciary law fits squarely within the structural pluralist conception of private law. For us, the law of financial fiduciaries is a private law institution aimed at expanding people's autonomy by allowing them to safely delegate to others (typically specialists) authority over a significant part of their welfarist interests. As with other private law institutions, fleshing out the regulative principle of fiduciary law can enhance our understanding of this important body of law while pointing to ways to reform it. But before we outline this understanding and investigate its doctrinal implications, it is worthwhile visiting three perspectives on fiduciary law. Although we do not endorse any of these accounts, each provides useful building blocks for our own theory.

A. Formalism

Paul Miller has developed a sophisticated account of the "juridical justification" of fiduciary duties and fiduciary remedies. Miller's theory does not look at fiduciary law as an "object of justification." Rather, it "treats the juridical character of [fiduciary law] as a source. . . of justification," seeking to "reveal" the "internal principle of organization" embedded in this "juridical concept or form" of liability.[13] As such, Miller claims, his formal account "implies nothing beyond the normative coherence of [a given basis] of private liability,"[14] yet it does, he insists, "enjoy analytical priority over philosophical justification."[15]

Miller argues that "fiduciary duties are distinctive and supported by reasons derived from formal properties of the fiduciary relationship."[16] He defines a fiduciary relationship as "one in which one party (the fiduciary) exercises discretionary power over the significant practical interests of another (the beneficiary)."[17] More specifically, fiduciary power, which is "the constitutive characteristic of the fiduciary relationship," is "a form of authority derived from capacities constitutive of the *legal personality*" of another person (typically the beneficiary). This authority applies to a variety of "objects of decision-making ordinarily within the exclusive legal capacity of the person granting authority to the fiduciary," ranging from "aspects of personality of corporate or natural persons who lack legal capacity" to matters of rights or welfare of corporate and natural persons. In all these matters, "[p]ower is vested in fiduciaries to enable them to act for or on behalf of beneficiaries or to otherwise serve their interests," rendering "rightful conduct that would otherwise be wrongful." This fiduciary authority has three important qualities: it is "*discretionary* in nature," allowing "latitude for judgment by the person invested with authority in determining its exercise"; it is "*relational*" to "a specific

[13] Paul B Miller, "Justifying Fiduciary Remedies," 63 *U Toronto LJ* 570, 582 (2013).
[14] Miller (n 1) at 1008. [15] Miller (n 13) at 584. [16] Miller (n 1) at 1023.
[17] Paul B Miller, "A Theory of Fiduciary Liability," 56 *McGill LJ* 235, 262 (2011).

individual or group" and "*derivative*" of the legal capacities of others; and it is "*specific*," as opposed to "plenary."[18]

These "formal properties of the fiduciary relationship" explain Miller's understanding of fiduciary power as "a capacity integral to the legal personality of another;" they also underlie, for him, both the content and function of the duty of loyalty. Fiduciary power legitimates "a limited form of legal substitution" by enabling the fiduciary to exercise "legal capacities of the beneficiary or those of a benefactor." This means that "the fiduciary relationship has an asymmetrical formal structure," with the fiduciary occupying the "dominant position," thereby setting up dependence and vulnerability to misuse (or careless exercise) of authority as inherent features of the relationship. Furthermore, "[t]he purpose for which fiduciary power is held" is also "implicit in [this] substitutive nature." Fiduciary power "enables one person to act purposively on behalf of another." More importantly (at least for us), "[t]he ability to confer fiduciary power. . . enhances [one's] ability to effectively pursue her purposes, for it enables her to draw upon a fiduciary's means (e.g., skills, knowledge, experience, professional licensure) in the exercise of her capacities."[19]

The substitutive nature of the fiduciary relationship justifies, Miller contends, both the fiduciary obligation and the typical consequence of its breach. Being "an extension of the legal personality of the person from whose capacity it is derived," fiduciary power should be treated as a means "derived from or devoted to the beneficiary" and, thus, "belonging rightfully" and "exclusively" to the beneficiary and "held for advancement of [her] ends alone."[20] The duty of loyalty "secures this status" of fiduciary power "by proscribing its appropriation by the fiduciary,"[21] thereby ensuring that the beneficiary's claim over fiduciary power is "exclusive."[22] In other words, because this claim derives from the beneficiary's personality, fiduciary disloyalty "entails exploitation in the sense of a person being treated as a mere means." This is, Miller asserts, the rationale for the harsh disgorgement remedy typifying fiduciary law. A fiduciary who "receives unauthorized profit from the exercise of fiduciary power" is treating that power as "a means of her own." This violation of the beneficiary's exclusive entitlement "necessarily extends to gains associated" with the fiduciary's exercise of this power, because these gains "belong" to the beneficiary "as an incident of its exclusive claim over the powers constitutive of [her] personality." Thus, disgorgement simply vindicates the beneficiary's right by restoring to her "gains to which she was entitled by virtue of [that] right and [its] juridical justification."[23]

Miller argues that the explanatory force of his theory is boosted by its ability to account for hard cases in which full disgorgement is currently available although "the wrong done is merely technical." For example, Miller accepts the applicability of the conflicts rule even where a fiduciary acts "in, and because of, a genuine belief that in so doing she is [serving] the best interests of the beneficiary." Although the fiduciary's "salutary motivation" may be "morally and practically significant," it properly bears no legal significance since the no-conflicts rule is not concerned with "potentially adverse outcomes," but is rather grounded on the beneficiary's exclusive ownership of "the

[18] Miller (n 1) at 1013.
[19] Miller (n 1) at 1019.
[20] Miller (n 1) at 1020.
[21] Miller (n 1) at 1021.
[22] Miller (n 13) at 611.
[23] Miller (n 13) at 617.

power acted upon through judgment." Similarly, Miller endorses the strict application of disgorgement where "the fiduciary profits from a conflict but causes no harm to, or [even] achieves a good outcome for, the beneficiary," because "outcomes are immaterial to the beneficiary's *legal entitlement* to [these] profits," which is "rooted in his exclusive claim over fiduciary power as a means." In the same vein, Miller argues that his theory nicely explains why the conflict of interest rule focuses on personal interests that "arise during the execution of the mandate" and not on the fiduciary's "interests in compensation," which "are determined before the mandate is undertaken on the understanding that the interests of the beneficiary will govern its execution." Although he realizes that remuneration arrangements may be structured in a way that generates a conflict, Miller seems content with the conventional view under which they are not covered by the conflicts rule.[24]

Miller mentions (almost in passing) the autonomy-enhancing function of the fiduciary relationship, but his juridical analysis does not rely on this *telos*. Rather, the engine of his account is the claim that the beneficiary *necessarily* holds a "sole and despotic dominion"[25]—to use Blackstone's conception of property, which Miller repeatedly invokes as analogy[26]—over fiduciary power. And the reason for the alleged necessity of the beneficiary's exclusivity lies, in his view, in the nature of that power as an extension of the beneficiary's personality.

Miller's claim seems to rest on the presupposition that whereas in certain categories of fiduciary law the fiduciary's authority relates to welfarist interests of the beneficiary, in others it implicates "matters of rights" and "aspects of personality." Should, indeed, all of these very different interests have been necessarily lumped together, a "leveling up" of the beneficiary's claim to the fiduciary power might have been required to prevent the use of the beneficiary's person as a means to the fiduciary's ends. Exclusivity could have then been safely regarded as conceptually necessary. But there is in fact no need—certainly not an a priori one—to assume that the delegation of all these interests is governed by a sole regulative principle.[27] Rather, the substantive differences among the types of interests at hand could justify divergent treatment; fiduciary law could encompass, as structural pluralism prescribes, a number of distinct private law institutions.[28] And once we limit our focus to welfarist interests, there is no longer a conceptual necessity to perceive the beneficiary's entitlement to the fiduciary power as exclusive.[29] Certainly, this conclusion does not suggest that beneficiaries are *not* exclusively entitled to the fiduciary's power or that the specific rules Miller discusses are *necessarily* wrong. But the failure of the attempt to derive the content of the duty of loyalty and the implications of disloyalty from the duty's juridical form means that these propositions should not be taken as a given. Moreover, caution is also called for regarding Miller's celebration of his theory's successful accounting for rules that seem

[24] Miller (n 13) at 606.
[25] William Blackstone, *Commentaries on the Laws of England* (1765–9; 1979 edn) vol 2, *2.
[26] Miller (n 1) at 998, 1006; Miller (n 13) at 611.
[27] This critique applies also to Avihay Dorfman in this volume.
[28] Cf Tamar Frankel, *Fiduciary Law* (2011) 8–10.
[29] This critique echoes the conceptual critique of Blackstone's understanding of property. See generally Dagan (n 9) Part I.

substantively questionable, because—like other legal theories that take accepted adjudicative law as their source of justification—his theory of fiduciary law is susceptible to the "professional hazard" of apology.[30]

These faults notwithstanding, Miller's account offers two important lessons. First, although the notion that form (or juridical justification) enjoys analytical priority over substance (or normative justification)—or even that form can be analyzed while bracketing substance—is misguided, the idea that fiduciary law, typified by the structural features Miller highlights, should be analyzed within the framework of private law (rather than as a means to promote the aggregate welfare or society's overall morality) is valuable. Second, although Miller's theory improperly sets aside the *telos* of fiduciary law, it helpfully mentions the good that fiduciary law as a private law institution can advance when alluding to its autonomy-enhancing potential.

As we argue in Section III, the key to understanding the law of financial fiduciaries and guiding its proper interpretation and future development is to figure out its precise role in an autonomy-based private law and to study the ways in which it can best perform this function. In engaging in this task—and so as to avoid the "juridical trap" of over-abstraction—we need to direct some attention to the specific type of beneficiary interests on which this chapter focuses. Although our account begins with autonomy as private law's ultimate value and, thus, also the animating value of fiduciary law, we take seriously structural pluralism's dictate to shape private law institutions along the lines of the goods they offer. Insofar as welfarist types of fiduciary relationships are concerned, this means that our autonomy-based perspective is necessarily interested in—and should potentially incorporate—the economic analysis of fiduciary law.

B. Efficiency

Conventional economic analysis conceptualizes private law as a complex set of incentives for inducing potential transactors to maximize aggregate social welfare, conventionally interpreted in terms of preference satisfaction.[31] But the leading economic account of fiduciary law focuses on the micro interaction fiduciary law anticipates, rather than on its aggregate consequences, and is thus helpful for our analysis.

Frank Easterbrook and Daniel Fischel advance a contractarian view of the fiduciary relationship, which leaves no room for anything else: "Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations. . . as other contractual undertakings."[32] When one person seeks the help of another to achieve a certain goal, the parties can write an explicit contract—if the task is simple enough and efforts sufficiently observable and verifiable. However, "when the task is complex, when efforts will span a substantial time, when the principal cannot measure (or evaluate) the agent's effort, when an assessment of the outcome is not a good substitute for measuring effort. . . a detailed contract would be silly."[33] In this world

[30] Cf Robin West, *Normative Jurisprudence: An Introduction* (2011) 26–7.
[31] See, eg, Robert Cooter and Thomas Ulen, *Law & Economics* (6th edn, 2011) 307.
[32] Frank H Easterbrook and Daniel R Fischel, "Contract and Fiduciary Duty," 36 *JL & Econ* 425, 427 (1993). See also, eg, Richard A. Posner, *Economic Analysis of Law* (3rd edn, 1986) 100–1.
[33] Easterbrook and Fischel (n 32) at 426.

of incomplete contracts,[34] where an agent's efforts and achievements are exceedingly hard to monitor, fiduciary duties replace explicit contracting. The easily observable and verifiable no-conflict rule of the duty of loyalty ensures that the agent remains committed to achieving the objectives of the contract,[35] and the duty of care ensures that she performs her role well. Most importantly, "because this process is contractual—because both the principal and agent enter this [undertaking] for gain—the details should be those that maximize that gain, which the contracting parties can divide."[36] Legal decision-makers should follow what the parties themselves would do in a world of complete contracts, by filling fiduciary duties with content that maximizes their welfare. Any effort to hold fiduciaries to a higher standard would be doomed, since "a beneficiary who does not value the new service or higher degree of loyalty at more than the cost of providing it is worse off, the opposite of the court's objective."[37] One important implication of this analysis is its strong endorsement of mutability, which explains why lawyer economists typically view the fiduciary duties as a simple garden-variety default that the parties should be able to override at will.[38]

This approach to shaping the contents of fiduciary duties explains their substantial variation across different types of fiduciary relationships. Consider the duty of care. In corporate law, the duty is quite lax. Managers make their business decisions with virtually no prospect of review for reasonableness thanks to the business judgment rule, which shields them from liability for any but the most egregious behavior.[39] In trust law, by contrast, the duty of care is quite stringent. A trustee is held to a relatively strict standard of prudence.[40] Economic analysis, by drawing on the welfare-maximization hypothetical-contracting standard, provides a rationale for this divergence. Since corporate managers are required to take on risky ventures, they must be shielded from judges' and juries' hindsight bias when their decisions turn out badly. Since shareholders want their managers to engage in such ventures, they would agree to protect them from this bias.[41] In contrast, trustees typically can diversify their trusts, so as to protect the beneficiaries, at low cost.[42] The difference in the content of these duties of care, therefore, derives from the divergent interests of the beneficiaries.

Finally, by focusing on the incentive structure typifying fiduciary relationships, the economic analysis provides a powerful justification for disgorgement as a remedy for disloyalty. As Robert Cooter and Bradley Freedman note, breaches of the duty of loyalty

[34] See generally Oliver Hart and John Moore, "Incomplete Contracts and Renegotiation," 56 *Econometrica* 755 (1988); Oliver Hart and John Moore, "Foundations of Incomplete Contracts," 66 *Rev Econ Stud* 115 (1999).

[35] See Robert Cooter and Bradley J Freedman, "The Fiduciary Relationship: Its Economic Character and Legal Consequences," 66 *NYU L Rev* 1045, 1074 (1991).

[36] Easterbrook and Fischel (n 32) at 426.

[37] Easterbrook and Fischel (n 32) at 431.

[38] See John Langbein, "The Contractarian Basis of the Law of Trusts," 105 *Yale LJ* 625, 629 (1995). See also, eg, Easterbrook and Fischel (n 32) at 429; Henry Hansmann and Ugo Mattei, "The Functions of Trust Law: A Comparative Legal and Economic Analysis," 73 *NYU L Rev* 434, 447 (1998).

[39] See Bernard Black et al, "Outside Director Liability," 58 *Stan L Rev* 1055, 1064–74 (2006).

[40] See text accompanying nn 116–20.

[41] See Hal R Arkes and Cindy A Schipani, "Medical Malpractice v the Business Judgment Rule: Differences in Hindsight Bias," 73 *Or L Rev* 587, 613–17 (1994); Jeffrey J Rachlinski, "A Positive Psychological Theory of Judging in Hindsight," 65 *U Chi L Rev* 571, 574, 619–23 (1998).

[42] We refine this statement in Section III.B.3.

may be hard to detect, because of two structural features of the fiduciary relationship.[43] First, the beneficiary's interests are subject to the fiduciary's discretion; the fiduciary is charged with controlling and managing an asset so as to serve the beneficiary's best interests and must use her own expertise and judgment to do so. Second, the management of the asset in question involves inherent risk and uncertainty, and therefore, a bad outcome cannot easily be tied to breach of the duty of loyalty. Under these conditions, the economics of enforcement suggest that "the optimal sanction for breach of the duty of loyalty must exceed the fiduciary's profit."[44] Fiduciary law usually achieves this through the remedy of disgorgement of profits, fortifying it with burden-shifting rules and strict presumptions.[45]

This understanding of disgorgement implies that its availability is related to the problem of deterrence. This could explain why in some fiduciary settings—particularly the corporate kind (especially in the United States)—disgorgement is less prevalent. In these contexts, underdeterrence may be beneficial in order "to spur the fiduciary to discover and exploit opportunities,"[46] due to the market devices that provide the fiduciary "with incentive compensation to align her interest with that of the [beneficiary]."[47] To be sure, in many (most?) fiduciary contexts, setting up the most efficient remedial response is quite an intricate task. But even in these contexts, focusing on the parties' incentives helps account for the broad prevalence of disgorgement as a species of "penalty default" rule, which induces fiduciaries to express contracting, namely: to negotiate with their beneficiaries to secure their specific consent to transactions that would ostensibly violate the duty of loyalty.[48]

Economic analyses that take private law to be merely a form of aggregate-welfare-increasing regulation prompt familiar debates as to the desirability of conceptualizing the public good in terms of aggregate preference satisfaction and—more relevant for our purposes—the legitimacy of using private law for such purposes.[49] Rehashing this controversy is not necessary here.[50] The account summarized here presents welfare maximization as an *instrumental* good, being the typical goal of the people who use financial fiduciaries law.[51] Framed this way, a welfarist analysis provides important data for any autonomy-based account of financial fiduciaries law properly attuned to the welfarist goods this institution can help people secure. What ultimately matters, in this view, is the way law offers people choices—safely delegating the authority over an important aspect of their welfarist interests—that would otherwise be practically unavailable.

[43] See Cooter and Freedman (n 35) at 1046–7.

[44] Easterbrook and Fischel (n 32) at 426. See generally Steven Shavell, *Foundations of Economic Analysis of Law* (2004) 351–4.

[45] See Cooter and Freedman (n 35) at 1053–5.

[46] See Easterbrook and Fischel (n 32) at 436.

[47] Roberta Romano, "Comment on Easterbrook and Fischel, 'Contract and Fiduciary Duty,'" 36 *JL & Econ* 447, 449–50 (1993).

[48] See Easterbrook and Fischel (n 32) at 445; Getzler (n 7) at 989. See generally Ian Ayres and Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules," 99 *Yale LJ* 87 (1989).

[49] See, eg, Ernest J Weinrib, *The Idea of Private Law* (1995).

[50] For a review, see Dagan (n 7) at ch 5.

[51] We do not deny the possibility of an inverse reading, in which the parties' choices acquire their significance only for epistemological reasons, as a means to secure the maximization of aggregate utility.

And yet this canonical economic analysis, which insists that there is nothing special ("there is no subject"[52]) to a fiduciary relationship, is disappointing. To begin with, the notion that identifying a fiduciary relationship as a species of contract straightforwardly prescribes the content of fiduciary duties is misguided. Properly understood, contract law is not a simple, unified body of doctrine, but rather a quite diverse body of contract types.[53] Contract law actively empowers people to form collaborative voluntary arrangements—both discrete and impersonal as well as long term and relational—by providing a broad menu of divergent background regimes for risky undertakings in the various relevant spheres of contracting (home, intimacy, work, and commerce). An autonomy-based contract theory should, therefore, be attentive to the structural pluralist prescription that people be provided with a sufficiently diverse set of frameworks to organize their various endeavors and interpersonal relationships.[54] Hence, even were we to classify fiduciary law as a form of contract, we would still have to think about the distinct features of this contract type and their doctrinal implications.

The main insight of the economic analysis lies in clarifying the inherent challenge of expanding people's autonomy by allowing them to delegate the authority over a significant share of their estate—namely, the systemic reasons that render this authority particularly susceptible to abuse. It further prescribes that in figuring out how to contend with this challenge, we need to keep in mind both the welfarist goals of all the parties involved and the divergent consequences likely to arise in the different legal regimes given the distinct incentives they generate to the parties. This line of analysis elucidates the significance of the duty of loyalty as well as the disgorgement remedy. Indeed, unlike its formalist counterpart, the economic analysis accounts for this typical remedy for fiduciary disloyalty without stipulating the content of the beneficiary's entitlement and, thus, provides useful tools for refining its details.[55]

Yet by dismissing the unique quality of fiduciary law as a private law institution—by arguing, for example, that "some persons [simply] start calling some contractual relations 'Fiduciary,' " whenever "transaction costs reach a particularly high level"[56]—lawyer economists obscure, and may undermine, important aspects of this body of law. To see why, recall that under structural pluralism, private law institutions have two chief roles: stabilizing the expectations of people who invoke them and expressing our social ideals with respect to the institutions. Discarding the normative core of fiduciary law disables these functions, which is particularly detrimental in light of their subtle interaction. As Melanie Leslie argues, stripping fiduciary duties of their moral content might "dilute the stigma" of opportunistic behavior.[57] This unfortunate expressive

[52] Easterbrook and Fischel (n 32) at 438.
[53] See Roy Kreitner, "Multiplicity in Contract Remedies," in Nili Cohen and Ewan McKendrick (eds), *Comparative Remedies for Breach of Contracts* (2005) 19, 19–20; Roy Kreitner, "On the New Pluralism in 'Contract Theory,'" 45 *Suffolk U L Rev* 915, 915, 923–4 (2012).
[54] See Dagan, "Contract Theory" (n 9); Hanoch Dagan and Michael A Heller, "Freedom of Contracts" (unpublished manuscript).
[55] See also Joshua Getzler, "Rumford Market and the Genesis of Fiduciary Obligations," in Andrew Burrows and Alan Rodger (eds), *Mapping the Law: Essays in Memory of Peter Birks* (2006) 577, 586.
[56] Easterbrook and Fischel (n 32) at 438.
[57] Melanie B Leslie, "Trusting Trustees: Fiduciary Duties and the Limits of Default Rules," 94 *Geo LJ* 67, 90 (2005).

consequence, she maintains, may, in turn, have implications on the material front as well, given the typical weakness of other means of guarding against financial fiduciaries abuse (such as exit, monitoring, or market discipline).[58] Chipping away at the normative force of the duty of loyalty not only can damage the functioning of the law of financial fiduciaries but may also impair its ability to optimally promote autonomy. Thus, our autonomy-based theory of financial fiduciaries law must also look to virtue-based accounts of this institution for some insights.

C. Virtue

Peter Birks has suggested that to capture the distinctive feature of trust fiduciary law we should organize the "primary obligations recognized by the law" according to the "degree of altruism" they entail. In general, law is quite cautious in its demands, requiring only that we "take other people into consideration, and to that extent curb our pursuit of our own interests, where reasonable care would prevent reasonably foreseeable harm." Only in "special circumstances"—think of the duty of rescue type of cases—does law go beyond the first, negative "degree of legally obligatory altruism" and "requires us to take positive action to improve another's position." Finally, the "third and highest degree of legally obligatory altruism" is that of the trustee, who "must not only take care of the interests of another but must do so disinterestedly,"[59] namely: "uninfluenced by any competing interest of [her] own."[60] Indeed, for Birks, "the core fiduciary obligation—the core trust obligation—is the compound obligation to take active care and to do so disinterestedly." This "very rare obligation in the third degree of altruism is found in the express trustee." In line with our cautious approach regarding the multiplicity of fiduciary institutions, however, Birks adds that although the word "fiduciary" may be used to refer to "persons in trustee-like positions," we should be careful in so doing because this degree of altruism "does not attach to every fiduciary."[61]

Birks's "positive duty" approach is "incomplete,"[62] Lionel Smith claims, and he refines it in two ways. First, Smith insists on understanding the fiduciary relationship as "premised on a voluntary undertaking to assume an office to which the law attaches fiduciary obligations, or. . . to put another's interests ahead of one's own." This ensures that fiduciary law's prophylactic rules are not "inconsistent with the internal rationality of private law," namely, that it properly focuses on "the relationship between plaintiff and defendant, and their conduct that gave rise to the litigation," rather than on attempting to "influence the conduct of others in the future." Furthermore—and here is Smith's second refinement—the duty of loyalty is qualitatively different from other duties. The duty of loyalty is "distinct in character, and not just in the particularly high standard" it prescribes, and therefore the attempt to understand it "in terms of results will always fail." The duty of loyalty "is a kind of adjectival obligation," which focuses

[58] See Melanie B Leslie, "In Defense of the No Further Inquiry Rule: A Response to Professor John Lengbein," 47 *Wm & Mary L Rev* 541, 555–63 (2005).
[59] See also Leonard I Rotman, *Fiduciary Law* (2005) 244.
[60] See also *Meinard v Salmon* 164 NE 545, 546–8 (NY 1928) (per Cardozo CJ).
[61] Peter Birks, "The Content of the Fiduciary Obligation," 34 *Isr L Rev* 3, 17–20, 37–8 (2000).
[62] This may derive from Birks's reference to legal altruism, which means that his account is not moralistic.

on the "*manner* of doing what one does." A fiduciary must exercise fiduciary powers "in what *he perceives to be* the best interests of the beneficiary." Thus, "the real heart" of the duty of loyalty is "in the justiciability of motive"; it is "a duty to act (or not) with the right motive."[63]

Under this construction, fiduciary law's prophylactic rules are intended not to prevent "any particular result" but to protect "against disloyalty, which is not motivated by harm as such, but rather by motive." Smith acknowledges that these duties (the no-conflict rule and the no-profits rule) "are not judged by motives but by events in the world"; however, he insists that they "are triggered by situations in which it may be especially difficult to know with what motive the fiduciary acted, because the fiduciary is subject to conflicting motivational pressures." In such circumstances, "to leave your beneficiary wondering whether you had been disloyal, or to force him to prove disloyalty" would be "inconsistent" with an "undertaking to be loyal."[64]

Standing on its own, this moralist account of fiduciary law is questionable. It is unclear why beneficiaries are owed the highest degree of altruism (à la Birks), or why law should be particularly concerned with motives in the context of fiduciary relationships (à la Smith). After all, as Annette Baier contends, whereas in the context of moral relationships, fidelity is virtuous, it is immoral in the context of immoral relationships, where "trust-busting" can actually be the "morally proper goal."[65] And while many fiduciary relationships are moral, neither Birks nor Smith explains why they are subject to higher moral standards than other categories of interpersonal relationships. Furthermore, whereas with some other private law institutions, such as marital property and certain types of relational contracts, trust is a constitutive, intrinsically valuable component of the relationship,[66] there are no parallel intrinsic communal goods in our relationship with our money managers. The latter relationship is purely instrumental for us, which means that people care about their fortunes and not about the virtues of their managers. A law that respects, as it must, the reasons why people typically resort to this private law institution should respect their approach to the relationship created.[67] It should therefore come as no surprise that "a breach of fiduciary duty may be committed without the fiduciary necessarily acting immorally."[68]

But as with the efficiency analysis, we read these moralist accounts not as stand-alone theories but as valuable input for our autonomy-based account. The starting point of this reading is Smith's refinements, which construct the fiduciary relationship as a form of voluntary obligation[69]—a private law institution—that is dependent upon intense

[63] Lionel Smith, "The Motive, Not the Deed," in Joshua Getzler (ed), *Rationalizing Equity, Property and Trusts* (2003) 53, 61–2, 65, 69–70, 73. Smith revised his view, to some extent, in his chapter in this volume.

[64] Smith (n 63) at 73–6.

[65] Annette Baier, "Trust and Antitrust," 96 *Ethics* 231, 232 (1986).

[66] See respectively Dagan (n 9) ch 9; Ian Macneil, "The New Social Contract: An Inquiry into Modern Contractual Relations," in David Campbell (ed), *The Relational Theory of Contract* (2001) 127, 136.

[67] Thus, although we agree with Matthew Harding that "a main purpose of fiduciary law ought to be to enable people to form, maintain and develop relationships characterized by a cycle of trust and trustworthiness," we insist that in the context of financial fiduciaries, the parties' attitudes are of purely instrumental value, so that facilitating such relationships in "terms of detachment" by "mimic[king] the normative world of trust" is *not* "a matter of regret." Matthew Harding, "Trust and Fiduciary Law," 33 *Oxford J Legal Stud* 81, 96–7, 100–2 (2013).

[68] Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (2010) 108.

[69] See also James Edelman, "When Do Fiduciary Duties Arise," 126 *Law Q Rev* 302 (2010).

emphasis on the fiduciary's other-regarding dispositions. However, in order to understand why "the theme of morality" ("Loyalty, fidelity, faith, and honor") should form the "basic vocabulary" of this private law institution,[70] we need to recall some of the insights gleaned from the economic analysis regarding the perverse incentives inherent to the fiduciary relationship and appreciate, with Leslie, fidelity's *instrumental* role in contending with these incentives.[71]

Irit Samet's justification for stringent disgorgement for disloyalty reinforces this point. She argues that the fiduciary's discretionary authority is vulnerable to abuse because fiduciaries—facing the temptation of profit in instances of potential conflict of interest—are "especially prone to self-deception and the biased judgment it yields." This is a significant risk because "[t]he all too human tendency to give charitable interpretation to our own actions and motivations endangers any social institution that is based on trust and integrity." Self-deception "enables virtuous people to justify their dishonest actions to themselves" by "turn[ing] off the inner voice of conscience so that immorality can go through undetected by the conscious self" and "subverting the process of evidence and weighing, thus. . . (mis)leading one to view illegitimate actions as permitted (or even prescribed)." The solution to this problem is "to eliminate the process of deliberation." That is to say, fiduciaries must be "prevent[ed]. . . from asking *themselves* whether a transaction that serves their interest is also good for their principals," which is exactly what the law does when it sets a bright-line no conflict rule.[72]

III. Financial Fiduciaries in the Service of Autonomy

A. The regulative principle of financial fiduciaries law

Our main claim regarding the law of financial fiduciaries emerges from this survey of the formalist, economic, and moralist accounts of fiduciary law. Like formalists, we believe that financial fiduciary law should be analyzed as a private law institution and, furthermore, accept the important autonomy-enhancing role of financial fiduciaries vis-à-vis the beneficiaries and/or benefactors as the *telos* of that institution.[73] For this reason we also endorse the economic account mandate that financial fiduciaries law must be attuned to the good for which people invoke it, which is welfarist in nature: people want to be able to rely on the time and expertise of others to manage

[70] Tamar Frankel, "Towards Universal Fiduciary Principles" (2013) § 5 (unpublished manuscript).

[71] This role may have its historical roots in an era when the fiduciary relationship was governed solely by ethical norms. See David J Seipp, "Trust and Fiduciary Duty in the Early Common Law," 91 *BU L Rev* 1011, 1016 (2011).

[72] Irit Samet, "Guarding the Fiduciary's Conscience—A Justification of a Stringent Profit-stripping Rule," 28 *Oxford J Legal Stud* 763, 765, 773–5, 781 (2008). See also Margaret M Blair and Lynn A Stout, "Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law," 149 *U Pa L Rev* 1735, 1785, 1787 (2001).

[73] We bracket the difficult issue of possible tensions between the autonomy of beneficiaries and that of benefactors. One notorious aspect of this difficulty, which arises especially in the context of family trusts, is that of the "dead hand" dilemma: "Individual freedom to dispose of [property] cannot simultaneously be allowed and fully maintained. If the donor of a property interest tries to restrict the donee's freedom to dispose of that interest, the legal system, in deciding whether to enforce or void that restriction, must resolve whose freedom it will protect, that of the donor or that of the donee." Gregory S Alexander, "The Dead Hand and the Law of Trusts in the Nineteenth Century," 37 *Stan L Rev* 1189, 1189 (1985).

significant aspects of their welfarist interests. Finally, the moral vocabulary of financial fiduciaries law is also important given the significant, albeit instrumental, role of trust and fidelity in this private law institution.

To appreciate these lessons, we need to return to our starting point, namely, that the role of private law is to enhance people's autonomy by facilitating forms of interpersonal interactions that are conducive to human flourishing. People, of course, need not resort to any of these private law institutions. They are simply a repertoire of frameworks for voluntary arrangements available to people in pursuing their projects and ends of choice. The law of financial fiduciaries exemplifies a main tenet of structural pluralism, that law is a major instrument for facilitating many of these forms of interaction. These forms of interaction face endemic difficulties, such as information costs (symmetric and asymmetric), cognitive biases, and heightened risks of opportunistic behavior, alongside more cultural obstacles, that make it hard to imagine forms of interaction that are not (yet) widely recognized and named. The task of recognizing and naming is, especially in modern times, often performed by the law. Indeed, private law's autonomy-enhancing function is rarely exhausted by way of a hands-off policy and receptive approach to freedom of contract. Rather, law must actively empower its institutional arrangements, including through reliable guarantees against opportunistic behavior.[74]

Financial fiduciaries law is one—particularly challenging—type of these arrangements.[75] It complies with the Razian injunction of autonomy-enhancing because it adds an option, and a valuable one at that: the reliable delegation of authority over a significant aspect of one's welfarist interests. Delegating this authority bolsters autonomy because it enables us to enlist the superior skills, knowledge, and experience (and thus, arguably, judgment), or the professional licensure of others for a task that is, for most of us, crucial, either because it impacts our own financial future (as with savings and pensions) or because it affects our ability to secure the well-being of our loved ones or advance a cause we care about after we die (as with many trusts). Enabling such a delegation is autonomy enhancing also because the alternative seems daunting given the resources—in time and expertise—that the proper management of our money requires. The ability to *safely* delegate this task to others removes these burdens so that we can focus on intrinsically valuable projects.

To properly perform this twofold autonomy-enhancing role, financial fiduciaries law must be responsive to the goal for which it is invoked, namely: managing the beneficiary's estate (or a significant portion thereof). It must be suited to the particular incentive structure created by its inherent circumstances, where the discretionary authority is particularly susceptible to both carelessness and (even more prominently) abuse. Fiduciary law's openly prophylactic treatment of disloyalty should therefore not be

[74] See generally Dagan and Heller (n 54) at pt III.A.

[75] Cf J E Penner, "An Untheory of the Law of Trusts, or Some Notes Towards Understanding the Structure of Trust Law Doctrine," 63 *Cur Legal Probs* 653, 665 (2010). Like us, Penner characterizes trust law as a facilitative legal device, but he claims that moral principles have no role to play in arguing about law's core principles (at 665–7). Our treatment of the various doctrines we address herein demonstrates, *pace* Penner, the role normative arguments can, and should, play in the ongoing interpretation, elaboration, and development of such facilitative institutions.

understood (as private law formalists often argue) as an illegitimate use of private law to promote collectivist purposes.[76] Rather, the ambitious facilitation of this vulnerable type of interpersonal relationship implies that the core task of fiduciary law is to structure the *ex ante* entitlements of the parties *inter se* in a way that deters abuse.[77]

Although the economic analysis offers the sharpest account of the significance of deterrence to the integrity and viability of the law of financial fiduciaries, it has, surprisingly, neglected one of the most important means for securing that deterrence. By discarding fiduciary law's normativity, the economic analysis fails to appreciate law's role in preserving, sustaining, and reinforcing social norms crucial for the functioning of this type of fiduciary relationship.[78] Law is more than a set of incentives that serve as the basis for predicting some external reaction to deviation from or compliance with its dictates. As H L A Hart argued, legal norms are also taken as bases for claims, demands, and criticism, as standards and guides for conduct and judgment.[79] Structural pluralism takes seriously the normativity of private law; in fact, in addition to stabilizing expectations, this expressive role of law is, as noted, the reason for the significance structural pluralism accords to the internal coherence of our private law institutions.[80] Accordingly, structural pluralism prescribes that alongside its pursuit of optimal incentives for the proper management of other people's money, the law of financial fiduciaries should continue to inculcate the traditional cultural perception of trustees and similar financial fiduciaries as "the quintessential figure(s) of the ethical subject *as* economic subject."[81]

Performing both these roles is the main challenge of financial fiduciaries law.[82] An autonomy-based conception of this private law institution cannot understate the importance of its incentives, as formalists and moralists tend to, given the predominantly welfarist purpose for which it is invoked. Respecting fiduciary law's modus operandi—the particular way in which it enhances people's autonomy—responsible decision-makers must consider the effects of the rules they prescribe on the intended beneficiaries. But because these effects are mediated by fiduciaries' self-understanding of their role, which is, in turn, affected by the normative content the law expresses, our

[76] See, eg, Ernest J Weinrib, "Restitutionary Damages as Corrective Justice," 1 *Theoretical Inquiries L* 1, 33–4 (1999).

[77] See Dagan (n 6) at 236. See generally Dagan (n 7) at ch 5.

[78] This neglect of law's expressive function and its attendant role in reinforcing desirable social norms is not inherent to the economic analysis of law. See Robert Cooter, "Expressive Law and Economics," 27 *J Legal Stud* 585 (1998). Nonetheless, it may be no mere coincidence that the accounts of the law and economics luminaries discussed in Section II.B fail to take this function into consideration: sidestepping the significance of factors that are difficult to measure may be the economist's professional hazard.

[79] See H L A Hart, *The Concept of Law* (1961) 79–88.

[80] See text accompanying n 12.

[81] Birla (n 8) at 71. We do not deny the limits of law's prescriptive effects and the possibility that in certain cases legal intervention might actually backfire by crowding out internal motivations. The literature on these dynamics of the interaction between law and culture is divided. See Yuval Feldman and Tom R Tyler, "Mandated Justice: The Potential Promise and Possible Pitfalls of Mandating Procedural Justice in the Workplace," *Reg & Gov't* 46 (2012). We do not purport to resolve this matter here, but see no reason to suspect a moral backlash that would undermine the instrumentally beneficial role of the expressive function of financial fiduciaries law.

[82] Another important challenge of our doctrine is to examine whether there are uses, within the broad range of uses trust law currently facilitates, that undermine, rather than enhance, autonomy. A possible candidate for such critical inquiry is the spendthrift trust. See, eg, Gregory S Alexander and Hanoch Dagan, *Properties of Property* (2012) 306–7.

doctrine must also be sensitive to the potential counterproductive effects of incentives that could dilute the normativity of financial fiduciaries law, thereby undermining its material functioning.[83] There is probably no precise formula for optimally balancing these effects. This articulation of the regulative principle of the law governing financial fiduciaries thus requires a critical examination of its main doctrinal features, with an eye to the need to accommodate material incentives and expressive effects as well as to the possible legal techniques that may be available at any given doctrinal junction.[84] The remainder of this chapter will be devoted to this task.

B. Reassurance and critique

1. Sole or best interest?

We begin with the most significant doctrinal detail of trust law: the standard of trustees' loyalty. The traditional standard of loyalty is strict. It prescribes that "[t]he trustee is under a duty to administer the trust *solely* in the interest of the beneficiaries,"[85] so that any transaction that implicates the trustee's personal interests will be struck down, even if she can prove that it was in the best interest of the beneficiary. This "sole interest" standard and its attendant "no further inquiry" rule are not absolute, however. The sole interest standard gives way, as John Langbein demonstrated, to a long list of exclusions and categoric exceptions. A transaction or set of transactions that are tainted by the benefit they bestow upon the trustee but are in the best interest of the beneficiary are deemed acceptable where the trustee obtains the settlor's authorization, the beneficiary's informed consent, or the court's prior approval. Likewise, courts and legislatures have exempted classes of transactions that implicate the trustee's self-interest, granting special prerogatives to institutional trustees in the financial-services industry, such as the authority to deposit trust funds in a financial institution affiliated with the trustee's intrafamilial transactions.[86]

Taking a welfarist perspective, Langbein argues that the traditional sole interest rule should be replaced with a "best interest" rule, although he would still require the trustee to prove the fairness of a given transaction. This reform, he argues, would conform to a parallel shift in corporate law; it would also make trust law more transparent, given the existing array of exclusions and exceptions that are aimed at incentivizing transactions best promoting beneficiaries' interests; finally, such a reform would properly protect good faith non-professional trustees, who are the main victims of the traditional rule.[87] We share many of Langbein's premises. Like him, we reject the purported moralist foundation of trust law and the attempt to provide conceptual grounding for the sole interest standard. Furthermore, our autonomy-based theory of the law of financial fiduciaries is committed to the law being shaped to maximize beneficiaries' welfare. And yet we cannot support his proposed reform.

[83] Cf Lynn Stout, *Cultivating Conscience* (2011)106–8, 249–52.

[84] Cf Penner (n 75) at 668, 670.

[85] *Restatement (Second) of Trusts* (1959) § 170(1).

[86] John H Langbein, "Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?," 114 *Yale LJ* 929, 931–2, 963–5, 968–79 (2005).

[87] Langbein (n 86) at 980–2, 989, 987, 984–5.

There are three reasons to suggest that the lessons Langbein draws from corporate law lack the force he attributes to them. The first reason aligns with our general emphasis on the diversity of fiduciary forms. Although corporate law considers officers, directors, and controlling shareholders to be fiduciaries, Langbein's analogy ignores important distinctions between them and fiduciaries subject to trust law. As others demonstrated, these differences are significant and may justify the relative harshness of trust law either due to the availability of alternative means for securing loyalty in the corporate context (notably, the prospect of shareholder exit and shareholders' ability to replace the managerial team) or due to the relative complexity of the task of corporate directors.[88] Delving into the implications of these differences is beyond the scope of this chapter,[89] but suffice it to say that they justify a cautious attitude to this analogy.[90] This is reinforced by the fact that developments in corporate law, especially those involving conflicts between shareholders and managers, might not be triggered by the innocuous pursuit of maximizing shareholders' welfare but, rather, by a race to the bottom between states competing over incorporation fees and prestige and driven by managers armed with corporate money.[91]

Finally, and maybe most tellingly, the analogy to corporate law may work *against* Langbein's normative prescription, because the leading trend over the last decade or so has been a shift away from "best interest" and towards "sole interest."[92] This has occurred in important (perhaps the most important) areas of conflict-of-interest transactions in the corporate setting: the managerial loan, executive compensation, and the "freeze-out" merger. In the early years of the twenty-first century, it became evident that managers were abusing the opportunity to borrow from their corporations. A substantial portion of American corporations granted hefty loans to top executives;[93] the full extent of the benefits built into these loans was partially hidden from the public eye.[94] Concluding that instances of abuse were too frequent, Congress enacted the 2002 Sarbanes–Oxley Act, prohibiting public corporations, almost without exception, from giving loans to their executives even if in the best

[88] See, eg, respectively, Robert H Sitkoff, "The Economic Structure of Fiduciary Law," 91 *BU L Rev* 1039, 1045 (2011); Leslie (n 57) at 99–100. Moreover, the decisions of corporate directors regarding shareholders' money implicate many other individuals, a complexity that is absent in our case.

[89] It is unclear that either the prospect of exit or the ability to replace the managerial team significantly protects shareholders. An exit exercised in the wake of managerial abuse is exit at an inferior price, and thus does not offer much protection. Takeovers are also imperfect since they require a complex collective action and considerable costs, and are often hampered by anti-takeover devices used by the incumbent managers. See Sharon Hannes, "The Market for Takeover Defenses," 101 *Nw U L Rev* 125 (2007).

[90] Another complication stems from the fact that shareholders are not the sole beneficiaries of the corporation. See Andrew S Gold, "Dynamic Fiduciary Duty," 34 *Cardozo L Rev* 491 (2012).

[91] This is admittedly a controversial claim. Compare, eg, Lucian Arye Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law," 105 *Harv L Rev* 1435, 1441 (1992) with Marcel Kahan and Ehud Kamar, "The Myth of State Competition in Corporate Law," 55 *Stan L Rev* 679 (2002).

[92] Langbein focuses on much earlier developments in corporate law. But in order for his argument to hold, corporate law must not have reversed its preference.

[93] See, eg, Paul Hodgson, *My Big Fat Corporate Loan* (2002) 1.

[94] See Lucian A Bebchuk and Robert J Jackson, Jr, "Executive Pensions," 30 J Corp L 823, 824 n 2 (2005). Moreover, executive loans were often forgiven by companies, in whole or in part—yet another boon for managers. See Kathleen M Kahle and Kuldeep Shastri, "Executive Loans," 39 *J Fin & Quant Analysis* 791, 798 (2004).

interests of the shareholders[95] (and even if preapproved by the latter[96]). Similar developments—which, taken together, could be an indication of a "glorious resurgence" of the "sole interest rule" in corporate law—include the emerging legislative requirement that executive compensation be approved by the shareholders[97] and the recent shift in the Delaware courts' treatment of the freeze-out merger,[98] moving from the "entirely fair to the minority" standard[99] (a typically lenient best interest rule) to a sole-interest-like requirement of preapproval by a majority of the minority shareholders.[100]

Although the fact that these developments are taking the path that trust law has long preferred is not indicative of definitive reform, it does suggest a need for some caution before jettisoning the traditional trust law doctrine. This is supported by the regulative principle underlying, in our view, the law of financial fiduciaries, which vindicates the seemingly awkward normative structure of a sweeping rule with numerous exceptions.

A financial fiduciaries law aimed at serving the welfare interests of beneficiaries should favorably carve out, as trust law did, exceptions to the sole interest rule to cover categories of cases in which optimizing beneficiaries' interests requires allowing fiduciaries some incidental benefits. Therefore, unlike moralist accounts of this doctrine, our theory is not shaken by the proliferation of such exceptions. In fact, because we share Langbein's critique of the treatment of good-faith nonprofessional trustees, we are unwilling to join Miller in endorsing this aspect of traditional law[101] and instead commend the emerging jurisprudence that sets new exceptions covering these (relatively rare) cases.[102] But whereas Langbein's strictly economic perspective implies that once the "bark" of the sole interest rule has become much "worse than its bite,"[103] its baseline prescription should be reversed, we applaud the doctrinal structure that supplements a sole interest baseline with as many exceptions as a sound welfarist account prescribes. Our account suggests that this combination constructs a legal edifice that is well suited to the main doctrinal challenges of the regulative principle of financial fiduciaries law.

The unique development of the duty of loyalty in trust law subtly, if unintentionally, utilizes the gap between law's material effects and its expressive function in order to accommodate the law's expressive and material goals. Because financial fiduciaries law typically targets sophisticated professionals who have access to ample legal advice,

[95] As is the case with loans to cover managers' relocation costs or for them to buy shares in the corporation so as to align their incentives with those of the shareholders.

[96] Section 402 of the Sarbanes–Oxley Act, which added s 13(k) to the Exchange Act of 1934 (48 Stat 894). Sarbanes–Oxley Act § 402(a), Pub L No 107–204, 2002 USCCAN (116 Stat) at 745, 787 (codified at 15 USC § 78m(k) (Supp 2006)).

[97] See text accompanying nn 165–70.

[98] The freeze-out merger—a device used by controlling shareholders to buy out the corporation's public shareholders and go private—is perhaps the most extreme example of a conflict-of-interest transaction.

[99] Robert C Clark, *Corporate Law* (1986) 518–30.

[100] See *In re Pure Resources, Inc*, Shareholder Litigation 808 A 2d 421 (Del Ch 2002); Guhan Subramanian, "Fixing Freezeouts," 115 *Yale LJ* 2, 59 (2005). True, Delaware still leaves the door open for controlling shareholders to conduct freeze-out mergers without the minority shareholders' prior approval. But its court discourages this practice. See, eg, *In re Emerging Communications, Inc*, Shareholders Litigation No 16415, 2004 Del Ch LEXIS 79 (Del Ch 3 May 2004). Moreover, modern codes of corporate law grant minority shareholders veto rights with regard to crucial self-dealing transactions, including freeze-outs. Related Party Transactions and Minority Shareholder Rights 30–6 (OECD 2012), available at <http://www.oecd.org/daf/ca/50089215. pdf>.

[101] See text accompanying n 24.

[102] Leslie (n 58) at 570, 574, 579.

[103] Langbein (n 86) at 933.

most doctrinal details are likely to be translated into incentives and to generate corresponding behavioral outcomes. But doctrinal details rarely produce broad cultural consequences and, thus, rarely impact broader social norms. Rather, what may affect people's preferences and social norms are "more fundamental legal concepts and institutions."[104] Accordingly, in sticking to the conception of the trustee as a person who is morally obligated to serve the beneficiary alone, trust law reinforces this socially popular perception, which is instrumental in facilitating the safe delegation of welfarist interests to trustees.

The existing structure and language of the duty of loyalty in trust law may seem puzzling for Langbein because he fails to consider the instrumental value of the social expectations created by the virtuous image of fiduciaries and trust law's contribution to this image. By contrast, our analysis appreciates the expressive effect of law and how broad social norms, alongside the corresponding moral commitments and reputational concerns they may consolidate, can have desirable behavioral effects. We therefore caution against discarding the existing doctrinal design, which neatly serves financial fiduciary law that must both entrench this social norm and allow conflicted transactions when they typically serve the interests of beneficiaries.

There is another benefit to the unique structure of trust law—another challenge it contends with—which might also be at risk under Langbein's proposed reform. Conceptualizing deviations from the sole interest rule as exceptions could serve as a reminder of the need to scrutinize the justifiability of these exceptions. The ongoing inquiry into these exceptions that could thus be facilitated is particularly worthwhile given the strong prospect of abuse—the source of the persistent threat to the functioning of financial fiduciaries law as an autonomy-enhancing private law institution.

Consider the debate over a 2003 amendment to the Uniform Trust Code that allows a trustee to purchase investment services from a company to which she is connected.[105] This new rule permits investments by institutional trustees in mutual funds run by companies related to them and sanctions the entailed fees and commissions they can thus capture. Langbein argues that the new rule makes good sense, because a settlor who chooses a trustee for her investment expertise will often wish to benefit from the investment vehicles (mutual funds) created by that trustee, rather than use investment services from a third party.[106] Leslie disagrees, contending that even without this rule, settlors could have captured this purported benefit by preapproving such investment strategies, whereas the new rule might encourage trustees to invest in inferior vehicles in order to reap extra fees, thus requiring the weak party to the transaction—the settlor or beneficiary—to pursue protection where they think it necessary.[107]

We do not claim that it is easy to determine the desirability of this new rule. Quite the contrary: a careful comparison of the benefits and costs of this innovative exception is required. More specifically, once enough data have accumulated on this rule, empirical inquiries should examine the relative performance of mutual funds with a trustee as a sponsor vis-à-vis independent mutual funds as well as the portfolio returns of beneficiaries whose trustees invest in related funds (taking into account the returns net of all

[104] Dagan (n 9) at 133.
[105] Unif. Trust Code § 802(f) (amended 2003).
[106] Langbein (n 86) at 976–8.
[107] Leslie (n 58) at 570, 574, 579.

fees and commissions) in comparison to the returns of other beneficiaries. Fashioning the trustee's permission to make self-interested investments exceptions makes them salient for investigation, whereas reversing the baseline may obscure the subject's analytical significance.[108]

2. *Investment policy*

We now turn to the second important duty borne by fiduciaries—the duty of care—and focus on the investment strategy that the fiduciary should adopt on behalf of the beneficiary. Whereas the duty of loyalty may well be fiduciary law's most distinctive feature, it is the duty of care and, more specifically, the investment policy it prescribes that are paramount in the context of the autonomy-enhancing promise of enabling people to safely delegate the authority to manage their financial resources.

The literature on investment policy is mostly economic. But its starting point—in line with our approach—is that efficiency in our context means an investment policy tailored to the preferences of the particular beneficiary.[109] On this background, we attempt to contribute to the debate over the lessons to be drawn from the 2008 financial crisis regarding the regulation of trustee investment policy. In order to set the stage for this discussion, we begin with some conventional wisdom that shows that the prudence of investment policies that satisfy the duty of care varies for different types of fiduciaries. As supported by our structural pluralist approach, rather than looking for a unifying principle, an account of fiduciaries' duties of care must analyze the diverging tasks performed by different fiduciaries.[110]

Individuals tend to diversify their passive investments.[111] The commonsensical idea of refraining from putting all of one's eggs into one basket dovetails with modern portfolio theory, which teaches that diversification allows investors to avoid idiosyncratic risks of individual investments.[112] For quite some time, corporate managers acted as though their companies' wealth was their own and diversified "their" portfolios. This led to the creation of enormous conglomerates, which controlled multiple subsidiaries in different sectors of the economy. Such internal diversification turns out to be a particularly pernicious strategy, however: The resulting corporate structures are too complex to manage, rendering their central administration an overhead consumer that adds no significant managerial value. They are also extremely opaque and therefore very hard for analysts to read and for markets to discipline. Moreover, they facilitate a harmful process of cross-subsidization, whereby a weaker arm of the conglomerate is

[108] We acknowledge that a system based on a rule with exceptions that often kick in might put an extra burden on unsophisticated parties. This observation may imply that financial fiduciaries law should prescribe disclosure as a prerequisite to the application of at least some of these exceptions (as it does, for example, regarding the double commission earned when the trustee uses investment vehicles that she herself manages, Leslie (n 58) at 576–7)). It also underlies the significance of stickiness we discuss in Section III.B.3.

[109] See Max H Schanzenbach and Robert H Sitkoff, "The Prudent Investor Rule: A Theoretical and Empirical Reassessment" (2013) 17 (unpublished manuscript).

[110] These differences also affect the pertinent standard of care. See text accompanying nn 39–41.

[111] When a person manages her own business, she is unable to diversify her wealth. But given passive investments and liquid markets, diversification can be achieved at a relatively low cost.

[112] See Harry M Markowitz, "Portfolio Selection," 7 *J Fin* 77 (1952).

subsidized by its healthy subsidiaries, thus distorting the incentives of division managers[113] and insulating their tenure from downturns in specific sectors of the economy.[114] The ensuing losses suffered by these conglomerates resulted in a broad process of "deconglomeration" throughout the 1980s.[115] Once the markets came to appreciate the downside of internal corporate diversification, it became common wisdom that corporate managers should stick to a single area of expertise and allow investors to take care of diversification.

In sharp contrast to the optimal investment strategy of corporate fiduciaries, money-manager trustees should generally diversify the assets in the trust's portfolio as a prudent investor would normally do with her own portfolio. To be sure, the current rigorous prescription of diversification is relatively new. The traditional common law rule set an exhaustive list of permissible investments, which included (extremely) safe investments and emphatically excluded risky securities.[116] The standard then gradually shifted in both the UK and US toward the so-called (old) "prudent man" standard, which abolished the fixed list of investments and directed the trustee to instead adhere to the practices of prudent marketplace investors.[117] The courts, however, continued to be partial to safer investments.[118] And since the conventional form of trustee compensation does not give the trustee a cut of the trust's profits, the threat of liability, however slight, led trustees to be highly conservative in their investment strategies. Scholars began to argue that the law should be modified so as to encourage trustees to make riskier investments for their beneficiaries, as prescribed by modern portfolio theory.[119] The law finally changed, moving towards the modern "prudent investor" standard.[120] Under this new standard, trustees were granted the discretion to invest in any asset they saw fit. And while they were still required to take into account the settlor's and beneficiary's penchant for risk, riskiness was to be evaluated vis-à-vis the portfolio as a whole, not specific investments. The rationale for the rule is that the riskiness of any particular investment may be uncorrelated with the riskiness of other investments so that the inclusion of a risky investment in a portfolio may increase returns without adding a significant amount of risk. This modification to the law—even though only a default

[113] Such cross-subsidization alleviates the pressure on underperforming division managers and penalizes successful ones.

[114] See David S Scharfstein and Jermey C Stein, "The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment," 55 *J Fin* 2537 (2000); Owen Lamont, "Cash Flow and Investment Evidence from Internal Capital Markets," 52 *J Fin* 83 (1997).

[115] See Sanjai Bhagat et al, "Hostile Takeovers in the 1980s: The Return to Corporate Specialization," in *Brookings Papers on Economic Activity: Microeconomics* (1990) 1; Steven N Kaplan and Michael S Weisbach, "The Success of Acquisitions: Evidence from Divestitures," 47 *J Fin* 107 (1992).

[116] See Joshua Getzler, "Fiduciary Investment in the Shadow of Financial Crisis: Was Lord Eldon Right?," 3 *J Equity* 1, 13–16 (2009).

[117] *Restatement (Second) of Trusts* (1959) § 227; *Harvard College v Armory*, 26 Mass (9 Pick) 446, 461 (1830); *In re Speight; Speight v Gaunt* [1883] 22 Ch D 727 (CA); [1883] 9 App Cas 1; 48 JP 84; 53 LJ Ch 419; 50 LT 330 (HL).

[118] See Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* (1986) 5.

[119] See, eg, John H Langbein and Richard S Posner, "Market Funds and Trust Investment Law," 3 *Am B Found Res J* 1 (1976).

[120] Unif Prudent Investor Act § 2 cmt (1994); *Restatement (Third) of Trusts* (1992) § 227; Pensions Act 1995 § 34(1); Trustee Act 2000 § 3(1).

rule—changed the way institutional trustees handle their trusts. The proportion of the average trust portfolio devoted to stock rose by as much as 4.5 percent.[121]

In the wake of the 2008 crisis, some scholars suggested that these most recent changes did not serve beneficiaries well and should be reevaluated. Joshua Getzler argues that a reversal should be considered—not merely back to the prudent man standard, but to the "court list" rule that prohibits altogether certain investments, such as corporate stock.[122] Stewart Sterk offers a less restrictive suggestion—to enact a pair of safe harbors: one that protects trustees from liability for excessive risk if they invest less than 60 percent of the trust's portfolio in equity, and another that precludes liability for *insufficient* risk if trustees invest at least 40 percent of the portfolio in equity. Moreover, in order to prevent a trustee from investing in specific, overpriced assets (since occasional market bubbles are presumably inevitable), Sterk would require a trustee engaged in active investment practices to explain to the court, in the event of failure, why he made each specific investment. Sterk claims that once trustees were permitted to invest in all possible ventures without fear of liability, they began to consider extremely risky investments with high returns. Then, when they achieved high returns, they were able to attract more clients by advertising these returns but downplaying the levels of risk they entailed. During market downturns, Sterk further argues, competing money managers are unlikely to advertise their returns at all, and therefore a highly risky investment strategy generates minimal risk for trustees. Sterk believes that the introduction of his safe harbors would help to reduce these excessive risk levels.[123]

Max Schanzenbach and Robert Sitkoff reject Sterk's proposal as well as any other alternative to the modern prudent investor standard. They argue, first, that there is no evidence that alternative investment strategies would have served beneficiaries better during the recent crisis. Second, they offer their own empirical study showing that the institutional trustees, who substantially increased their trusts' investment in shares after the adoption of the modern prudent investor standard, were those whose beneficiaries were well suited to bearing the additional risk. Finally, Schanzenbach and Sitkoff claim that a safe harbor that shields trustees from liability if they follow certain guidelines would cause too many trustees to follow these guidelines, because—being compensated by a percentage of the corpus—"they have little incentive to increase returns."[124]

Both sides of this debate make valid points. It is true, as Schanzenbach and Sitkoff note, that the old regime did not encourage enough risk-taking and that "formerly disfavored assets" may actually be "an important part of a diversification strategy" insofar as they are "not perfectly correlated with other asset classes."[125] By the same token, although given the heterogeneity of beneficiaries' preferences we are hesitant to endorse the idea of *general* thresholds of investment in equity (even if crafted as safe harbors),[126] Sterk may be right that the new, more fluid, standard drives trustees

[121] Max M Schanzenbach and Robert H Sitkoff, "Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?," 50 *JL & Econ* 681, 707 (2007).

[122] Getzler (n 116) at 26–7.

[123] Stewart E Sterk, "Rethinking Trust Law Reform: How Prudent Is Modern Prudent Investor Doctrine?," 95 *Cornell L Rev* 851, 882, 887–8, 891, 896 (2010).

[124] Schanzenbach and Sitkoff (n 109) at 2, 7, 13, 26–40.

[125] Schanzenbach and Sitkoff (n 109) at 10.

[126] If investments of a specific kind are overseen by a regulator, such as a pension regulator, it would seem reasonable for her to set thresholds that are circumstance dependent and subject to periodic revision.

towards excessive risk-taking, especially in times of market bubbles and overpriced equity. To be sure, some of Sterk's concerns may (and should) be ameliorated through rules that prevent trustees from attracting clients by advertising inflated returns that stem from extreme risks: trustees who publicize their past returns should be required to provide information for a long period of time along with data on the riskiness of their investments. But it is not clear that these measures can sufficiently overcome the concern with excessive risk-taking.

These valid and conflicting concerns can be attributed to the detrimental impact of the traditional way trustees (and trust advisers) are compensated, which is typically computed as a set annual percentage of the value of the trust's assets.[127] The prudent man standard might have worked well had it paired the relatively mild threat of liability for speculative investing with some type of performance-based remuneration allowing the trustee to enjoy more of an upside from fruitful investments.[128] Similarly, the threat of excessive risk-taking could be alleviated were trustees to share in the risk by way of a suitable fee formula (or share the investments themselves). Moreover, the prevailing percentage-of-the-assets fee structure, in which financial fiduciaries can gain or lose mostly from getting a larger or smaller market share, exacerbates a herding problem. A money manager currently loses almost nothing by performing badly if her peers do not perform much better. And since the upside of outsmarting the market is likewise limited, she will often opt to mimic her peers' investment strategies. This herding tendency is particularly harmful during market bubbles, when overpriced investment opportunities become readily available, because herding exacerbates bubbles. Since this may have been a background factor in the recent financial crisis (especially the subprime crash),[129] it may be high time for a change to the traditional fee structure for financial fiduciaries.[130]

A thorough discussion of what fee structure could produce optimal incentives for money managers' investment policy is unnecessary for our purposes, but two conclusions seem appropriate. First, we assert that an analysis of financial fiduciaries' investment policy must reexamine their compensation structure. (Hence our treatment of the relationship between fiduciary compensation and the duty of loyalty in our last section.) Second, although we find overly aggressive the suggestion that financial fiduciaries' fees follow hedge-fund managers' fees, a generous (usually 20 percent) cut of the profits,[131] we believe that a balanced scheme can be reached. For instance, the fee structure could be along the lines of restricted stock grants to corporate managers, so

[127] See Robert C Illig, "The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring," 60 *Ala L Rev* 41, 68 (2008).

[128] The trustee's upside under the percentage-of-the-corpus-based compensation structure is mild. Thus, if the annual return earned is 5 percent and the percentage-of-the-corpus is 1 percent, the trustee enjoys an upside of only 0.05 percent of the assets she manages.

[129] See generally Adam J Levitin and Susan M Wachte, "Explaining the Housing Bubble," 100 *Geo LJ* 1177 (2012).

[130] Untraditional fee structures may be found even today in the incentive schemes of investment advisers. In a directed trust it is possible to outsource the investment function to an investment adviser who directs the trustee how to invest the assets of the trust. In such cases it is common to find success fees and untraditional fee arrangements for the adviser. Interestingly, it is unclear to what extent the investment adviser is subject to the requirements of trust law. See Jesse Dukeminier and Robert H Sitkoff, *Wills, Trusts and Estates* (9th edn, 2013) 654.

[131] Illig (n 127) at 102.

that the fiduciary would share the fate of her beneficiary for better or worse.[132] Such a fee structure would be symmetric in that managers would enjoy part of the fruits of success, but their exposure to the downside could prevent them from taking excessive risks.

3. Opt-outs

We began our doctrinal survey with the duty of loyalty because it is the signature feature of fiduciary law. Adding to this our earlier discussion of the disgorgement remedy for disloyalty[133] and the duty of care just covered, we have canvassed much of the doctrinal fabric of the law of financial fiduciaries. Our next inquiry relates to the status of this doctrine: Is it, as its canonical economic analysis suggests, "naturally" open to contrary agreement by the parties,[134] just like any other default, or should it instead be deemed immutable, as the moralist account of the duty of loyalty may suggest? We believe that it should be neither. Rather than comprising "mere" defaults or fully mandatory rules, we conceptualize financial fiduciaries law as a set of "sticky" default rules[135] wrapped in two standards—the duty of loyalty and the duty of care—which can be similarly derogated, but not completely set aside.

Our starting point is structural pluralism's emphasis on private law's autonomy-enhancing role, which implies a wide scope of freedom of contract. For pluralists, private law institutions offer unifying normative ideals for core categories of interpersonal relationships. People should be able to choose from these institutions in line with their own conceptions of the good and the means necessary for its realization given their particular needs and circumstances. This fundamental commitment to self-authorship—accompanied by a degree of caution regarding legal regimes that put too much power in the hands of lawmakers—requires that, in general, people should be able to choose not only from among the various private law institutions, but also within each of them. Immutability is troublesome from this perspective, because it does not accommodate heterogeneity, let alone idiosyncrasy, nor does it sufficiently accommodate the possibility of mistaken rules. Thus, where no third-party negative externalities are at stake, private law should not force its rules; rather, people should be able to consensually modify the rules of the pertinent institution if they so choose. Of course, at times the law might legitimately regulate and even strictly scrutinize such opt-outs in order to guarantee that they reflect people's informed choices. Nonetheless, to the extent possible, private law should attempt to overcome problems of information asymmetry and cognitive biases by prescribing sticky defaults rather than by curtailing choice through mandatory rules.[136]

132 See Kevin J Murphy, "Executive Compensation: Where We Are, and How We Got There," in George Constantinides et al (eds), *Handbook of the Economics of Finance* (forthcoming 2014), available at <http://ssrn.com/abstract=2041679> (manuscript at 10).

133 See text accompanying nn 43–8.

134 See Sitkoff (n 88) at 1045. See also text accompanying n 38.

135 On sticky defaults, see Ian Ayres, "Regulating Opt Out: An Economic Theory of Altering Rules," 121 *Yale LJ* 2032, 2084–8 (2012).

136 See Dagan (n 9) at 1436.

It is hard to see why any specific rule of financial fiduciaries law should not be subject to these conclusions.[137] After all, significant welfare interests of the beneficiaries are on the line, and it is unlikely that government officials will inevitably do better than the parties at analyzing the situation and choosing the optimal solution. And while it is true that private parties suffer from cognitive-behavioral biases, limited willpower, and many other imperfections that may well justify stickiness, public officials are not necessarily immune from these either or, for that matter, other similar biases.[138] Even the expressive function of the duty of loyalty does not justify immutability, as opposed to stickiness. To be sure, we do not deny that immutability may send a clear message that, arguably, supports a particular social norm, and there may be cases where there is no other viable way to express such a message (the legal regime governing insider trading in securities law may be a case in point). But we do dispute that all default rules, irrespective of their structure and degree of stickiness, carry no normative content or signal indifference regarding the law's expressive message. While the rhetoric of gap-filling and optionality may dilute this expressive function,[139] the law can structure its doctrine so as to preserve, even inculcate, the social norms it deems of value, without sacrificing people's ability to opt out of its rules.[140]

Financial fiduciaries law can, and to some extent already does, address both the behavioral and expressive concerns while avoiding immutability. One important way to do this is by offering loyalty and care as defaults. As we argue, while embracing the traditional sole interest rule, such a default rule—like the reasonableness counterpart insofar as the duty of care is concerned—serves an important expressive function, especially in an environment that increasingly requires the carving-out of exceptions and exemptions. These traditional defaults are also justified on behavioral grounds that seem particularly pertinent to weak and unsophisticated parties. Even if most beneficiaries prefer a different default, opting out of the sole interest rule yields lower expected costs for them than the expected costs entailed by a more subtle default for unsophisticated beneficiaries (and settlors). Therefore, even if it were to turn out that most fiduciary relationships choose to opt out of a sole interest default rule, financial fiduciaries law should not replace its demanding defaults with simple majoritarian rules.[141]

A second, no less important legal device that can help law attain the delicate balance between opting out and expressiveness, while properly addressing these behavioral

[137] The rule governing delegation of investment decisions, which we do not discuss in detail, can exemplify this. Prior to the Uniform Prudent Investor Act of 1994, the default was that investment decisions should not be delegated by the trustee, but if the trustee does decide to delegate, then she is liable for any negligent act by the investment adviser. Given the enhanced duty to diversify and thus the greater need to delegate investment decisions, section 9 of the Uniform Prudent Investor Act changed the default, and the trustee is currently liable only for negligent selection of the investment adviser. Schanzenbach and Sitkoff (n 109) at 14, hail this change, whereas Sterk (n 123) at 898, prefers the old default. We would opt for a middle-ground default rule that imposes liability on the trustee if the delegation was to an entity or person who was (1) professionally unfit for the stint or (2) lacked the financial resources or insurance that could meet potential liability. The trustee could opt out of this standard after alerting the settlor or receiving permission from the beneficiary.

[138] See Christine Jolls et al, "A Behavioral Approach to Law and Economics," 50 *Stan L Rev* 1471, 1543 (1998).

[139] See Leslie (n 57) at 69–70, 91, 116.

[140] See Dagan (n 9) at 1436. But cf Leslie (n 57) at 89.

[141] Cf Lucian Bebchuk, "The Debate on Contractual Freedom in Corporate Law," 89 *Colum L Rev* 1395 (1989). Contra Langbein (n 38) at 660; Langbein (n 86) at 987–90.

concerns, is "impeding altering rules."[142] We join Leslie in insisting that although parties should be (and, in fact, are) able to "authorize particular acts that would otherwise be a breach of the duty [of loyalty]," this should be allowed by way of "limited, specific initial waivers," and they should not be able (and, in fact, are unable) to "agree to dispense with the duty entirely."[143] Sweeping exculpatory clauses run counter to the regulatory principle of financial fiduciaries law—to its distinct autonomy-enhancing function, which is the rationale for resorting to it—and a fully informed settler would be unlikely to agree to them. With Leslie we believe that a similar approach should apply regarding the duty of care for professional financial fiduciaries,[144] or at least that the law should resort to a "thought-requiring altering rule"[145] by requiring fiduciaries who offer a broad exculpatory clause for a discount to offer two different prices for the two types of services.[146]

Other impeding altering rules could further enable opting-out without diluting law's normative force or risking suboptimal opt-outs, especially by less sophisticated parties who may otherwise be misled by fiduciary law's expressive function. Leslie supports, as do we, requiring financial fiduciaries who offer "suspicious" waivers (eg, investing in their own investment vehicles and thus earning double commissions) to at least notify their beneficiaries about their conflicting interest.[147] Financial fiduciaries law could similarly use a "reversibility altering rule" to contend with the concern that if circumstances change and pro-fiduciary norms become outdated, it tends to be difficult for beneficiaries to adjust them.[148] This rule could take the form of a sunset provision, requiring beneficiaries to periodically confirm that they are still interested in these provisions.[149] Alternatively, the legislature or courts could be authorized to create new, future-oriented defaults if they identify a market-wide change in circumstances that calls into question all choices made by parties to fiduciary relationships at earlier dates.[150] Such unique altering rules would override all prior opt-outs from anti-fiduciary rules, while allowing parties to reaffirm their wish to deviate from the default by choosing to opt-out once again.

[142] Ayres (n 136) at 2086. [143] Leslie (n 57) at 112–13.

[144] Leslie (n 57) at 95–110. But cf Adam S Hofri-Winogradow, "The Stripping of the Fund: From Evolutionary Scripts to Distributive Results" (unpublished manuscript) (arguing, based on a UK empirical study of settlors' attitudes towards exculpatory clauses, that "most settlors are unlikely to be sufficiently aware of the implications" of such clauses).

[145] Ayres (n 136) at 2069–71.

[146] Leslie (n 57) at 102.

[147] See Leslie (n 57) at 116. This obligation seems to be entailed by the duty of candour.

[148] See Ayres (n 136) at 2083–4. Ayres does not address sunset provisions of the type we recommend here. His example of a reversibility altering rule—of cooling-off periods—has the effect of allowing the reconsideration of decisions that were initially mistaken and is especially effective against aggressive marketing techniques. Sunset provisions are important for allowing people to correct their decisions following changed circumstances that demonstrate that they either were initially mistaken or no longer properly serve the intended interests.

[149] For examples of sunset provisions, see Hong Kong law on prolonged interested party transactions, Related Party Transactions and Minority Shareholder Rights (n 99) at 35, and similar legislation in Israel, Companies Law 5759–1999, 44 LSI 119 § 275(a1), § 121(c) (1999). Beneficiary-reconfirmation requirement could, however, cause holdout problems in certain circumstances.

[150] See Sharon Hannes, "Corporate Stagnation: Discussion and Reform Proposal," 30 *J Corp L* 51, 61–73 (2004).

These and other possible measures would all be intended to ensure that an opt-out is deemed valid if and only if (1) it is sufficiently detailed and refers to circumstances the beneficiary (or testator) can reasonably assess *ex ante* (this requirement implies that no wholesale list of all possible exemptions should be validated) and (2) it is carried out in a way that conforms with an altering rule tailored to address the problem this category of exemption could raise for weak and unsophisticated beneficiaries (or testators).[151] Focusing on these latter actors is the most important prescription of an autonomy-based analysis of the law of financial fiduciaries (given that there is no simple way of splitting up the universe of beneficiaries into distinct categories).

4. Fiduciaries' compensation

Our last doctrinal question concerns fiduciary compensation. Although historically, the paradigmatic financial fiduciary was a trusted family or community member who performed the task of trusteeship gratuitously, nowadays it is a professional profit-making firm.[152] This is not necessarily a detrimental development and understandable given the increasingly complicated tasks involved. What we do find worrisome is fiduciary law's standard disinterest in the fiduciary's pay, which is perceived as exogenous to the duty of loyalty[153] despite the truism that this compensation comes at the beneficiary's expense.

Two explanations have been offered for this approach. Miller suggests that because the duty of loyalty focuses on the fiduciary's execution of the beneficiary's mandate, it cannot conceptually cover compensation arrangements, which are determined before the fiduciary takes office.[154] Leslie provides practical support for the same comforting conclusion: that "allowing settlors to compensate professional trustees generate[s] obvious benefits for the trust, with no offsetting risk."[155] We find neither of these arguments convincing. Perhaps the currently prevalent compensation arrangements are indeed innocent, but this is a contingent conclusion; and it is misguided and potentially damaging to view fiduciary pay as lying outside the ambit of the duty of loyalty. This may well be the most significant doctrinal implication of our account.

If there is one area in fiduciary law that can benefit from the corporate experience it is fiduciary pay, given the overwhelming contribution of modern schemes of executive compensation to two financial mega-crises over the last decade or so. The corporate context demonstrates that fiduciary compensation cannot be regarded as temporally extrinsic to the fiduciary relationship, because compensation is often adjusted during their term. In the last four decades, these adjustments resulted in an enormous upsurge in corporate executive pay,[156] a shift which is partly attributed to managers' ability to

[151] Corporate law also took a similar position. Thus, when Delaware allowed companies to exempt directors from monetary liability for breaches of duty of care, it maintained a full liability default, although as expected, most companies immediately opted out and exempted their directors. See Henry N Butler, "*Smith v Van Gorkom*, Jurisdictional Competition, and the Role of Random Mutations in the Evolution of Corporate Law," 45 *Washburn LJ* 267 (2006). This minoritarian standard may have been justified in order to protect shareholders who prefer to preserve liability but would have found it hard to opt out from a reverse no-liability standard.

[152] See Leslie (n 57) at 86.

[153] See text accompanying n 24.

[154] Miller (n 13) at 606; see also text accompanying n 24.

[155] Leslie (n 58) at 568.

[156] See Murphy (n 132) at 14; Lucian A Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," 21 *Oxford Rev Econ Pol'y* 283, 285 tbl 1 (2005).

influence their own compensation.[157] This "managerial power hypothesis"—which may be relevant also in fiduciary settings in which compensation is determined while the relationship is ongoing—is cogent and convincing. Yet traditional corporate law also contributed to this unjustified trend because, in line with the conventional divorce of fiduciary pay from the fiduciary relationship, it did not view pay practices as conflict-of-interest transactions and, therefore, did not set the appropriate safeguards.[158]

This cautionary note is bolstered by the fact that, *pace* Leslie, compensation formulas could generate conflicts of interest resulting in severe and hard to predict effects. The corporate setting thus offers a further, disturbing lesson: pay formulas designed to enhance the fiduciary's incentives and to align her interests with those of the beneficiary may, ironically, exacerbate the agency problem and aggravate the prospect of abuse by the fiduciary. Indeed, the sharp rise in corporate executive compensation can be attributed to the corresponding dramatic increase in stock-option grants to executives.[159] Moreover, empirical research has shown that equity-based compensation has perverse negative effects, which intensify as salary is dwarfed by options and, more generally, by incentive pay.[160] Equity-based compensation, it turns out, is a major catalyst for all forms of corporate misrepresentation, from mere abuse of accounting discretion by whitewashing or sugar-coating harmful disclosures, to paltering and outright fraud. Simply put, once managers' pay is dependent on share prices, it is hard to detach their incentives to improve the firm from their incentives to artificially misrepresent the firm's performance.[161] Thus, even after Congress made it much harder for managers to engage in manipulative practices following the 2001–2 accounting scandals,[162] deleterious incentive-based pay practices persisted. Because stock options and annual bonuses yield attractive profits in good scenarios versus mild penalties in bad scenarios, this feature of executive compensation is widely claimed to have led to the excessive risk levels that culminated in the recent financial crisis.[163]

Ultimately, Congress had to switch course and incorporate a "say-on-pay" mechanism into the Dodd–Frank Act.[164] And while the outcome of the shareholders' vote is currently only precatory in the US[165]—but might soon become binding overseas[166]—more

[157] Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (2004) 80.

[158] See Clark (n 98) at 192.

[159] See Bebchuk and Grinstein (n 158) at 290 tbl 4; Kevin J Murphy, "Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options," 69 *U Chi L Rev* 847, 848 (2002).

[160] For a literature review, see Sharon Hannes and Avi Tabbach, "Executive Stock Options: The Effects of Manipulation on Risk Taking," 38 *J Corp L* 533 (2013).

[161] See, eg, John C Coffee, Jr, "What Caused Enron? A Capsule Social and Economic History of the 1990s," 89 *Cornell L Rev* 269 (2004).

[162] See Sarbanes–Oxley Act of 2002, HR 3763, 107th Cong (2002); Sharon Hannes, "Compensating for Executive Compensation: The Case for Gatekeeper Incentive Pay," 98 *Cal L Rev* 385 (2010).

[163] See, eg, Sanjai Bhagat and Roberta Romano, "Reforming Executive Compensation: Focusing and Committing to the Long-Term," 26 *Yale J on Reg* 359 (2009); Lucian A Bebchuk and Holger Spamann, "Regulating Bankers' Pay," 98 *Geo LJ* 247 (2010).

[164] Dodd–Frank Wall Street Reform and Consumer Protection Act § 951 (codified as section 14A of the Securities Exchange Act of 1934, 15 USC § 78a).

[165] Shareholders litigation aimed against corporate directors that approved compensation packages against the shareholders vote have consistently failed. See, eg, *Raul v Rynd* No 11-560-LPS, 2012 US Dist LEXIS 25256, at 28–32 (D Del 14 March 2013).

[166] A government-sponsored bill in the UK aims to contend with this shift. Dep't for Bus Innovation & Skills, Enterprise & Regulatory Reform Bill: Directors' Pay, <http://discuss.bis.gov.uk/enterprise-bill/files/2012/11/12-1255-enterprise-regulatory-reform-bill-directors-pay.pdf>.

than half of the firms respond to an adverse shareholder vote by engaging with investors and making changes to their compensation plans.[167] This new requirement for shareholder approval of compensation properly mirrors the traditional trust-law structure of a sole interest rule paired with an exception for conflict-of-interest transactions that are approved by the beneficiaries (here, the shareholders). Compensation arrangements should not be regarded as intrinsically beyond the scope of the duty of loyalty. Delaware's Chancery Court recently affirmed this important understanding when it decided (in departure from earlier decisions) to carefully scrutinize the directors' stock-option plan, even though the plan had been generally approved by the company's stockholders.[168]

These changes have been triggered by the macro consequences of the fiascos that generated the recent financial crisis. But behind these consequences stand real people whose trust has been betrayed and fortunes depleted. Corporate law had to experience crisis in order to appreciate that the compensation of corporate managers should be subject to careful scrutiny and approval processes. Because fiduciary pay is no different, a credible theory of financial fiduciaries cannot ignore these lessons. Compensation of financial fiduciaries may well be unavoidable nowadays and thus warrants an exemption from the sole interest rule. But it is wrong and, as we have seen, potentially devastating to treat it as exogenous to the fiduciary relationship. Construing fiduciary pay as an exception to the rule implies that those crafting or sanctioning remuneration schemes must keep the beneficiaries' interests in mind. It also preserves the presumption that this kind of transaction should be carefully scrutinized and periodically reexamined.

This conclusion is, by and large, forward-looking: The typical compensation schemes for financial trustees are presently not afflicted with the most severe problems that plagued its corporate counterparts. But because, as noted, more sophisticated pay structures may be in the making, certain safeguards are required. Thus, the current fee structure for pension plan trustees, based on a fixed annual percentage of the assets they oversee,[169] does not incentivize short-termism or intense risk-taking. Quite the contrary: Under such a scheme, not only does the money manager not reap immediate profit from short-term gains or excessively risky investments, but she can also expect to be rewarded for long-term successes. For once performance can be assessed, more money is likely to be channeled to the best money managers, and consequently, the fees generated as a percentage of the assets they manage will increase. But given the significant distortions (noted above) this conventional fee structure yields for financial fiduciaries' investment strategies,[170] the formula may eventually change. If and when this happens, it will be important to keep in mind the conflict of interest that more sophisticated pay structures tend to produce. Here lies the importance of monitoring fiduciary pay as an exception to the sole interest rule and of periodically reexamining

[167] See Yonca Ertimur et al, *Shareholder Vote and Proxy Advisors: Evidence from Say on Pay* (2013), available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019239>. Many other firms avoid such an outcome at the outset by adapting to shareholders anticipated wishes.

[168] *Seinfeld v Slager* Civ No 6462-VCG, 2012 WL 2501105 at *32 (Del Ch 29 June 2012). Cf *In re 3COM Corp Shareholders Litigation* No CA 16721, 1999 WL 1009210, at *1 (Del Ch 25 Oct 1999).

[169] See text accompanying nn 127–32. [170] See text accompanying nn 127–32.

its impact for the sake of the economy and of the beneficiaries whose pensions, savings, and bequests are at stake.

Finally, even today, with the traditional compensation formulas for money-managers still in place, their pay should be conceptualized as an exception to the sole interest rule and closely scrutinized, because fiduciary pay is often not an arm's length transaction. *Jones v Harris*,[171] dealing with the review standard for compensation of a mutual fund adviser (the fund's de facto money manager) who is by law "deemed to have a fiduciary duty with respect to the receipt of compensation,"[172] is illustrative. Whereas Judge Easterbrook refused to examine the "reasonableness" of the adviser's fee,[173] Judge Posner's dissent—highlighting the adviser's influence on its own pay-setting mechanism, expressing concern that "the advisor's charging its captive funds more than twice what it charges independent funds," and advocating more careful scrutiny of the size of the adviser's fee package—is clearly preferable.[174] Furthermore, because fiduciary pay should be governed by norms similar to those governing other deviations from the sole interest rule, his approach should apply to all instances of fiduciary pay that are not set by a market mechanism or other reassuring device.

Concluding Remarks

Financial fiduciaries law is an important case study on the contribution of private law to our personal autonomy. In a complicated world, with increasingly complex challenges to our ability to manage our finances and secure our welfare, law offers the option of delegating the authority to do so to others. For this option to be viable and enable us to focus on our intrinsically valuable projects, financial fiduciaries law must appreciate the significant risks of abuse and carelessness inherent to the delegation of such discretionary authority, while keeping in mind beneficiaries' welfarist purposes. The law should accordingly tailor its rules to provide fiduciaries with optimal incentives while inculcating the social norms associating these rules with the virtues of trust and loyalty.

This chapter celebrates the structure of traditional financial fiduciaries law, which tackles this challenging mission by entrenching a strict sole interest rule alongside many exceptions and exemptions that serve beneficiaries' best interests. Yet it also offers some direction for reform that could further the law's ability to pursue this task. The law should allow opt-outs but also design a range of sticky defaults that respond to the needs of weak and unsophisticated beneficiaries. The law should also realize the significance of revisiting the fee structure for fiduciaries, as well as reexamine its investment policy prescriptions. Finally and significantly, it should renounce its traditional treatment of fiduciary pay so that it is no longer considered exogenous to the duty of loyalty.

[171] *Jones v Harris Assoc LP* 527 F 3d 627 (No 07-1624) (7th Cir 19 May 2008), reh'g denied, 537 F 3d 728 (7th Cir 8 Aug 2008).

[172] Investment Company Act of 1940 § 36(b), 15 USC § 80a-35(b).

[173] *Jones* 537 F 3d at 733.

[174] *Jones* (n 173) at 731–2.