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Fiduciary Discretion

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Discretion is an important feature of all contractual relationships. In this Article, we rely on incomplete contract theory to motivate our study of discretion in fiduciary relationships. We make two contributions to the substantial literature on fiduciary law. First, we describe the role of fiduciary law as "boundary enforcement," and we urge courts to honor the appropriate exercise of discretion by fiduciaries, even when the beneficiary or the judge might perceive a preferable action after the fact. Second, we answer the question, how should a court define the boundaries of fiduciary discretion? We observe that courts often define these boundaries by reference to industry customs and social norms. We also defend this as the most sensible and coherent approach to boundary enforcement.

TABLE OF CONTENTS

I. INTRODUCTION

Discretion is an important feature of all contractual relationships. A complete contract would specify all obligations of all parties under every conceivable circumstance,[1] leaving no room for discretion or judgment. Real-world contracts are incomplete,[2] giving one or more of the parties some

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[1] *See* Steven Shavell, *Contracts*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 436, 436 (Peter Newman ed., 1998) ("A contract is said to be *complete* if the list of conditions on which actions are based is exhaustive, that is, if the contract provides explicitly for all possible conditions.").

[2] Although he did not use the term "incomplete contract," Ronald Coase identified the problem of incompleteness in his seminal piece on the theory of the firm. *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 391 (1937) ("[O]wing to the difficulty of

discretion over performance.[3] In this Article, we rely on incomplete contract theory to motivate our study of discretion in fiduciary relationships.[4]

Discretion implies the possibility of choice, which in turn calls for the exercise of judgment.[5] Discretion is universally recognized as an essential aspect of fiduciary relationships.[6] We contend that the grant of discretion in

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forecasting, the longer the period of the contract is for the supply of the commodity or service, the less possible, and indeed, the less desirable it is for the person purchasing to specify what the other contracting party is expected to do.").

Oliver Williamson coined the term "contractual incompleteness." Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112, 117 (1971). Williamson later embraced the concept of "bounded rationality" as described by Herbert Simon: "The capacity of the human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behavior in the real world . . . ." HERBERT A. SIMON, MODELS OF MAN: SOCIAL AND RATIONAL 198 (1957); *see* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 31–33 (1975).

Under the assumption of bounded rationality, economists assume that complete contracts do not exist in the real world. *See, e.g.*, PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 160 (1992) ("Because real people are only *boundedly rational*, complete contracts that specify what they will do in every conceivable circumstance are impossible to negotiate and write.").

[3] *See* Philippe Aghion & Richard Holden, *Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?*, 25 J. ECON. PERSP. 181, 182 (2011) ("When contracts are incomplete, and consequently not all uses of an asset can be specified in advance, any contract negotiated in advance must leave some discretion over the use of the assets.").

[4] For an excellent introduction to incomplete contract theory, see PATRICK BOLTON & MATHIAS DEWATRIPONT, CONTRACT THEORY (2005). In this Article, we apply contractualist reasoning to fiduciary relationships, but we recognize, as Paul Miller observes, that "not all fiduciary relationships are established through contract." Paul B. Miller, *Justifying Fiduciary Duties*, 58 MCGILL L.J. 969, 982 (2013). The insights from incomplete contract theory that we rely on in this Article apply with equal force to other consensual relationships, and we view fiduciary relationships as fundamentally consensual. *Cf. id.* at 1015 ("Ordinarily, given that fiduciary power is authority derived from the legal capacity of another person, it must be conferred by some manifestation of consent of the person from whose capacity it is derived.").

[5] The exercise of discretion is not the same merely as having a choice. *See* H.L.A. Hart, *Discretion*, 127 HARV. L. REV. 652, 656 (2013) ("[I]t would be mistaken to identify the notion of discretion with the notion of choice (*tout court*)."). But precisely defining the nature of choices that constitute "discretion" is challenging. *See id.* at 658 ("It seems to me then that discretion occupies an intermediate place between choices dictated by purely personal or momentary whim and those which are made to give effect to clear methods of reaching clear aims or to conform to rules whose application to the particular case is obvious.").

[6] The most commonly cited scholarly works in the canon of fiduciary law emphasize the importance of discretion in fiduciary relationships. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1046 (1991) ("Ideally, for the beneficiary, this relationship would be governed by specific rules that dictate how the fiduciary should manage the asset in the

fiduciary relationships is not merely an artifact of human weakness, but a crucial part of the fiduciary bargain. To borrow an expression from software design, contractual incompleteness is not a bug, it's a feature.[7]

The law has two strategies for dealing with discretion in the fiduciary context: disempowerment and fiduciary duty.[8] Disempowerment is effective at protecting the beneficiaries from opportunism, but disempowerment disables the fiduciary from engaging in transactions that would be desirable for the beneficiary.[9] As a result, "modern law has come to substitute fiduciary obligation for disempowerment as the preferred regulatory response."[10]

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beneficiary's best interests. In fact, however, the fiduciary's obligations are open-ended."); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 901 ("If the relationship, as the parties structure it, does not confer discretion on the 'fiduciary,' then his actions are not subject to the fiduciary constraint."); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426 (1993) (describing fiduciary relationships as situations in which "one party hires the other's knowledge and expertise"); Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 813 (1983) ("[E]ven if [complete] contractual arrangements were feasible, the transaction costs involved in drawing up a detailed prior agreement covering all possible discretionary uses of power over the life of the relation would not only be enormous, but also would probably exceed the benefits of the proposed relation."); Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 232 ("[F]iduciary duties are justified in particular situations where other devices for controlling discretion are likely to be ineffective."); L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 69 (1962) (finding the origin of fiduciary law in relationships where one person "reposed confidence" in another); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1403 (2002) ("What distinguishes a fiduciary from many other contracting parties . . . is that a fiduciary exercises discretion with respect to a critical resource belonging to the beneficiary, whereas most contracting parties exercise discretion only with respect to their own performance under the contract."); Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 7 (1975) ("[T]he hallmark of a fiduciary relation is that the relative legal positions are such that one party is at the mercy of the other's discretion.").

[7] The notion that parties bargain for discretion is related to the idea of "deliberate ambiguity" in contract drafting. *See* Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1583 (2005) ("Deliberate ambiguity may be a necessary condition of making the contract; the parties may be unable to agree on certain points yet be content to take their chances on being able to resolve them, with or without judicial intervention, should the need arise. It is a form of compromise like 'agreeing to disagree.'"). Another related concept is "strategic incompleteness." *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 127 (1989) ("[W]hen one party to a contract knows more than another, the knowledgeable party may strategically decide not to contract around even an inefficient default. Because the process of contracting around a default can reveal information, the knowledgeable party may purposefully withhold information to get a larger piece of the smaller contractual pie.").

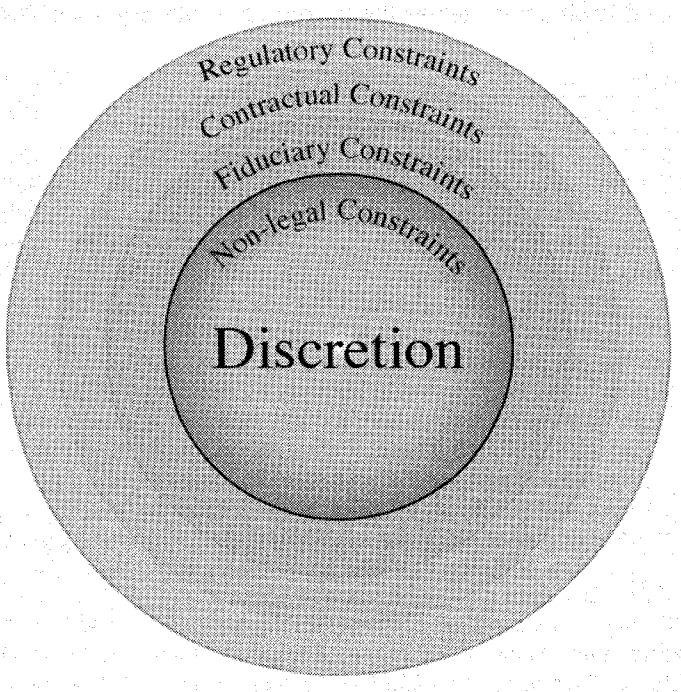
[8] Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1042 (2011).

[9] *Id.*

[10] *Id.*

Fiduciary duty is a "doctrine of last resort," meaning that it is "activated only when all other potentially applicable commands from constitutions, statutes, regulations, ordinances, common law decisions and contracts have been exhausted."[11] The space for decision-making that remains after taking account of fiduciary duty is *discretion*, as illustrated by the figure below.

Figure 1: *Discretion as a "Doctrine of Last Resort"*



The outside boundary of these concentric circles is intended to encompass all actions that could occur in a state of nature. Some of those actions are proscribed by positive law, and we call these proscriptions "regulatory constraints." These regulatory constraints shrink the decision-making space. Within the remaining decision-making space, parties engage in private ordering, and the obligations imposed in that process are labeled "contractual constraints." These include all of the express and implied obligations in contracts, as well as obligations derived from the implied covenant of good faith and fair dealing.

The contractual constraints further shrink the decision-making space, and what remains is the space allocated for good-faith decision-making in the

[11] D. Gordon Smith, *Doctrines of Last Resort*, *in* REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY: ON THE EMPIRICAL AND THE LYRICAL 426, 427 (Jean Braucher et al. eds., 2013).

contractual relationship. If that relationship is fiduciary in nature, the decision-making space is further constrained by the duty of loyalty, which proscribes "self-interested behavior that constitutes a wrong to the beneficiary as a result of the fiduciary exercising discretion with respect to the beneficiary's critical resources."[12] The remaining space (the center circle) represents actions that are possible after accounting for all legal and contractual constraints. This is a fiduciary's discretion. As noted in the center circle (and suggested by the shading), discretion can be influenced by various non-legal constraints, including market forces, reputational concerns, industry customs, social norms, and moral values.[13]

Some legal commentators have observed a distinction between standards of conduct and standards of liability in fiduciary law.[14] Standards of conduct,

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[12] Smith, *supra* note 6, at 1407 (emphasis omitted). The duty is often expressed more succinctly as a duty to refrain from self-dealing. *See, e.g.*, Larry E. Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899, 908 (2011) ("The fiduciary duty is properly conceived as simply one to refrain from self-dealing."). We avoid this simpler construction because it could imply a duty of complete unselfishness, which is an inaccurate description of fiduciary obligation. *See infra* notes 137–48 and accompanying text.

Paul Miller claims that fiduciaries are subject to two conflict rules:

> The *conflict of interest rule* prohibits the fiduciary from allowing personal interests actually or potentially to conflict with the interests of the beneficiary. The conflict of interest rule thus prohibits disloyal conduct grounded in the self-interest of the fiduciary. The *conflict of duty rule* prohibits the fiduciary from acting under conflicting mandates. In other words, it prohibits disloyal conduct grounded in conflicting duties to two third parties, even if the fiduciary's self-interest is not in play. The conflict of duty rule thus proscribes disloyal conduct rooted in inconsistent allegiances of the fiduciary.

Miller, *supra* note 4, at 977 (footnotes omitted). While conflicts of duty are unpleasant, they are inevitable for some fiduciaries, and fiduciary law does not prohibit action in the face of such conflicts. For example, a trustee must act impartially with regard to beneficiaries who have conflicting interests. *See* RESTATEMENT (THIRD) OF TRUSTS § 79(1)(a) (2007) ("[T]he trustee must act impartially and with due regard for the diverse beneficial interests created by the terms of the trust.").

[13] The concentric circles offer only a rough representation of the relationship between the varied constraints on behavior. We use the circles primarily to suggest the residual nature of discretion in fiduciary relationships. One potentially interesting and unexplored (in this Article) feature of the figure is that the annuli (i.e., the spaces between the concentric circles) would be different sizes in different legal systems. One sees this, for example, in Legal Origins Theory, which holds that "common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations." Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285, 286 (2008).

[14] Credit goes to Mel Eisenberg for initially raising this distinction in corporate law. Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 437 (1993). Gordon Smith criticized the use of this distinction by drafters of the Model Business Corporation Act. *See* D. Gordon Smith, *A Proposal To Eliminate Director Standards from the Model Business Corporation Act*, 67 U. CIN. L. REV. 1201, 1202 (1999). For a recent treatment of these concepts, see Julian Valasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 WM. & MARY L. REV. 519 (2012).

which tell a fiduciary to act or deal fairly with regard to the beneficiary,[15] motivate fiduciaries to move toward the core of the circle, the place least likely to face resistance from legal or non-legal constraints. Meanwhile, standards of liability define the boundary of the inner circle. Our primary task in this Article is to explain how courts draw that boundary between the appropriate exercise of discretion and breach of fiduciary duty.

By enforcing the boundaries of fiduciary discretion by reference to industry customs and social norms, fiduciary law encourages contract formation.[16] As observed by Judge Easterbrook and Professor Fischel, "legal rules can promote the benefits of contractual endeavors in a world of scarce information and high transactions costs."[17] Gordon Smith and Darian Ibrahim recently argued that "promoting entrepreneurial action is a fundamental value of the U.S. legal system."[18] In this Article, we find that value at the heart of fiduciary law.[19]

In Part II we describe the inevitability of discretion in contractual relationships, then briefly catalogue various legal and non-legal constraints on that discretion. In Part III we argue that the duty of loyalty performs boundary enforcement on fiduciary actions. We further argue that the content of the duty of loyalty is derived from non-legal sources, particularly industry customs and social norms. We conclude in Part IV by applying these concepts to the area of competition in employment.

II. CONSTRAINTS ON DISCRETION

In examining constraints on discretion, we are concerned only with situations of conflict. Where the interests of contracting parties are aligned, no constraints are necessary.[20] Complete contracts would, theoretically, result in

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[15] Eisenberg, *supra* note 14, at 450.

[16] *See* Smith, *supra* note 11, at 427.

[17] Easterbrook & Fischel, *supra* note 6, at 426.

[18] D. Gordon Smith & Darian M. Ibrahim, *Law and Entrepreneurial Opportunities*, 98 CORNELL L. REV. 1533, 1536 (2013).

[19] Our claim that the content of the duty of loyalty is derived from industry customs and social norms is consistent with the "centrality of custom to our torts system." Gideon Parchomovsky & Alex Stein, *Torts and Innovation*, 107 MICH. L. REV. 285, 286 (2008). Nevertheless, there is some tension between our claim that fiduciary law, thus conceived, promotes entrepreneurial action, and the claim that "courts' reliance on customs and conventional technologies as the benchmark for assigning tort liability chills innovation and distorts its path." *Id.* We offer a more complete defense of the connection between fiduciary law and innovation elsewhere, *see* D. Gordon Smith & Jordan C. Lee, Loyalty Across Time (2014) (unpublished manuscript) (on file with authors), but for present purposes it should suffice to observe that tort law and fiduciary law influence different aspects of a relationship. Thus, while tort law's reliance on custom and norms may discourage innovation in industrial procedures, product development, or medical care, fiduciary law's reliance on custom and norms encourages formation of relationships that lead to entrepreneurial action.

[20] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) ("[I]t is

the perfect alignment of interests, but in a world of incomplete contracting, the threat of liability often combines with self-interest, social norms, and trust to embolden the parties to form a relationship and to align their interests in that relationship.[21] In this Part, we describe the inevitability of discretion in contractual relationships, then briefly catalogue the legal and non-legal constraints on discretion that embolden contract formation.

A. *Inevitability of Discretion*

Nobel Laureates Kenneth Arrow and Gérard Debreu imagined a world without discretion in developing their general equilibrium theory.[22] In that world, markets are complete, and complete markets always clear, with every seller finding a buyer at a negotiated price.[23] Market participants operate in the face of uncertainty, but they are able to order their affairs through complete contingent claims contracts, which anticipate all states of the world and specify the obligations of all parties in each of those states.[24] In this imaginary world, post-contractual discretion does not exist because it is not necessary.

Markets are not complete in the sense described by Arrow and Debreu, of course, because (among other reasons) contracting parties suffer from bounded rationality,[25] a concept that includes an inability to negotiate future plans because parties "have to find a common language to describe states of the world and actions with respect to which prior experience may not provide much of a guide."[26] As a result, complete contingent claims contracts do not exist in the

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generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint.").

[21] *See* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1253 (1999) ("Insofar as corporate law is regulatory, it provides incentives and disincentives to the major actors in the corporate enterprise . . . through the threat of liability. In significant part, however, these actors are motivated not by the desire to avoid liability, but by the prospect of financial gain, on the one hand, and by social norms, on the other.").

[22] *See* Kenneth J. Arrow, *Alternative Approaches to the Theory of Choice in Risk-Taking Situations*, 19 ECONOMETRICA 404, 405 (1951); Kenneth J. Arrow & Gerard Debreu, *Existence of an Equilibrium for a Competitive Economy*, 22 ECONOMETRICA 265, 265 (1954). *See generally* Gerard Debreu, *The Coefficient of Resource Utilization*, 19 ECONOMETRICA 273 (1951).

[23] The notion of "commodity" includes the place and time of the trade. *See* Arrow & Debreu, *supra* note 22, at 266.

[24] *See* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1090 (1981) (describing the complete contingent claim contract).

[25] *See* Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECONOMICS 99, 104 (1955); Herbert A. Simon, *Rationality as Process and as Product of Thought*, 68 AM. ECON. REV., May 1978, at 1, 10; Herbert A. Simon, *Theories of Decision-Making in Economics and Behavioral Science*, 49 AM. ECON. REV. 253, 254–55 (1959).

[26] OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 23 (1995). The degree to which contracts are incomplete depends in part on the tradeoff between the anticipated hazards of ex post opportunism and the costs of ex ante design. *See* Keith J.

real world. Contracts are inevitably incomplete.[27] Judge Easterbrook and Professor Fischel make the point with more flair:

> 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 (because the outcome may be attributable to luck, or to a superior effort by some competitor), and when a relative shortage of information hinders the drawing of conclusions even when the outcome may be highly informative, a detailed contract would be silly.[28]

When contracts are incomplete, one or more of the parties will possess some discretion over performance, and this discretion introduces the possibility of opportunism.[29] We can fruitfully divide this discretion into two types: discretion over the performance of contract duties and discretion over the performance of fiduciary duties.[30] Each of these forms of discretion is assigned its own legal doctrine to mitigate opportunism.[31] Incompleteness in the specification of the performance of contract duties is governed by the duty of good faith and fair dealing, and incompleteness in the specification of performance of fiduciary duties is governed by the duty of loyalty.[32]

Crocker & Kenneth J. Reynolds, *The Efficiency of Incomplete Contracts: An Empirical Analysis of Air Force Engine Procurement*, 24 RAND J. ECONOMICS 126, 127 (1993).

[27] BOLTON & DEWATRIPONT, *supra* note 4, at 491. For a summary of legal and economic conceptions of contracting, see D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 4–19 (2009).

[28] Easterbrook & Fischel, *supra* note 6, at 426.

[29] Oliver Williamson famously defined opportunism as "self-interest seeking with guile." OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47 (1985); *see also* Robert P. Bartlett, III, Commentary, *Contracts as Organizations*, 51 ARIZ. L. REV. 47, 48–49 (2009) ("[I]n any cooperative relationship one party inevitably holds some amount of discretionary and unobservable decision-making authority that can affect the welfare of the other party.").

[30] The difference between fiduciary relationships and arm's-length contractual relationships has been the subject of much debate. *See* D. Gordon Smith, *Contractually Adopted Fiduciary Duty*, 2014 U. ILL. L. REV. (forthcoming). In this Article, we take the identification of the relationship as a given.

[31] *Cf.* DeMott, *supra* note 6, at 892 (noting that both fiduciary duties and the duty of good faith and fair dealing "operate to limit a party's permissible use of discretion or of a power or advantage obtained over another person").

[32] *Cf.* Daniel Markovits, *Sharing* Ex Ante *and Sharing* Ex Post*: The Non-contractual Basis of Fiduciary Relations*, *in* THE PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW (forthcoming 2014) (asserting that a "contract promisor . . . must honor her contract but go no further," while a "fiduciary must take the *initiative* on her beneficiary's behalf").

B. *Contractual Constraints*

Generally speaking, courts award money damages for the breach of express and implied-in-fact obligations in enforceable contracts.[33] In addition, a covenant of good faith and fair dealing is implied in law in (almost) every contract.[34] This covenant is a judicial acknowledgement of the incompleteness of contracts.[35] Even after accounting for all express and implied terms, judges still find gaps in contracts. In many instances, contracting parties recognize the inevitability or usefulness of discretion and either grant unfettered discretion to one of the parties[36] or grant discretion that is bounded by the express terms of the contract. In this Section, we describe ways in which transactional lawyers create and control discretionary authority.[37]

Loan agreements are notorious for the breadth of discretion granted to lenders. For example, loan agreements frequently give a lender broad discretion to determine whether the performance of a borrower satisfies a requirement in the agreement.[38] This discretion, combined with many detailed covenants, places the borrower in a vulnerable position. As noted by Claire Hill, "If

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[33] RESTATEMENT (SECOND) OF CONTRACTS § 4 (1981) provides, "A promise may be stated in words either oral or written, or may be inferred wholly or partly from conduct." When one of the parties breaches a promise and injures another party, the injured party has a right to damages. *Id.* § 346.

[34] *See, e.g.*, *id.* § 205 ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."). A notable exception to this rule is preferred stock in Delaware, the terms of which are strictly construed. *See* D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 841 (2004) (discussing an interpretive rule of strict construction for preferred stock terms).

[35] *See* Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What To Do When Parties Have Not Achieved Bargains or Have Drafted Incomplete Contracts*, 2004 WIS. L. REV. 323, 343–44 (linking incomplete contracts to the implied covenant of good faith and fair dealing).

[36] *See, e.g.*, Potlatch Educ. Ass'n v. Potlatch Sch. Dist. No. 285, 226 P.3d 1277, 1279 (Idaho 2010) (describing a contract governing the terms of teacher employment that gave the principal discretion with regard to the granting of professional leaves); Dick Broad. Co. of Tenn. v. Oak Ridge FM, Inc., 395 S.W.3d 653, 657–58 (Tenn. 2013) (interpreting a contract providing that assignment of a right of first refusal cannot be made "without the consent of the [other party]"). Even if contracts are unambiguous in their grant of unfettered discretion, courts are reluctant to enforce such provisions without imposing the covenant of good faith and fair dealing. *See, e.g.*, *Potlatch Educ. Ass'n*, 226 P.3d at 1281 ("Even though the plain text of the Master Agreement seems to impart unfettered discretion to the principal in authorizing professional leave, this Court implies a covenant of good faith and fair dealing into all contracts."); *Dick Broad. Co.*, 395 S.W.3d at 669 ("To avoid the imposition of the implied covenant of good faith and fair dealing, the parties must explicitly state their intention to do so.").

[37] For a useful introduction to this topic, see TINA L. STARK, DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO 142–45 (2007).

[38] Thomas J. Hall & Stacey Trimmer, *Good Faith and Lenders' Exercise of Contractual "Sole Discretion,"* 126 BANKING L.J. 483, 483 (2012).

contract words had their literal meaning, the lender's discretion would be limitless: conventional wisdom is that at all times, every borrower under every loan agreement is in 'technical' default."[39]

Lender discretion can be created through an aggressive grant of discretion, such as a statement in the contract providing that some action is in the "sole discretion" of the bank,[40] or merely by using the word "may," as in "the Bank *may* waive the Event of Default."[41] Regardless of the form of the grant of discretion, courts incline toward limiting that discretion through the application of the implied covenant of good faith and fair dealing.[42]

Gordon Smith has referred to the duty of good faith and fair dealing as a "form of loyalty obligation,"[43] but this implied duty inheres in most contractual relationships, not only in fiduciary relationships.[44] Moreover, the duty of good faith and fair dealing is unlike a fiduciary duty because the former requires fidelity to the deal, while the latter demands fidelity to the beneficiary of the duty.[45]

While the content of the duty of good faith and fair dealing is derived from the contract, industry customs and social norms play an important role in extrapolating from the express terms of the contract to the content of the duty.[46] For example, in the well-known case of *Market Street Associates Ltd. Partnership v. Frey*,[47] Judge Richard Posner measured the "sharp dealing" of a contracting party against social norms in analyzing the duty of good faith and fair dealing:

> We do not usually excuse contracting parties from failing to read and understand the contents of their contract; and in the end what this case comes down to—or so at least it can be strongly argued—is that an immensely

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[39] Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracting*, 77 CHI.-KENT L. REV. 29, 50 (2001).

[40] *See, e.g.*, Whitney Nat'l Bank v. Rockwell, 661 So. 2d 1325, 1327 (La. 1995) (note "gave the Bank the right in its sole discretion to extend the maturity date of the note").

[41] *See* STARK, *supra* note 37, at 142.

[42] *See* Hall & Trimmer, *supra* note 38, at 491–92 ("[T]he implied duty of good faith and fair dealing frequently is called upon in a court's analysis of the propriety of a lender's contractual regard of sole discretion.").

[43] Smith, *supra* note 6, at 1409.

[44] *See, e.g.*, Dalton v. Educ. Testing Serv., 663 N.E.2d 289, 291 (N.Y. 1995) ("Implicit in all contracts is a covenant of good faith and fair dealing in the course of contract performance.").

[45] Smith, *supra* note 6, at 1410 ("[T]he fiduciary must refrain from self-interested behavior that wrongs the beneficiary, whereas contracting parties may act in a self-interested manner even where the other party is injured, as long as such actions are reasonably contemplated by the contact.").

[46] U.C.C. § 1-203 cmt. 20 (2002) ("[T]he obligation of 'good faith,' applicable in each Article, is to be interpreted as including both the subjective element of honesty in fact and the objective element of the observance of reasonable commercial standards of fair dealing.").

[47] 941 F.2d 588, 594 (7th Cir. 1991).

> sophisticated enterprise simply failed to read the contract. On the other hand, such enterprises make mistakes *just like the rest of us*, and deliberately to take advantage of your contracting partner's mistake during the performance stage . . . is a breach of good faith.[48]

Situations in which contracting parties place boundaries on their counterparties are somewhat different from the "sole discretion" cases. While the implied duty of good faith and fair dealing would still place some limits on discretion, most of the heavy lifting is done by the express terms of the contract. The boundaries are often drawn by negative covenants, which are prominent in venture capital contracts,[49] bond indentures,[50] merger agreements,[51] intellectual property license agreements,[52] and other formal contracts.[53] The negative

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[48] *Id.* at 597 (emphasis added); *see also* Rawlings v. Apodaca, 726 P.2d 565, 574 (Ariz. 1986) (holding that testimony regarding industry customs was relevant to analysis of breach of the implied covenant of good faith and fair dealing); Reed v. State Farm, 857 So. 2d 1012, 1022 n.9 (La. 2003) (noting that the concept of good faith and fair dealing represents a "moral and ethical obligation" legally imposed by the legislature); Brunswick Hills Racquet Club, Inc. v. Route 18 Shopping Ctr. Assocs., 864 A.2d 387, 399 (N.J. 2005) (finding that the duty enforces "ethical norms").

[49] *See Model Legal Documents*, NAT'L VENTURE CAPITAL ASS'N, http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136 (last visited Mar. 2013) (including many "protective provisions" that cabin the discretion of the corporation with regard to matters of importance to the venture capitalists). For a study of these covenants, see Ola Bengtsson, *Covenants in Venture Capital Contracts*, 57 MGMT. SCI. 1926 (2011).

[50] *See* Comm. on Trust Indentures & Indenture Trs., ABA Section of Bus. Law, *Model Negotiated Covenants and Related Definitions*, 61 BUS. LAW. 1439, 1490 (2006) (describing covenants that limit the actions of the issuer of bonds). For a study of these covenants, see Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

[51] 1 AM. BAR ASS'N MERGERS & ACQUISITIONS COMM. ON NEGOTIATED ACQUISITIONS, MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY (2d ed. 2010); *see also* Afra Afsharipour, *Transforming the Allocation of Deal Risk Through Reverse Termination Fees*, 63 VAND. L. REV. 1161, 1171–72 (2010) (describing a covenant that obligates the seller to "operate its business only in the 'ordinary course' and 'consistent with past practice' between signing the acquisition agreement and closing in order to ensure that no significant or unusual transactions are undertaken without the buyer's knowledge and consent") (footnote omitted); Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 499 (2009) (describing "material adverse change" clauses, which "is a provision in an acquisition agreement that permits an acquirer to refuse to complete the transaction if a material and adverse change, as defined in the acquisition agreement, occurs to an acquiree prior to the time of completion of the acquisition").

[52] *See, e.g.*, Amy Slater, *Software License Agreement*, *in* 2 CAL. TRANSACTIONS FORMS: BUS. TRANSACTIONS § 9:57 (2013) (explaining that software licensing agreements commonly "place[] responsibility on the licensee to ensure that the software is not exported in violation of . . . government restrictions").

[53] Bobby Bartlett describes two challenges inherent in contracting: (1) "The very concept of a contract as a legally enforceable promise presumes a situation where a contracting party no longer finds it in her interest to honor a promise and must be forced to do so (or at least pay for the resulting damage)"; and (2)

covenants often permit actions by a contracting party, subject to limits specified by the size or effects of the transactions.

When independent contractors act within the parameters defined by the negative covenants, they are acting within the scope of their discretion. Subject to an exceptional challenge under the implied covenant of good faith and fair dealing, such parties are in compliance with the contract, even if their actions are self-serving. The difference between independent contractors and fiduciaries is that the latter are subject to the additional constraint of the duty of loyalty, which regulates their self-interested actions, even when those actions are within the scope of the discretion granted by the contract.

C. *Fiduciary Constraints*

Although incomplete contracts are inevitable, contracting parties routinely create fiduciary relationships, in which one party (the beneficiary) seems especially vulnerable to opportunism by the counterparty (the fiduciary).[54] The source of a beneficiary's vulnerability is the fiduciary's discretion with respect to some critical resource belonging to the beneficiary,[55] and that discretion is

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> just as self-interest may encourage a party to break a promise in the first instance, it may also compel a party to use what other discretion she has in a relationship to seek individual advantage in less direct ways that can nonetheless adversely affect the welfare of other parties in that relationship.

Bartlett, *supra* note 29, at 50. Bartlett then observes:

> [A]s both a student and drafter of contracts, I am repeatedly surprised at how the architecture of contracts across a variety of domains consistently maps onto these two basic real-world challenges. Be it a bond indenture, an acquisition agreement, a supply agreement, or even a home purchase agreement, I expect a short provision (usually early in the agreement) outlining the basic bargain ("The undersigned Lenders promise to loan . . . ."; "I promise to sell . . . ."; "Buyer promises to purchase . . . .") followed by a cascade of ancillary promises, representations, and express conditions that seek to cabin the ability of a party to use its residual discretion in a manner that might impair this bargain ("Seller represents that it has full right and title in all Trademarks listed on Appendix A . . . ."; "Target agrees that Buyer may terminate this Agreement if any representations are materially inaccurate as of the Closing Date"; "Seller represents that the premises are free of all rodents.").

Id. at 50–51.

[54] Commentary on fiduciary law often emphasizes the vulnerability of beneficiaries. *See, e.g.*, Evan J. Criddle, *Fiduciary Administration: Rethinking Popular Representation in Agency Rulemaking*, 88 TEX. L. REV. 441, 470 (2010) ("[A]ll beneficiaries are vulnerable to the fiduciary's abuse of legally entrusted administrative power over their legal and practical interests."); Evan Fox-Decent, *The Fiduciary Nature of State Legal Authority*, 31 QUEENS L.J. 259, 275 (2005) (asserting that a fiduciary obligation arises "whenever one party unilaterally assumes discretionary power of an administrative nature over the important interests of another, interests that are especially vulnerable to the fiduciary's discretion").

[55] *See* Smith, *supra* note 6, at 1404 ("[T]he beneficiary's vulnerability emanates from an inability to protect against opportunism by the fiduciary with respect to the critical

often identified as an essential characteristic of fiduciary relationships.[56] The fiduciary duty of loyalty constrains that discretion by proscribing certain forms of self-interested behavior by fiduciaries. In Part III, we argue that the central role of the fiduciary duty of loyalty is boundary enforcement, and the content of this duty is derived from industry customs and social norms. For present purposes, however, it is enough to know simply that the fiduciary duty of loyalty constrains discretion.

The fiduciary duty of loyalty requires the fiduciary to "refrain from self-interested behavior that constitutes a wrong to the beneficiary as a result of the fiduciary exercising discretion with respect to the beneficiary's critical resources."[57] This other-regarding duty is common to all fiduciary relationships,[58] but courts tailor the duty to specific contexts.

Commentators disagree about the breadth of application of fiduciary obligation, with some arguing for application of the duty of loyalty in a wide variety of contexts,[59] while others would limit the duty to a much smaller number of relationships.[60] Commentators also disagree about the duties that

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resource [and] fiduciary law can be justified on the grounds that it deters opportunistic behavior."). Smith does not attempt to define "critical resource" with precision, instead noting:

> Whether the existence of a particular thing justifies the imposition of fiduciary duties . . . depends on whether that thing provides the fiduciary with the occasion to act opportunistically. And whether that thing provides the fiduciary with the occasion to act opportunistically will depend in large part on whether society has made a normative decision that the thing *belongs to* the beneficiary. This decision is exogenous to the critical resource theory.

Id. at 1444. Smith's critical resource theory has been used in a variety of settings to evaluate relationships, but Paul Miller has argued that the theory suffers from indeterminacy. Miller, *supra* note 4, at 1001. Miller has proposed instead that fiduciary relationships form when "one party (the fiduciary) enjoys discretionary power over the significant practical interests of another (the beneficiary)." Paul B. Miller, *A Theory of Fiduciary Liability*, 56 MCGILL L.J. 235, 262 (2011) (emphasis omitted).

[56] *See, e.g.*, Miller, *supra* note 55, at 273 ("[T]he fiduciary must have scope for judgment in the exercise of power."); Weinrib, *supra* note 6, at 4 ("Two elements thus form the core of the fiduciary concept and these elements can also serve to delineate its frontiers. First, the fiduciary must have scope for the exercise of discretion, and, second, this discretion must be capable of affecting the legal position of the principal.").

[57] Smith, *supra* note 6, at 1407.

[58] *See* RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. b ("Despite the differences in the legal circumstances and responsibilities of various fiduciaries, one characteristic is common to all: a person in a fiduciary relationship to another is under a duty to act for the benefit of the other as to matters within the scope of the relationship.").

[59] *See, e.g.*, TAMAR FRANKEL, FIDUCIARY LAW 42–62 (2011) (applying fiduciary law to trustees, corporate directors, physicians, lawyers, brokers and dealers, spouses, and friends).

[60] *See, e.g.*, Ribstein, *supra* note 12, at 900 ("I maintain that fiduciary duties should be fenced into a limited area rather than allowed to roam freely on the range of human relationships."); Leonard I. Rotman, *Fiduciary Law's "Holy Grail": Reconciling Theory and Practice in Fiduciary Jurisprudence*, 91 B.U. L. REV. 921, 935 (2011) ("[F]iduciary law

properly fall within the ambit of "fiduciary duty." For example, many commentators do not view the duty of care as a fiduciary duty,[61] even though it is typically treated as a fiduciary duty by courts.[62]

Some commentators view fiduciary duties as a species of implied contract terms,[63] but we believe that view is, at best, imprecise, and, at worst, seriously misleading with regard to the role of judges.[64] One problem is that viewing fiduciary duties as contract terms implies that judges should craft particular rules for the parties.[65] Often framed in terms of a hypothetical bargain,[66] this approach urges judges to choose the result the parties would have chosen had they anticipated the situation at issue, but this sort of reasoning is quite different from deciding simply whether the fiduciary acted appropriately within the scope of her discretion.

D. *Non-legal Constraints*

Non-legal forces also act as boundaries on discretion, even where legal constraints are absent. Sociologists, economists, psychologists, philosophers,

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was never intended to apply to the garden variety of cases. Fiduciary law supplements the laws of contract, tort, and unjust enrichment by filling in their gaps where they are either silent or deficient and enforcing both the spirit and intent of law, not merely its letter.").

[61] *See, e.g.*, William A. Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 AKRON L. REV. 181, 206 (2005) ("The muddled state of the law of fiduciary breach can be improved if the courts realize that negligence and intent are quite different concepts."); *see also* DeMott, *supra* note 6, at 915 (asserting that the duty of care "is not distinctively fiduciary").

[62] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) *overruled by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009) (describing a director's "duty to exercise an informed business judgment" as a fiduciary duty).

[63] *See, e.g.*, Easterbrook & Fischel, *supra* note 6, at 427 ("The duty of loyalty replaces detailed contractual terms, and courts flesh out the duty of loyalty by prescribing the actions the parties themselves would have preferred if bargaining were cheap and all promises fully enforced."); Ribstein, *supra* note 12, at 900 ("[T]he fiduciary duty is most usefully viewed as a type of contract.").

[64] *See* Markovits, *supra* note 32 ("[F]iduciary relations and the obligations that they involve cannot inhabit a contractual form.").

[65] *Cf.* Miller, *supra* note 4, at 983:

> In contract it is assumed that the parties will act in a mutually self-interested manner. Each is responsible for securing their interests in dealings with the other. In fiduciary law, by contrast, it is assumed that the parties are interacting for the exclusive benefit of one of them—the beneficiary. The fiduciary is responsible for the beneficiary. The beneficiary is entitled to the fiduciary's loyalty. There is no mutuality, for the beneficiary has no duty to the fiduciary by virtue of the fiduciary relationship as such.

[66] Easterbrook & Fischel, *supra* note 6, at 431 ("A court setting out to protect principals from their agents *must* use the hypothetical contract approach; the only alternative is to injure the persons the rule makers want to help."). Easterbrook and Fischel refer to approaches other than the contractual view which produces the hypothetical bargain as "noneconomic approaches." *Id.* at 432.

anthropologists, and others have been studying norms and their influence on human behavior for decades.[67] In recent years, legal scholars have incorporated the study of norms into the legal literature,[68] which attempts to use social norms to explain human behavior and predict the effect of legal rules.[69]

The terms and definitions legal scholars use to identify the social forces that influence behavior are many and varied.[70] At a basic level, norms are social "rules and standards that define the limits of acceptable behavior."[71] In this Article, we speak of norms in a general sense,[72] referring to social customs[73] and rules[74] that constrain individual behavior within a society.[75]

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[67] *See, e.g.*, ROBERT AXELROD, THE EVOLUTION OF COOPERATION 145–50 (1984); GARY S. BECKER, ACCOUNTING FOR TASTES 225–30 (1996); JAMES S. COLEMAN, FOUNDATIONS OF SOCIAL THEORY 245–92 (1990); RUSSELL HARDIN, ONE FOR ALL: THE LOGIC OF GROUP CONFLICT 140–41 (1995); TALCOTT PARSONS, THE SOCIAL SYSTEM 16 (1912); JOHN MAYNARD SMITH, EVOLUTION AND THE THEORY OF GAMES 167–73 (1982); EDNA ULLMANN-MARGALIT, THE EMERGENCE OF NORMS 8–10 (1977); MAX WEBER, THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM 27 (Talcott Parsons trans., 1958); Judith Blake & Kingsley Davis, *Norms, Values, and Sanctions*, *in* HANDBOOK OF MODERN SOCIOLOGY 456, 456–82 (Robert E.L. Faris ed., 1964); Alvin W. Gouldner, *The Norm of Reciprocity: A Preliminary Statement*, 25 AM. SOC. REV. 161, 177–78 (1960).

[68] Robert Ellickson is often credited as the first legal scholar to address norms in the context of law in his book ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 184–240 (1991), but other legal scholars were also considering the interaction between norms and law around the same time period. *See, e.g.*, Stewart Macaulay, *Non-contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 63 (1963); Warren F. Schwartz et al., *The Duel: Can These Gentlemen Be Acting Efficiently?*, 8 J. LEGAL STUD. 321, 321–22 (1984). For well-known contributions to the legal literature, see RICHARD A. POSNER, THE ECONOMICS OF JUSTICE (1981); Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1766 (1996); Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 585 (1998); William K. Jones, *A Theory of Social Norms*, 1994 U. ILL. L. REV. 545, 545; Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943, 951 (1995); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 355 (1997); Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1698 (1996) [hereinafter Posner, *Law, Economics, and Inefficient Norms*]; Richard A. Posner, *Social Norms and the Law: An Economic Approach*, 87 AM. ECON. REV. 365, 365 (1997); Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 27 J. LEGAL STUD. 765, 797 (1998) [hereinafter Posner, *Symbols, Signals, and Social Norms*]; Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 907 (1996).

[69] McAdams, *supra* note 68, at 340.

[70] Eisenberg, *supra* note 21, at 1255 ("An analysis of the operation of social norms in the law presents severe problems of terminology."); McAdams, *supra* note 68, at 342 ("[T]here is as yet no consensus about . . . the *meaning* of norm."); Posner, *Symbols, Signals, and Social Norms*, *supra* note 68, at 797 (noting that the term "social norm" is used to refer to "many different kinds of behavior").

[71] Jones, *supra* note 68, at 545.

[72] *See* Posner, *Law, Economics, and Inefficient Norms*, *supra* note 68, at 1699 (noting that arbitrary definitions are a defect of all writings on norms).

Norms are most influential when they are both obligational[76] and internalized.[77] Robert Cooter described internalization as the "acceptance of a new reason for acting."[78] He noted that the effects of internalization on behavior are twofold: "First, people who have internalized a norm would obey it even when doing so does not serve their narrow self-interest," and "[s]econd, people who feel that a norm should be obeyed tend to criticize or punish others who violate the norm."[79] Thus, internalization influences internal (or self) enforcement and external (or social) enforcement of social norms.

Cooter also discussed the situations in which individuals are most likely to internalize social norms.[80] He determined that "[a] rational person internalizes a norm when commitment conveys an advantage relative to the original preferences and the changed preferences."[81] He predicted that such internalization would also perpetuate norms and norm adherence in situations in which "unanimous endorsement" of a certain behavior "will convince some

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[73] *See* Steven Hetcher, *Creating Safe Social Norms in a Dangerous World*, 73 S. CAL. L. REV. 1, 2 n.2 (1999) ("While the concepts 'norm' and 'custom' may be usefully distinguished in some contexts, in tort law they are best treated as synonymous.").

[74] *See* Posner, *Law, Economics, and Inefficient Norms*, *supra* note 68, at 1699 ("A norm can be understood as a rule that distinguishes desirable and undesirable behavior [that] . . . constrains attempts by people to satisfy their preferences.").

[75] We also acknowledge that an in-depth study of norms might warrant a more particularized definition of norms and customs. *See, e.g.*, Eisenberg, *supra* note 21, at 1261 (distinguishing between "obligational" and "nonobligational" norms in the corporate context); *see also* David Charny, *Illusions of a Spontaneous Order: "Norms" in Contractual Relationships*, 144 U. PA. L. REV. 1841, 1845 (1996) (noting that it might not be helpful to use the same term, "norms," to refer to both "comprehensive and relatively complex regimes" with a central governing agency and decentralized "informal and diffuse sanctioning systems").

[76] *See* Eisenberg, *supra* note 21, at 1257 (referring to obligational norms as those norms that are self-consciously adhered to and carry with them a sense of obligation, either because of self-criticism or criticism by others).

[77] *Id.*; *see* Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1665 (1996) ("[A] social norm is ineffective in a community and does not exist unless people internalize it."); *see also* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1739–40 (2001) (positing that a trusted actor will sometimes behave "trustworthily" because of an "internalized" desire); Lessig, *supra* note 68, at 997 ("[S]ocial meanings can and often do function as selective incentives . . . because (1) social meanings construct a . . . semiotic content . . . and because (2) individuals internalize these norms and feel this semiotic content."). *But see* McAdams, *supra* note 68, at 381 (arguing that a person may feel obligated to comply with norms either for "esteem reasons [that he seeks the esteem of others], *or* because the obligation is internalized, or both").

[78] Cooter, *supra* note 77, at 1662.

[79] *Id.* at 1695.

[80] Cooter, *supra* note 68.

[81] *Id.* at 586. Cooter labels this commitment a "Pareto self-improvement." *Id.*

members of the community to internalize the obligation, and to inculcate it in the young."[82]

Norms often carry moral implications,[83] but not necessarily.[84] Some norms are simply so engrained in the society with which the actor associates that he feels obligated, despite a lack of moral impetus, to engage in or not engage in a particular behavior.[85] Many actors do not experience norms as just another consideration in their cost–benefit analysis. Rather, they subconsciously behave in compliance with norms because the action is simply something that people do or don't do.[86]

Insofar as an actor makes a conscious choice to comply or not comply with social norms, norms are enforced through a variety of mechanisms.[87] People often adhere to social norms either because of self-criticism or criticism by others.[88] When a person has the discretion to act self-interestedly, if his action would be in opposition to social norms, the actor is less likely to behave self-interestedly. Sometimes legal rules facilitate or impede the enforcement of social norms.[89] Other times norms are enforced through social mechanisms,

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[82] Robert D. Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT'L. REV. L. & ECON. 215, 224 (1994). Cooter's work speculates about when a rational person internalizes a norm, but the more important issue for policymakers is when people in fact internalize norms. For a nuanced discussion of this issue in the corporate context, see Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 515–22 (2009).

[83] Eisenberg, *supra* note 21, at 1259 ("[F]or many or most actors in many or most situations internalized moral norms operate without a cost-benefit calculation . . . .").

[84] *Id.*

[85] *Id.* (noting that for actors who have internalized moral norms, "certain things (like picking pockets) are simply not done, while other things (like assisting the unsighted across the street) simply are done").

[86] Stephen A. Smith, *The Normativity of Private Law*, 31 OXFORD J. LEGAL STUD. 215, 216 (2011) ("[C]itizens sometimes do what legal rules stipulate simply because they are legal rules and not because of the incentives that the law offers for compliance.").

[87] *See* Lessig, *supra* note 68, at 956 (noting that social meanings are instrumental: "One uses an insult to oppress; one uses a 'thank you' to endear. One selects certain words over other acts; in some contexts, one chooses a certain language to signal one meaning rather than another."); *see also, e.g.*, Blair & Stout, *supra* note 77, at 1748 (arguing that fear of retaliation, reputational loss, and social sanctions are all market sanctions that act as enforcement mechanisms of social norms); Charny, *supra* note 75, at 1841 (providing examples of "non-legal" enforcement mechanisms, including expulsion from a trade association or revocation of a license to use a trade emblem); Cooter, *supra* note 77, at 1668 (explaining that individuals who have internalized social norms are willing to enforce social norms for the benefit of others through "[i]nformal sanctions like gossip and ostracism"); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1820 (2001) ("A norm cannot survive unless it is enforced and, loosely speaking, norms are enforced in one or more of three different ways: guilt, shunning, and shaming.").

[88] Eisenberg, *supra* note 21, at 1257.

[89] *See* McAdams, *supra* note 68, at 346; *see also* Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021, 2025 (1996).

independent of legal sanctions.[90] Informal social restraints include reputational sanctions, loss of esteem, and shaming. Social norms may also be complied with as a result of self-constraints, such as guilt or moral obligation.

Legal enforcement of social norms, either explicitly or implicitly, is common in the American legal system. Sometimes legal constraints may directly regulate compliance with social norms by incorporating norms into the law.[91] Law may also encourage compliance with particular social norms through its expressive function[92] or impede the formation and promulgation of social norms by "crowding out" informal social norms.[93]

Law most directly enforces social norms when it incorporates norms, either explicitly or implicitly, into a regulatory scheme. Some laws achieve an enforcement function by making explicit reference to social norms in the text of the regulation itself. One interesting example of this is the Uniform Commercial Code sections,[94] drafted primarily by Karl Llewellyn, that explicitly require decision-making with reference to social norms.[95] Lisa Bernstein observed that, although the Code requires courts to look first to the "express terms of the agreement," then to the course of performance, course of dealing, usage of trade, and finally to "the Code's own gap-fillers," in practice, social norms often play a much more central role in judicial decision-making.[96]

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[90] *See infra* notes 108–11 and accompanying text.

[91] *See infra* notes 94–100 and accompanying text.

[92] *See infra* note 101.

[93] *See infra* note 107.

[94] *See, e.g.*, U.C.C. § 1-102(2)(b) (1991) ("Underlying purposes and policies of this Act are . . . to permit the continued expansion of commercial practices through custom, usage and agreement of the parties."); *id.* § 1-103 ("Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant . . . shall supplement its provisions."); *id.* § 2-314(3) ("[I]mplied warranties may arise from course of dealing or usage of trade."); *id.* § 2-504(b) (requiring a seller to provide those shipping documents required by usage of trade); *id.* § 2-609(2) ("Between merchants the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards.").

[95] *See, e.g.*, Bernstein, *supra* note 68, at 1766; *see also* Charny, *supra* note 75.

[96] *See* Columbia Nitrogen Corp. v. Royster Co., 451 F.2d 3, 7 (4th Cir. 1971) (holding that, despite express price and quantity terms and a standard integration clause, evidence to show that it was a custom and usage of the fertilizer industry that "express price and quantity terms in contracts for materials in the mixed fertilizer industry are mere projections to be adjusted according to market forces" was admissible to establish a consistent additional term to the parties' written contract); Am. Mach. & Tool Co. v. Strite-Anderson Mfg. Co., 353 N.W.2d 592, 597 (Minn. Ct. App. 1984) (recognizing that judges, in "extend[ing] themselves to reconcile trade usage and course of dealing with seemingly contradictory express terms . . . have permitted course of dealing and usage of trade to add terms, cut down or subtract terms or lend special meaning to contract language"); Modine Mfg. Co. v. N.E. Indep. Sch. Dist., 503 S.W.2d 833, 837–38 (Tex. App. 1973) (holding that although the contract provided that air-conditioning cooling "capacities shall not be less than indicated," it was nevertheless reversible error to exclude evidence that in the air-conditioning industry it was customary for "reasonable variations in cooling capacity [to be] considered to comply with the specifications"); Bernstein, *supra* note 68, at 1782–84 (citing, e.g., Nanakuli Paving

Sometimes the incorporation of norms is more subtle through the use of rules or standards that implicitly refer to social norms. Examples of implicit incorporation of norms are the use of standards such as "reasonable expectations,"[97] "negligence,"[98] "reasonableness,"[99] or "ordinary care"[100] in a variety of legal contexts. Although these terms have abstract legal definitions, they cannot be understood and applied without reference to social norms.

Law may also facilitate compliance with social norms by expressing the desirability or undesirability of engaging in a particular behavior, without actually imposing corresponding legal liability. Law often serves the function of expressing, or creating, social norms, and these norms, in turn, influence the behavior of the governed.[101] Law's "statement" about the impropriety of certain actions "may be designed to affect social norms and in that way ultimately to affect both judgments and behavior."[102] In other words, law matters not only because of what it does but also because of what it says to and about those

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& Rock Co. v. Shell Oil Co., 664 F.2d 772, 780 (9th Cir. 1981) (holding that a Hawaiian custom regarding "price protection" governed rather than an explicit contract provision)).

[97] William C. Heffernan, *Fourth Amendment Privacy Interests*, 92 J. CRIM. L. & CRIMINOLOGY 1, 37 (2001) (positing that the reasonable expectations test set forth by the Supreme Court in *Katz v. United States*, 389 U.S. 347, 361 (1967) (Harlan, J., concurring), requires courts to examine social norms of privacy to determine whether property is private for purposes of the Fourth Amendment).

[98] *See, e.g.*, Stephen G. Gilles, *On Determining Negligence: Hand Formula Balancing, the Reasonable Person Standard, and the Jury*, 54 VAND. L. REV. 813, 834 (2001) ("Obviously, insofar as the negligence standard is not fully defined or specified, the law cannot simply be applied. By establishing popular valuations as controlling for purposes of the risk-utility test, however, the *Restatement* can be seen as giving those informal social norms the force of law.").

[99] *See, e.g.*, Daniel Gilman, *Of Fruitcakes and Patriot Games*, 90 GEO. L.J. 2387, 2387 (2002) ("Myriad norms, mores, customs, and customary understandings play a complex role in the law, from informing the 'reasonable man' and 'reasonable person' standards in tort law (and elsewhere), to filling in the normal and customary practices that vary across trades in commercial law."); *see also* Steven D. Smith, *The Critics and the "Crisis": A Reassessment of Current Conceptions of Tort Law*, 72 CORNELL L. REV. 765, 786 (1987) (noting that norms "constitute the essence of tort law, which seeks to capture such norms with formulas that often amount to little more than open-ended, incorporative allusions to whatever pertinent social norms may exist. Thus, when people act in ways that affect others, tort law requires them to use the care expected of 'the reasonable person.'").

[100] *See, e.g.*, Hetcher, *supra* note 73, at 4 ("Ordinary behavior is customary behavior. Courts look to whether an injurious action conformed to an accepted custom or social norm in determining whether the action was . . . negligent . . . .").

[101] Lawrence Lessig recognized these expressive effects of law in his analysis of the construction of social meanings. *See* Lessig, *supra* note 68, at 951. He described social meanings as "the semiotic content attached to various actions, or inactions, or statuses, within a particular context." *Id.* Lessig posited that these social meanings are constructed and that they can be constructed by government actors. *Id.* at 949–50. He asserted that changes in law could, or have, changed the popularity or desirability of a wide range of social behavior. *Id.* at 1013.

[102] Sunstein, *supra* note 89, at 2025.

subject to it.[103] Thus, lawmakers create law not only for the causal results they expect as a result of legal sanctions, but also to "make more and perhaps richer statements about themselves, their institutions and the larger social setting in which law and legal messages are generated and transmitted."[104] One popular example of this is the development of law regarding race discrimination. Much of the debate over school segregation, for example, was also a debate about the meaning of laws calling for segregation.[105]

Law also has the potential to inadvertently encourage non-compliance with socially useful norms, or even to quash them all together.[106] This occurrence, referred to as "crowding out," has been discussed extensively in recent years. Many scholars have argued that regulation can have adverse effects on the formation and enforcement of social norms.[107] Thus, although law may act as an enforcement mechanism to constrain behavior to comply with socially useful norms, it may also have the opposite effect.

Even where legal enforcement mechanisms are not in place, norms may still be enforced through informal social mechanisms, such as reputation, esteem, or shaming. A person is more likely to adhere to norms when he believes that acquiring a reputation for doing so will further his own interests.[108] Relatedly, esteem may also act to enforce adherence to social norms. Richard McAdams explained that people can "*costlessly* punish norm violators by withholding from them the esteem they seek."[109] Shaming also acts to enforce social norms.[110] Shaming may be used by courts as a legal enforcement mechanism,

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[103] *Id.* at 2022.

[104] Jonathan C. Lipson, *The Expressive Function of Directors' Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224, 262–63 (2007).

[105] Sunstein, *supra* note 89, at 2022 (explaining that *Plessy v. Ferguson* asserted that laws calling for segregation did not "mean" black inferiority and that *Brown v. Board of Education* further attempted to support this assertion via empirical work to the contrary).

[106] *See* Blair & Stout, *supra* note 77, at 1739 (discussing the negative impact of regulation on trustworthiness).

[107] *See, e.g.*, Bernstein, *supra* note 68, at 1769 (discussing the negative effects on social norms as a result of the search for "immanent business norms" advocated in the UCC); Robert A. Kagan, Neil Gunningham & Dorothy Thornton, *Explaining Corporate Environmental Performance: How Does Regulation Matter?*, 37 LAW & SOC'Y REV. 51, 52 (2003) (arguing that regulation of corporate environmental performance may discourage beyond-compliance behavior); Eric A. Posner, *The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action*, 63 U. CHI. L. REV. 133, 136 (1996) (discussing the effect of regulation on the effectiveness of group social enforcement mechanisms).

[108] Robert Cooter & Melvin A. Eisenberg, *Fairness, Character, and Efficiency in Firms*, 149 U. PA. L. REV. 1717, 1722 (2001) (noting that "a superior may tell the truth, reciprocate, and act like a trustworthy person, not authentically, because he has internalized firm-specific fairness norms, but instrumentally, to obtain the reputation that he needs to induce supracontractual performance from subordinates").

[109] McAdams, *supra* note 68, at 355.

[110] Skeel, *supra* note 87, at 1821 ("[S]haming sanctions, like shaming generally, are a device for enforcing norms.").

but informal shaming may also act as an enforcement mechanism of social norms.[111]

Norms may also be enforced by internal enforcement mechanisms,[112] such as guilt,[113] pride,[114] or moral obligation. Guilt is the "psychological discomfort a violation causes one who has internalized the norm, regardless of whether others think she has violated the norm."[115] Guilt often acts as a selective incentive to induce individuals to comply with social norms because "(1) social meanings construct a certain semiotic content to an individual act that make it possible for them to be 'cheating' or 'disloyal' and because (2) individuals internalize these norms and feel this semiotic content."[116] Essentially, guilt creates an emotional or psychological compulsion to obey norms.[117] Guilt may act as a sub-conscious compulsion to comply with norms or it may be a conscious part of a party's cost–benefit analysis.[118]

Furthermore, norms may also be internally enforced as they become a part of an actor's moral character, encouraging compliance through the party's moral compass.[119] As an actor internalizes the content of social norms, his preferences change and his preferences then act to constrain him to comply with

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[111] *See generally id.*

[112] *See* Martha C. Nussbaum, *Flawed Foundations: The Philosophical Critique of (a Particular Type of) Economics*, 64 U. CHI. L. REV. 1197, 1211 (1997) ("[W]e need to recognize sympathy and commitment as independent sources of motivation . . . economic theories could not have predicted that anyone would risk life, family, comfort, and reputation to rescue Jews during the Holocaust. And yet a significant number of people did." (citations omitted)).

[113] Cooter & Eisenberg, *supra* note 108, at 1724 ("Just as violating a social standard provokes criticism from others, so violating an internalized standard provokes self-criticism and guilt.").

[114] *See* Peter H. Huang, *Trust, Guilt, and Securities Regulation*, 151 U. PA. L. REV. 1059, 1089 (2003) (noting that "[p]ride from not breaching a duty of loyalty clearly is a positive utility or a benefit in assessing social welfare").

[115] McAdams, *supra* note 68, at 380.

[116] Lessig, *supra* note 68, at 997.

[117] *See* Posner, *Law, Economics, and Inefficient Norms*, *supra* note 68, at 1709 ("We say about most norms that people bound by them feel an emotional or psychological compulsion to obey the norms; norms have moral force. The compulsion might be slight or it might be overwhelming; it does not prevent people from violating a norm, necessarily, but violation does evoke feelings of shame or guilt." (citation omitted)). Posner further noted that the observation that moral compulsion is a motivating factor in human behavior was made by the philosopher David Hume. DAVID HUME, ENQUIRIES CONCERNING HUMAN UNDERSTANDING AND CONCERNING THE PRINCIPLES OF MORALS 285–94 (L.A. Selby-Bigge ed., 3d ed. 1975) (1777).

[118] *See* Eisenberg, *supra* note 21, at 1259–60 ("In deciding whether to adhere to an internalized moral norm, an actor may weigh the pain of guilt, the pleasure of rectitude, and the external costs and benefits of adherence and nonadherence.").

[119] *See* Cooter, *supra* note 68, at 586 ("Internalizing a social norm is a moral commitment that attaches a psychological penalty to a forbidden act.").

the internalized moral norm.[120] Thus, one's morality can also act as a powerful force to induce compliance with social norms.

E. *Trust*

Many scholars discuss trust in much the same way they discuss social norms.[121] They often reference the same types of internal and societal enforcement mechanisms.[122] Insofar as trust is calculative,[123] or operates as any other social norm would, it can be analyzed in much the same way as the other social norms discussed above.[124]

However, where trust is not enforced by market sanctions as a social norm would be, it operates as a residual category, encouraging a trustor to expose himself to unconstrained discretion. When used in this sense, trust is the concept underlying the fulfillment of promises and expectations in contractual relationships. At its most basic level, trust is simply "believing that others tell the truth and will keep their promises."[125] Relationships of trust are often characterized by a vulnerability to the risk of disappointment.[126] Trust as we

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[120] *See id.* at 589 ("Internalization puts morality into preferences, not external constraints.").

[121] *See, e.g.*, Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 557 (2001) (describing "principled trust" and explaining it much in the same terms as any other social constraint, as trust "where the trustor is technically free to breach but 'opportunistic behavior would violate values, principles, and standards of behavior that have been internalized by parties to an exchange'").

[122] *See, e.g.*, Jay B. Barney & Mark H. Hansen, *Trustworthiness as a Source of Competitive Advantage*, 15 STRATEGIC MGMT. J. 175, 175 (1994) (describing "weak form" and "semi-strong form" trust as types of trust that rely on external enforcement mechanisms—that the parties have voluntarily taken on constraints that ensure performance). *See generally* Blair & Stout, *supra* note 77.

[123] Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J.L. & ECON. 453, 476–86 (1993). Williamson, in his influential article defining "calculative" trust, argued that most of what we call trust is actually strategic behavior driven by the fear of retaliation or loss of reputation. *Id.* at 474. Although Williamson did not entirely dismiss the idea of noncalculative trust, he suggested that it is "irrelevant to commercial exchange." *Id.* at 469. He noted that the term "calculative trust" is actually a contradiction and argued that it is misleading and confusing to use the word "trust" in connection with commercial relationships. *Id.* at 463. Many scholars have similarly noted that "trust" formed as a result of fear of retaliation, reputational loss or social sanctions is not really trust at all, but rather a market constraint on behavior. *See generally* Blair & Stout, *supra* note 77.

[124] *See, e.g.*, JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 40 (2008) (norms are necessary to generate trust in public corporations "because of the vague, almost wholly unspecified nature of the relationship between shareholders and the companies in which they invest").

[125] TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 49 (2006).

[126] Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. REV. 1717, 1724 (2006) (positing that trust is "a state of mind that enables its possessor to be willing to make herself vulnerable to another—that is, to rely on another despite a positive

discuss it here is free from external incentives, a "willingness to make oneself vulnerable to another, based on the belief that the trusted person will choose not to exploit one's vulnerability."[127] This type of trust has been characterized as "an optimistic view of others"—the "confident expectation that, when the need arises, the one trusted will be directly and favorably moved by the thought that you are counting on her."[128]

Trust allows a contracting party to expose herself to at least some unconstrained discretion. After the terms of the contract, fiduciary duties, and social norms have all played their boundary enforcement roles, any remaining discretion is left to trust. A contracting party will be more likely to engage in relationships where more residual discretion exists if she believes that the other party to the contract is trustworthy.[129] Such a trust exchange increases efficiency[130] and emboldens parties to enter into contractual relationships even where some discretion is left unconstrained.[131]

III. BOUNDARY ENFORCEMENT

In Part II we described a system of constraints on discretion. In this Part, we use our focus on discretion as the foundation for two conceptual contributions to the understanding of fiduciary law. First, reasoning from the observation that fiduciary relationships are consensual, we contend that the grant of discretion in fiduciary relationships is not merely an artifact of bounded rationality, but a crucial part of the bargain.[132] Second, we answer the question, how should a court define the boundaries of fiduciary discretion. We observe that courts often define these boundaries by reference to industry customs and social norms. We

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risk that the other will act in a way that can harm the truster"); *see also* Barney & Hansen, *supra* note 122, at 176 (using vulnerability to the risk of disappointment as a key feature to distinguish between "weak form," "semi-strong form," and "strong form" trust).

[127] *See* Blair & Stout, *supra* note 77, at 1739–40.

[128] Frank B. Cross, *Law and Trust*, 93 GEO. L.J. 1457, 1464–65 (2005) (describing the concept of "affective trust").

[129] From a rational choice or economic perspective, trustworthiness is simply "the likelihood that the person relied on will honor his promise." *See* Ribstein, *supra* note 121, at 556 (citation omitted). It has also been described as "an unwillingness to exploit a trusting person's vulnerability even when external rewards favor doing so." *See* Blair & Stout, *supra* note 77, at 1740.

[130] *See* Blair & Stout, *supra* note 77, at 1757 ("Trust permits transactions to go forward on the basis of a handshake rather than a complex formal contract.").

[131] *See id.* ("Trust behavior also reduces losses from others' undetectable or unpunishable opportunistic behavior, losses that could discourage the formation of valuable agency and team production relationships in the first place."); *see also* Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 425 (1993) ("[T]rust is essential for corporate survival.").

[132] *See* Easterbrook & Fischel, *supra* note 6, at 426 (noting that fiduciary duties "reflect both the nature of the principal's choice (he is hiring expertise) and an obvious condition (the principal is unwilling to put himself at the mercy of an agent whose effort and achievements are both exceedingly hard to monitor)").

defend this as the most sensible and coherent approach to boundary enforcement.

An important implication of these insights is that courts applying fiduciary law should respect the grant of discretion to the fiduciary, rather than attempting to displace that discretion with judicial mandate.[133] Thus, we describe the role of fiduciary law as boundary enforcement,[134] and we urge courts to honor fiduciary actions that represent an appropriate exercise of discretion, even when the beneficiary or the judge might perceive a preferable action after the fact. The challenge for courts is to define the limits of fiduciary discretion in the absence of express guidance from the beneficiary.[135]

If the role of fiduciary law is to enforce the boundaries of fiduciary discretion, the question naturally arises, how should a court define those boundaries? Commentators generally begin the examination of the duty of loyalty with an abstract standard, such as the one articulated by then-Chief Judge Cardozo in his justly famous opinion in *Meinhard v. Salmon*:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.
>
> . . . .
>
> Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation.[136]

Inspired by the language of *Meinhard*, many courts and commentators have concluded that the fiduciary standard is "unselfishness" or "selflessness."[137]

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[133] This principle is sometimes acknowledged by leading authorities. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 87 cmt. b ("[J]udicial intervention is not warranted merely because the court would have differently exercised the discretion."); *cf.* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 90 (2004) (arguing that under the business judgment rule, a "court . . . abstains from reviewing the substantive merits of the directors' conduct unless the plaintiff can rebut the business judgment rule's presumption of good faith").

[134] *Cf.* Miller, *supra* note 55, at 275 ("[T]he scope of rightful conduct is at once open and bounded. Fiduciaries have discretion within the limits of authority reposed in them or undertaken by them.").

[135] If the beneficiary provides express boundaries in the contract, the court should enforce those boundaries. *See* Smith, *supra* note 6, at 1492 ("[I]n most fiduciary settings, parties may modify default rules of fiduciary duty through contract.").

[136] Meinhard v. Salmon, 164 N.E. 545, 546–48 (N.Y. 1928) (citations omitted).

[137] *See, e.g.*, Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 CORNELL L. REV. 767, 776 (2000) (stating that the duty of loyalty requires fiduciaries to "completely subordinate self-interest and act exclusively for the benefit of the other party"); Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L.

This is understandable, given Cardozo's assertion that "thought of self was to be renounced, however hard the abnegation."[138] Although superficially appealing, this abstract standard cannot be understood literally because many fiduciaries are motivated simultaneously by self-interest and a desire to serve their beneficiaries.[139] Thus, interpreting the standard of "unselfishness" requires some contextualization.

Despite proclaiming that a "trustee is held to something stricter than the morals of the market place,"[140] Cardozo examined industry customs to evaluate Salmon's behavior.[141] For example, Cardozo inquired about Meinhard's reasonable expectations of notice of termination in light of local practices[142] and suggested that Salmon's duty of candor might be quite different if the new lease related to "a building at a location far removed."[143] Cardozo observed, "For this problem, as for most, there are distinctions of degree."[144] These distinctions of degree are informed by the judge's sense of variations in industry customs or social norms in different situations.

Courts and commentators follow this same pattern of contextualization regardless of the abstract standard. Of course, the most commonly employed abstract standard is simply "loyalty," which is often defined as a duty to act for the "sole benefit" of the beneficiary.[145] As noted above, however, many fiduciaries are motivated simultaneously by self-interest and a desire to serve their beneficiaries, so "sole benefit" cannot mean *sole* benefit.

Moreover, in many fiduciary relationships, "sole benefit" or "undivided loyalty" does not even mean that a fiduciary is required to preference the beneficiary's interests over the fiduciary's own interests in all matters. For example, the law of agency requires an agent to "refrain from competing with the principal,"[146] but acknowledges that the agent "who plans to compete is free to make extramural arrangements for setting up a new business, such as incorporating a new firm and arranging for space and equipment."[147] Similarly,

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REV. 537, 542 (1997) ("As Justice Cardozo's statement makes clear, fiduciaries owe a duty of unselfishness.").

[138] *Meinhard*, 164 N.E. at 548.

[139] *See* RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. b (2006) (noting that "an agent's interests are often concurrent with those of the principal").

[140] *Meinhard*, 164 N.E. at 546.

[141] The disjunction between Cardozo's aspirational language ("standard of conduct") and the less demanding application ("standard of liability") is a widely recognized feature of fiduciary law. *See* Smith, *supra* note 14, at 1208–09; *see also* Eisenberg, *supra* note 14, at 467–68; Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1012, 1106 (1997).

[142] *Meinhard*, 164 N.E. at 547.

[143] *Id.* at 548.

[144] *Id.*

[145] FRANKEL, *supra* note 59, at 108; *see also* RESTATEMENT (THIRD) OF TRUSTS § 78 (2007) (requiring the trustee to act "solely in the interest of the beneficiaries").

[146] RESTATEMENT (THIRD) OF AGENCY § 8.04 (2006).

[147] *Id.* § 8.04 cmt. c.

law firm partners are notorious for "grabbing and leaving," leading one commentator to observe, "fiduciary duties have not restricted the placement of individual interest above the interest of the group to any meaningful degree."[148]

Perhaps hoping to enhance the precision of the standard, courts and standard-setting bodies often unbundle the duty of loyalty into various subsidiary duties, such as the duty to account for profits,[149] the duty to refrain from dealing as or on behalf of an adverse party,[150] the duty to refrain from competition with the beneficiary,[151] and the duty to keep confidences.[152] Of course, even these more particular statements of the duty of loyalty do not eliminate the fiduciary's discretion, nor do they provide well-defined limits on that discretion. As we demonstrate in Part IV below in the context of employment competition, judges often appeal to industry customs and social norms in discerning the line between compliance and breach.

Peter Birks argues that the words "loyalty" and "fidelity" are "less than useful"[153] in answering the question, "What does fiduciary obligation require one to do?"[154] He prefers "disinterestedness" as the standard, which he describes as "the elimination of the pursuit of any conflicting interest of the actor himself."[155] This formulation suffers from the same infirmity as the "sole benefit" and "undivided loyalty" tests, discussed above, and even Birks seems to recognize that his abstract standard begs for contextualization.[156]

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[148] Robert Hillman, *Loyalty in the Firm: A Statement of General Principles on the Duties of Partners Withdrawing from Law Firms*, 55 WASH. & LEE L. REV. 997, 999 (1998).

[149] *See, e.g.*, UNIF. P'SHIP ACT § 404(b)(1) (1997) ("A partner's duty of loyalty to the partnership and the other partners is limited to the following: (1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity . . . .").

[150] *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 8.03 (2006) ("An agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship.").

[151] *See, e.g.*, REVISED UNIF. LTD. LIAB. CO. ACT § 409(b)(3) (2006) ("The duty of loyalty of a member in a member-managed limited liability company includes the dut[y] . . . to refrain from competing with the company in the conduct of the company's activities before the dissolution of the company.").

[152] *See, e.g.*, RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 16 (2000) ("[A] lawyer must . . . comply with obligations concerning the client's confidences and property, avoid impermissible conflicting interests, deal honestly with the client, and not employ advantages arising from the client-lawyer relationship in a manner adverse to the client.").

[153] Peter Birks, *The Content of Fiduciary Obligation*, 34 ISR. L. REV. 3, 11–12 (2000).

[154] *Id.* at 4.

[155] *Id.* at 20.

[156] Birks examines a case from the High Court of Australia to illustrate the distinction between "promot[ing] the interests of [the] employer" and "promoting the interests of the employer disinterestedly." *Id.* at 21–22 (discussing *Hosp. Prods. Ltd. v. U.S. Surgical Corp.* (1984) 156 CLR 41 (Austl.)).

Despite their shortcomings, these attempts to describe the boundaries of fiduciary obligation through close analysis of abstract standards advance our understanding.[157] In this Article, however, we are focused on the mechanisms by which these abstract standards are contextualized. As noted above, our thesis is that judges often appeal to industry customs and social norms in discerning the line between compliance and breach. Essentially, these judges are attempting to distinguish the *appropriate pursuit of self-interest* from the *inappropriate pursuit of self-interest*.[158]

This view of fiduciary analysis makes sense of the frequent invocation of "reasonable expectations" in fiduciary cases.[159] By asking whether a fiduciary fulfilled the reasonable expectations of the beneficiary, courts are implicitly endorsing boundary enforcement as the goal of fiduciary law, as "reasonable expectations" typically would suggest a range of possible actions. Moreover, the reference to the beneficiary's reasonable expectations may suggest the need to import industry customs and social norms into the analysis.[160] After all, while the beneficiary may form expectations from the negotiations, often such

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[157] In addition to the commentators discussed above, see Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 38 (2003). Johnson discussed in depth the disparate definitions of loyalty. *Id.* Drawing on moral philosophy, Johnson distinguished the "minimal condition" and the "maximum condition" for loyalty in corporate law. *Id.* The "minimal condition" of loyalty requires that the fiduciary "reject temptation" and that she refrain from "betraying the object of one's loyalty." *Id.* He further explained that when courts emphasize a benefit to the fiduciary as a hallmark of a loyalty breach or the need to avoid self-interest seeking to fulfill the duty of loyalty, they are describing the minimal condition for loyalty. *Id.* In contrast, the "maximum condition" includes "an element of devotion" and "affirmative duties of devotion" as well. *Id.* Thus, corporate actors may breach their duty of loyalty even when they obtain no personal gain as a result of the breach. Thus, simply attempting to determine whether a fiduciary gained a windfall from his action may not sufficiently account for all breaches of the duty of loyalty.

[158] The American Law Institute is proposing a standard for the duty of loyalty in nonprofit organizations that is framed in similar language. *See* AM. LAW INST., PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 310 (Tentative Draft No. 1, 2007) ("The duty of loyalty requires each governing-board member . . . (b) to handle appropriately . . . situations in which the interests of the charity do or might conflict with the interests of fiduciaries and related persons.").

[159] *See, e.g.*, Hollis v. Hill, 232 F.3d 460, 471 (5th Cir. 2000); Berreman v. W. Publ'g Co., 615 N.W.2d 362, 374 (Minn. Ct. App. 2000); Fox v. 7L Bar Ranch Co., 645 P.2d 929, 934 (Mont. 1982); Meiselman v. Meiselman, 307 S.E.2d 551, 558 (N.C. 1983); Kortum v. Johnson, 755 N.W.2d 432, 439 (N.D. 2008); McLaughlin v. Schenck, 220 P.3d 146, 156–57 (Utah 2009).

[160] We do not intend to suggest that "reasonable expectations" are established exclusively by reference to industry customs and social norms. One can easily imagine a novel contracting environment in which industry customs and social norms have not yet developed. Nevertheless, the beneficiary of a fiduciary duty may have reasonable expectations of being treated in a certain manner based on statements made or actions taken during the formation or maintenance of the relationship.

expectations arise from the normal course of dealing in a particular situation.[161] Although this standard looks to the circumstances of the specific parties to the agreement, it also involves an analysis of what is customary under the circumstances.[162]

For example, in *In re Kemp & Beatley, Inc.*, the New York Court of Appeals discussed the reasonable expectations analysis in the shareholder oppression context.[163] The court explained that, in considering an allegation of oppressive conduct, it must look not only to what the majority shareholders knew, but also what they "should have known" about the minority shareholders' expectations.[164] The court further counseled that "[m]ajority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled."[165] Thus, a court must look beyond the actual expectations of the parties to the expectations that would be customary for similarly situated parties to hold.

Courts also use the notion of "fairness" in a similar manner to evaluate the boundaries of fiduciary discretion. For example, the Delaware courts use the "entire fairness" standard to evaluate breach of the duty of loyalty claims.[166] The entire fairness standard has two prongs, fair dealing and fair price, each of which references industry customs. Fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[167] The goal of this part of the inquiry is to test the challenged transaction against market transactions.[168]

Fair price "relates to the economic and financial considerations of the proposed" transaction.[169] A fair price is "not a point on a line, but a range of

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[161] *See* Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989, 993–95 (2001) (explaining that the reasonable expectations analysis is fundamentally different from an implied-in-fact contract and that the difference in analyses between contract law and oppression law protects the parties' interests differently).

[162] Harris v. Ahtna, Inc., 107 P.3d 271, 274 (Alaska 2005) ("Reasonable expectations may be ascertained through the language of the contract, the behavior of the parties, case law, and any relevant extrinsic evidence."); Balvik v. Sylvester, 411 N.W.2d 383, 387–88 (N.D. 1987) (acknowledging that the subjective understandings of the parties do not end the analysis).

[163] *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984).

[164] *Id.*

[165] *Id.* (The court went on to explain that majority conduct would only be oppressive if it "substantially defeats expectations that, objectively viewed, were . . . reasonable under the circumstances.").

[166] *See* Weinberger v. UOP, Inc., 475 A.2d 701, 710 (Del. 1983).

[167] *Id.* at 711.

[168] *Cf.* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 798 (2003) (noting "the importance of a process that mirrors a real arm's-length transaction").

[169] *Weinberger*, 475 A.2d at 711.

reasonable values."[170] In arriving at that range of values, the Delaware courts consider "any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court."[171] As is evident from this reasoning, the Delaware courts freely refer to industry customs in evaluating fiduciary action.

Sometimes courts do more than simply apply an abstract standard, reflecting more openly about the importance of industry customs and social norms.[172] For example, as Melvin Eisenberg has noted, the American Law Institute's *Principles of Corporate Governance* provides that a court "may properly take into account ethical considerations that are generally recognized as relevant to the conduct of business," even if a fiduciary did not benefit from the transaction.[173] Eisenberg points to the example of *United States v. Bestfoods*,[174] in which the Supreme Court was asked to determine whether an action by a dual officer of a parent and a subsidiary took action on behalf of the parent or on behalf of the subsidiary. The Court reasoned, "the presumption that an act is taken on behalf of the corporation for whom the officer claims to act is strongest when the act is perfectly consistent with the norms of corporate behavior, but wanes as the distance from those accepted norms" increases.[175] Similarly, the Court held that in determining whether conduct by a parent's officer involves parental oversight or direct parental control, "[t]he critical question is whether . . . actions . . . by an agent of the parent alone are eccentric under accepted norms of parental oversight of a subsidiary's facility."[176]

The enforcement of industry customs and social norms through fiduciary law is desirable because it is likely to yield a result closest to the parties' expectation interests by responding to social change.[177] This result will

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[170] Cede & Co. v. Technicolor, Inc., No. Civ.A. 7129, 2003 WL 23700218, at *2 (Del. Ch. Dec. 31, 2003), *aff'd in part, rev'd in part on other grounds*, 884 A.2d 26 (Del. 2005).

[171] *Weinberger*, 475 A.2d at 713.

[172] In evaluating the reasonableness of trustee compensation, for example, courts are to consider "local custom." RESTATEMENT (THIRD) OF TRUSTS § 38 cmt. c(1) (2007).

[173] Eisenberg, *supra* note 21, at 1265 (citing AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(b)(2) (1994)).

[174] Eisenberg, *supra* note 21, at 1265 (citing United States v. Bestfoods, 524 U.S. 51, 55 (1998)).

[175] *Bestfoods*, 524 U.S. at 70 n.13.

[176] *Id.* at 72.

[177] Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 30–31 (2006) ("The life of the law, including the life of corporate law, is in a constant state of change in response to social changes. Circumstances change, the social norms applicable to the conduct of business change, business practices change, concepts of efficiency and other issues of policy applicable to corporate law change. Sometimes, social changes indicate that an existing fiduciary obligation should be modified or cut back. An example is the widespread legislative adoption of exculpatory or shield provisions. Other times, social changes indicate that a new specific fiduciary obligation should be articulated because a type of conduct that was once regarded as proper is no longer so regarded.").

embolden beneficiary action ex ante.[178] Of course, some industry customs and social norms may be undesirable from a societal standpoint.[179] And courts sometimes render decisions in opposition to industry customs and social norms, though we view these cases as the exceptions that prove the rule.[180]

We recognize that when courts incorporate social norms into law, they run the risk of altering the very social norms they are attempting to incorporate.[181] For example, Einer Elhauge has argued that the duty of corporate managers to maximize profit was not socially efficient "because even optimal legal sanctions are necessarily imperfect and require supplementation by social and moral sanctions to fully optimize conduct."[182] He argued that regulating the decisions of managers through such a duty and subjecting them to shareholder review

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[178] Smith & Ibrahim, *supra* note 18, at 1538–39.

[179] *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-governing Corporation*, 149 U. PA. L. REV. 1619, 1643 (2001) (discussing the deference of traditional directors to chief executive officers, which was on display in *Kahn v. Sullivan*, 594 A.2d 48, 51–58 (Del. 1991)).

[180] Perhaps the most notorious example of a court standing up to industry customs and social norms is *Smith v. Van Gorkom*, 488 A.2d 858, 864, 874–75 (Del. 1985), in which the Delaware Supreme Court held that the business judgment rule did not protect a board's approval of a proposed merger, even though the board was disinterested and independent, because the directors had failed to inform themselves adequately concerning the intrinsic value of their company. The board of directors in that case acted like other boards of the time, but the court found its actions wanting. The reaction to the case was immediate and harsh. *See, e.g.*, Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1455 (1985) (describing the case as "surely one of the worst decisions in the history of corporate law"); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 1 (1985) (noting that the "corporate bar generally views the decision as atrocious"). In the wake of *Van Gorkom*, the behavior of directors changed, and fairness opinions in mergers became "customary." Paul Sweeney, *Who Says It's a Fair Deal?*, J. ACCOUNTANCY, Aug. 1999, at 44, 45; *see also* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 688 (2002) ("[C]orporate law shapes directors' behavior primarily through its 'sermonizing' or 'expressive' function.").

[181] *See infra* notes 104–05 and accompanying text (discussing the theory that regulation has the potential to "crowd out" socially useful norms and customs); *see also* Bernstein, *supra* note 68, at 1769 (discussing U.C.C. § 1-102(2)(b): "[W]hile the drafters of the Code sought to incorporate these norms into the law in an effort to make commercial law more responsive to and reflective of commercial reality, they failed to recognize that this approach would fundamentally alter the very reality they sought to reflect, and would do so in ways that would have undesirable effects on commercial relationships and would undermine the Code's own stated goals of promoting flexibility in commercial transactions and 'permit[ting] the continued expansion of commercial practices through custom, usage and agreement of the parties.'").

[182] Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 733 (2005).

would undermine social and moral enforcement because managers are subject to social and moral sanctions, whereas shareholders are not.[183]

Other authors have disagreed, arguing that law and norms are interdependent and that, where law and norms conflict, "the legal duty may eventually alter the substantive norms, or the latter may weaken the norm of obedience to law, or both."[184] This concept—that law will be more likely to be adhered to when it mirrors social norms—provides further incentive for fiduciary law to incorporate social norms.

IV. COMPETITION IN EMPLOYMENT: A CASE STUDY

In this Part, we discuss the principles related above as they apply to competition in the employment context. We selected competition in employment as an illustrative topic because the *Restatement (Third) of Employment Law* is currently under production by the American Law Institute,[185] and the tentative drafts have identified several jurisdictional splits, which represent fundamental differences in conceptions of fiduciary duties in the employment relationship. No single theoretical framework seems to provide guidance to courts as they apply fiduciary principles to the employment relationship, especially in the case of non-managerial employees.[186] We seek to provide that framework.

As we discussed in Part III above, the role of fiduciary duties is boundary enforcement. Although the duty to be loyal adheres in every fiduciary relationship, the scope of that duty varies relative to the amount of discretion afforded to the fiduciary.[187] This insight is especially prominent in the

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[183] *Id.* at 800 (arguing that a legal duty to maximize profits would entail "the sort of suboptimal conduct we would get with *zero* social and moral sanctions").

[184] Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 564 (2006) ("Liability risk and the norm of obedience to law pull the manager in the direction of choosing the profit-maximizing course of conduct, while the substantive norms pull in the other direction."); *see also* Janice Nadler, *Flouting the Law*, 83 TEX. L. REV. 1399, 1403 (2005) (arguing that laws perceived as unjust will not necessarily alter social norms or moral perceptions, but rather that such laws "can generate general disrespect and increased lawbreaking").

[185] *Restatement Third, Employment Law*, ALI, http://www.ali.org/index.cfm?fuseaction=publications.ppage&node_id=31 (last visited Mar. 2, 2014).

[186] The regulation of employee competition is heavily influenced by agreements not to compete, *see* RESTATEMENT (THIRD) OF EMP'T LAW §§ 8.05–8.07 (Tentative Draft No. 4, 2011), and laws governing confidential information, including the law of trade secrets. *Id.* §§ 8.02–8.03. As noted above, the duty of loyalty is a doctrine of last resort and, as a result, may play a less prominent role in the regulation of employee competition than these other areas of law.

[187] *Id.* § 8.04 cmt. a ("[T]he duty of loyalty applies to all employees, but the scope of the duty varies with the nature of employment. Because an employee with managerial authority can often bind the employer by the discretionary exercise of that authority, the scope of that employee's duty of loyalty is broader than that of an employee who does not exercise such authority.").

employment context because of the wide disparity in discretion among non-managerial employees and high-level managers.[188] Many courts have referred to the duty of loyalty for managers as "higher,"[189] "heightened,"[190] or "greater."[191] Although some of the case law discussing the variation in the duty of loyalty may be confusing or difficult to reconcile,[192] we believe these variations are best understood as referring to differences in levels of discretion.

To demonstrate the boundary enforcement role of fiduciary duties in the employment context, we call upon the employee in the oft-cited case of *Cameco, Inc. v. Gedicke*[193] to serve as the model of a lower-level employee.[194] Donald Gedicke was an at-will employee of Cameco, Inc., a manufacturer of food products.[195] As traffic manager, Gedicke was responsible for arranging the shipping of Cameco's products through common carriers to retail stores.[196] His duties included coordinating shipping schedules, negotiating shipping rates, supervising warehouse employees, overseeing the shipping process, and inspecting Cameco's off-site warehouses.[197] While carrying out these tasks, Gedicke became familiar with information that Cameco considered to be

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[188] Some courts have held that certain non-managerial employees are not fiduciaries. *Id.* § 8.06, reporter's notes (a)(iii) ("Apparently reluctant to endorse a robust fiduciary duty on all employees, a good number of courts assert that not all employees owe a duty of loyalty.").

[189] *See, e.g.*, Condon Auto Sales & Serv., Inc. v. Crick, 604 N.W.2d 587, 600 (Iowa 1999) ("A higher duty of loyalty exists for employees who occupy a position of trust and confidence than those who occupy a low level task."); Cameco, Inc. v. Gedicke, 724 A.2d 783, 791 (N.J. 1999) (noting that "[a]n officer, director, or key executive . . . has a higher duty than an employee working on a production line").

[190] *See, e.g.*, McConaghy v. Sequa Corp., 294 F. Supp. 2d 151, 164 (D.R.I. 2003) (holding that controlling owners and corporate managers "had a fiduciary relationship with these companies, and, as such, had heightened duties of loyalty and care"); Enterprise Recovery Sys., Inc. v. Salmeron, 927 N.E.2d 852, 865 (Ill. App. Ct. 2010) ("[C]orporate officers owe a heightened fiduciary duty of loyalty to their corporate employer . . . .").

[191] *See, e.g.*, *In re* Bennett, 989 F.2d 779, 790 (5th Cir. 1993) (holding that "[t]he critical fact underlying this 'greater duty of loyalty than is normally required,' was the greater degree of control that one partner (i.e., the managing or business partner) had over the operation of the partnership and hence the investment of the other partners"); Huffington v. Upchurch, 532 S.W.2d 576, 579 (Tex. 1976) ("As managing partner of their partnership enterprise, respondent owed his partners even a greater duty of loyalty than is normally required.").

[192] The *Restatement* acknowledges an analytical split between courts that are "reluctant to endorse a robust fiduciary duty on all employees" and those which "either apply a functional analysis of the duty of loyalty, or simply apply that duty to all employees." RESTATEMENT (THIRD) OF EMP'T LAW § 8.01, reporter's notes (a)(iii) (Tentative Draft No. 4, 2011). We believe that most of the analytical confusion surrounding this issue is resolved by viewing fiduciary duties as boundaries on discretion.

[193] 724 A.2d 783 (N.J. 1999).

[194] *Id.* at 786. Gedicke was salaried, earning about $38,000 per year. *Id.*

[195] *Id.*

[196] *Id.*

[197] *Id.*

confidential, including the identities of Cameco's customers, suppliers, and common carriers, as well as rates and delivery routes.[198]

Gedicke had discretion to perform a variety of tasks. For example, he might choose to ship to one customer before another or he might choose to inspect the off-site warehouses on Thursdays instead of Tuesdays. He might also negotiate different shipping rates with different customers. Although Cameco could terminate Gedicke if it were not satisfied with his performance,[199] fiduciary law has nothing to say about the way in which Gedicke exercises his discretion, unless he does so in a manner that is disloyal to his employer.

The *Restatement* provides that the exercise of discretion is disloyal when, among other things, an employee "compet[es] with the employer while employed by the employer."[200] It then develops this boundary by delineating what does or does not constitute competition by a lower-level employee.[201] The *Restatement* explains that working for a competitor, soliciting customers for a competitor, or recruiting employees for a competitor constitutes a breach of the duty not to compete.[202] It also describes situations in which what would normally be described as competition is not competition for purposes of the duty of loyalty, including reasonable preparation to compete and moonlighting.[203] Each of these activities seems to be self-interested competition, but some forms of competition have been continually affirmed as acceptable by courts. This raises the question we asked above: how should a court define the boundaries of fiduciary discretion? As discussed above and illustrated below, courts draw these boundaries with reference to industry customs and social norms.

In *Cameco*, the disputed action was Gedicke's decision to start a shipping company in his off-hours.[204] Gedicke used the skills he had acquired during his employment at Cameco to arrange shipping for Cameco's competitors.[205] Gedicke often arranged commingled shipments of Cameco's products and the

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[198] *Id.*

[199] *Cameco*, 724 A.2d at 786–87. Cameco ultimately fired Gedicke for "poor performance": for failing to conduct off-site warehouse inspections, failing to negotiate lower freight rates, and allowing too much overtime in his department. *Id.*

[200] RESTATEMENT (THIRD) OF EMP'T LAW § 8.01 (Tentative Draft No. 4, 2011).

[201] *Id.* § 8.04(c).

[202] *Id.* § 8.04(b).

[203] Section 8.04(b) explains that competition "does not include reasonable preparation by an employee or group of employees to compete with the employer." *Id.* Section 8.04(c) permits nonmanagerial employees to work for a competitor

> as long as the work is not done during time committed to the first employer, does not involve the use or disclosure of the first employer's confidential information, and does not cause economic injury to the first employer greater than the injury that would be caused by any other person working for the competitor.

Id. § 8.04(c).

[204] *Cameco*, 724 A.2d at 786.

[205] *See id.*

products of his own customers.[206] The court, in analyzing whether Gedicke had breached his duty of loyalty, did so with reference to social norms. In determining that lower-level employees are permitted to work for competitors of their employer under some circumstances, the court explained:

> A reality of contemporary life is that many families will consist of two wage earners, one wage earner with two jobs, or both. For some employees, particularly those earning low or modest incomes, second sources of income are an economic necessity. For them, a second job or "moonlighting" is the only way to make ends meet.[207]

After laying out several context-specific factors to determine whether an employee has breached his duty of loyalty, the court ultimately determined that "[a]bsent a governing contractual provision, the judicial task is to search for a fair and reasonable solution in light of the relevant considerations."[208]

Cameco illustrates how a court might derive the substance of fiduciary duties from industry customs and social norms. The court acknowledged that not all competition constitutes a breach of the duty of loyalty, despite the general rule, acknowledging that this type of competition is a "reality of contemporary life."

Another concept in employment law that demonstrates the use of social norms as content for fiduciary duties is the discussion regarding an employee's preparation to compete. The *Restatement* adopts the rule that "an employee breaches the duty of loyalty to the employer if, without the employer's consent . . . the employee . . . works for a competitor or otherwise competes with the employer."[209] However, it creates a caveat for "reasonable preparation by an employee or group of employees to compete with the employer."[210] Courts seem to define "reasonable preparation" with reference to social norms. For example, several courts have drawn the line between appropriate preparation to compete and inappropriate solicitation of customers or co-workers by determining whether the contact was more like a solicitation or a professional courtesy.[211] Courts engage in a fact-specific inquiry,[212] commonly

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[206] *Id.* The court seemed to accept Gedicke's testimony that this type of "commingled" shipping is customary and that Cameco benefitted from reduced shipping rates as a result of sharing space with Gedicke's customers. *See id.*

[207] *Id.* at 789.

[208] *Id.* at 791. Under the facts of this case, the court affirmed the appellate court's determination that the employer had established a prima facie case against the employee for breach of the duty of loyalty. *Id.* at 792.

[209] RESTATEMENT (THIRD) OF EMP'T LAW § 8.04(a) (Tentative Draft No. 4, 2011).

[210] *Id.* § 8.04(b).

[211] *See, e.g.*, Warwick Grp., Inc. v. Cipolla, No. C.A. NO. 86-2259, 1986 WL 714207, at *3 (R.I. Super. Ct. Sept. 12, 1986) (determining that "the announcement sent out by the defendants is not so much a direct solicitation of business as a notice of professional association and change of address"); *see also* Aetna Bldg. Maint. Co. v. West, 246 P.2d 11, 15 (Cal. 1952); Morgan's Home Equip. Corp. v. Martucci, 136 A.2d 838, 847 (Pa. 1957)

citing to standards that implicate social norms, such as honesty and fair dealing.[213] Courts also seem to have similar social norms in mind when making these determinations as they do in the moonlighting context. For example, the Court of Appeals of Maryland acknowledged that "courts have been receptive to the view that every person has or at least ought to have the right to ameliorate his socio-economic status by exercising a maximum degree of personal freedom in choosing employment."[214]

Another context in which the content of fiduciary duties is supplied by industry customs and social norms is the discussion of what constitutes a corporate opportunity for purposes of employee competition with an employer. For example, the Idaho Supreme Court, in finding that there was no corporate opportunity, looked to "[c]ommon sense" and "practical advantage."[215] Similarly, in the not-for-profit context, the New York Supreme Court, Appellate Division looked to fairness in determining that a fiduciary misappropriated a corporate opportunity.[216]

All of these examples demonstrate that the duty of loyalty acts as a boundary on employee discretion and courts do not simply apply abstract

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(discussing the issue of professional courtesy when soliciting co-workers: "The systematic inducing of employees to leave their present employment and take work with another is unlawful when the purpose of such enticement is to cripple and destroy an integral part of a competitive business organization rather than to obtain the services of particularly gifted or skilled employees.").

[212] RESTATEMENT (THIRD) OF EMP'T LAW § 8.04, reporter's notes (b) (Tentative Draft No. 4, 2011) ("As in the context of determining what constitutes mere preparation, determining what constitutes going beyond mere announcement is, however, a fact-intensive inquiry."); *see* Bancroft–Whitney Co. v. Glen, 411 P.2d 921, 935 (Cal. 1966) (noting that "[n]o ironclad rules as to the type of conduct which is permissible can be stated"); *see also* Cameco, Inc. v. Gedicke, 724 A.2d 783, 789 (N.J. 1999) (noting that "[t]he contexts giving rise to claims of employee disloyalty are so varied that they preclude the mechanical application of abstract rules of law").

[213] *See, e.g.*, Jet Courier Serv., Inc. v. Mulei, 771 P.2d 486, 492 (Colo. 1989) ("Underlying the duty of loyalty arising out of the employment relationship is the policy consideration that commercial competition must be conducted through honesty and fair dealing."); Md. Metals, Inc. v. Metzner, 382 A.2d 564, 568 (Md. 1978) ("Fairness dictates that an employee not be permitted to exploit the trust of his employer so as to obtain an unfair advantage in competing with the employer in a matter concerning the latter's business.").

[214] *Maryland Metals*, 382 A.2d at 569.

[215] Jenkins v. Jenkins, 64 P.3d 953, 958 (Idaho 2003) ("Common sense suggests that expanding a closely held corporation made up of four shareholders including contentious ex-spouses and estranged sisters, is not practical. The acrimony among the few shareholders of Summer Wind not only speaks to whether a new opportunity would have been of practical advantage, but also calls into question the viability of the corporation as a whole.").

[216] Am. Baptist Churches of Metro. N.Y. v. Galloway, 271 A.D.2d 92, 97 (N.Y. App. Div. 2000) (determining that "it would be unfair and counterproductive for a charitable organization to have no recourse against a dishonest fiduciary who thwarts the organization's endeavors and renders futile the expenditures of time and money invested in developing the project").

standards to factual situations to determine whether an employee has breached his duty of loyalty. Rather, courts draw the boundary between appropriate and inappropriate self-interest with reference to social norms.

IV. CONCLUSION

Discretion is part of the design of fiduciary relationships. Judge Easterbrook and Professor Fischel have said that fiduciary relationships are typified by the hiring of knowledge and expertise,[217] and in these circumstances, "there is not much they can write down."[218] Given the impossibility of predicting the future, the party granting discretion makes a considered choice to invest the counterparty with power, and the counterparty is enticed to enter the relationship, at least in part, based on the expectation of using this power. In evaluating the exercise of this discretion, courts should employ fiduciary law in the task of boundary enforcement.

The notion of boundary enforcement suggests that courts should respect the reasonable exercise of discretion by a fiduciary. Most courts seem to understand this point, recognizing that they should not substitute their own judgments for the judgments of fiduciaries, unless the fiduciaries are not to be trusted because they are acting inappropriately in a self-interested manner. Courts should not attempt to justify overriding a fiduciary's discretion simply because someone else would exercise the discretion differently. The nature of discretion is that reasonable people might come to different conclusions.

In deciding how to define the boundaries of fiduciary discretion, courts often turn to industry customs and social norms, either implicitly (by applying standards that require reference to industry customs and social norms) or explicitly. We believe that this appeal to industry customs and social norms is a sensible way to meet the reasonable expectations of the parties. This approach emboldens people to enter into fiduciary relationships and mitigates opportunism within those relationships.

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[217] Paul Miller takes issue with this characterization of fiduciary relationships, arguing, "Expertise is not a de jure or de facto qualification of fiduciaries." Miller, *supra* note 4, at 982. Perhaps Easterbrook and Fischel should have said that the beneficiary hires the fiduciary's judgment or discretion, but their main point is well taken: a fiduciary is expected to make decisions in circumstances that cannot reasonably be predicted, so the contract will be incomplete.

[218] Easterbrook & Fischel, *supra* note 6, at 426.