Tulsa Law Review

Volume 41
Issue 3 *Disputed Concepts in Contemporary Business Association Law: Discussion on Fiduciary Duty and Capital Lock-in*

Spring 2006

Closely-Held Firms and the Common Law of Fiduciary Duty: What Explains the Enduring Qualities of a Punctilio

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CLOSELY-HELD FIRMS AND THE COMMON LAW OF FIDUCIARY DUTY: WHAT EXPLAINS THE ENDURING QUALITIES OF A PUNCTILIO?

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I. INTRODUCTION

Increasingly, the law of business associations is developed through legislation rather than litigation. Recent years have seen a proliferation of state statutes streamlining established forms of business association (corporations and partnerships) and offering new and alluring associational options (limited liability companies and limited liability partnerships). Examples of statutory reforms that dominate developments in the law underlying closely-held firms are associational forms limiting liability of owners, standards applicable to partnership mergers, and elaborate filing systems for the purpose of notifying third parties on questions of authority and changes in ownership.

The sustained transfer of lawmaking from courts to legislatures has allowed a systematic and rapid development of law to address increasingly complex business relationships and transactions. As the statutory underpinnings of business associations have expanded and grown in complexity, the role of courts in defining and developing norms of conduct in the business setting has diminished. Courts are ill-equipped to deal with issues of systematic reform, and legislation—rather than litigation—is the vehicle by which major change is accomplished.

An excellent example of the shift of lawmaking from courts to legislatures is provided by recent reforms in partnership law. One need only compare the style and content of the Uniform Partnership Act of 1914 ("UPA")[1] with the style and content of the Revised Uniform Partnership Act of 1997 ("RUPA")[2] to see the extent to which partnership law has been captured by codification. UPA stood unmodified in any important way for virtually the entirety of the last century. In contrast, RUPA was

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1. 6 U.L.A. 275 (2001).

2. 6 U.L.A. 1 (2001). Although the official name of the Act is "Uniform Partnership Act (1997)," the National Conference of Commissioners on Uniform State Laws refers to it as the "Revised Act" or "RUPA." *Id.* at 5–6.

approved in 1992 but then amended in 1993, 1994, 1996, and 1997.[3] The achievement of UPA was the framework it provided for the subsequent judicial development of partnership law. RUPA, in contrast to the highly conceptual UPA, adopts the style of a traffic code, leaving little to chance in its effort to comprehensively state the law of partnerships.[4]

The development and application of standards of conduct expected of business partners, loosely referred to as fiduciary duties, offers something of an exception to legislative preeminence in defining the standards of associational law. Such has been the level of litigation and reported decisions on the duties business partners owe each other that there has emerged a common law of fiduciary duty defining duties and rights that run among business partners. Indeed, some of the most distinguished of the American jurists—including Cardozo,[5] Holmes,[6] Traynor,[7] and Pollock[8]—have participated in the development of this law through opinions that are both beautifully crafted and timeless in their appeal.

This is not to suggest that courts have succeeded in developing a coherent jurisprudence of fiduciary duty. To the contrary, contemporary fiduciary law is soft at the core and indeterminate in application.[9] As to fundamental issues addressed by fiduciary theory, the answers offered today are essentially the same as the answers offered fifty years ago.[10] Decades of judicial activity have done little to advance fiduciary doctrine or provide meaning beyond the usual statements emphasizing fairness in transactions, disclosure of conflicting interests, and effectuating the unstated bargain of the parties. As law goes, fiduciary doctrine is long on generalities and short on substance.

Fiduciary law may tell us that a fiduciary owes a duty of loyalty or a duty of care, but such statements say little about the real meaning of the duty and the conditions necessary to support a finding that it has been discharged. The substantive content of fiduciary duties is determined on a case-by-case basis, with each decision resting on highly particularized facts and, therefore, providing relatively little "law" to be applied in future controversies. That said, there is a consistency and durability to the generalized

3. *Id.* at 2. The 1996 amendments were particularly important because they included comprehensive provisions on limited liability partnerships and foreign limited liability partnerships. *See id.* at 5, 7–9.

4. As just one example, consider the varying statutory approaches to defining access to information. UPA states simply that the books shall be kept at the principal place of business and "every partner shall at all times have access to and may inspect and copy any of them." UPA § 19. RUPA, on the other hand, states that access to books and records, if any, must be given to partners and their agents and attorneys, the information must pertain to the period during which the requesting party was a partner, access need be provided only during ordinary business hours, and the partnership may impose a reasonable charge for copying to cover the costs of labor and material. RUPA § 403(b).

5. *E.g. Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

6. *E.g. Bates v. Dresser*, 251 U.S. 524 (1920).

7. *E.g. Jones v. Ahmanson*, 460 P.2d 464 (Cal. 1969).

8. *E.g. Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981).

9. *See generally* Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limitations of Doctrine*, 22 Cardozo L. Rev. 51 (2000).

10. Probably the most important change is in the area of private ordering. In some jurisdictions, participants enjoy greater freedom than they had in the past to bargain for the level of fiduciary duties that will govern their relationships. The greater role for private ordering, however, is as much a function of statutory reform as it is the evolution of the common law of fiduciary duties.

standard of ethics embraced by the courts for business partners, suggesting there is substance underlying the rhetoric.

This article explores fiduciary norms in the closely-held firm. It focuses generally on judicially developed standards of business ethics and specifically on the perceived gap between articulated and applied norms.

II. ARTICULATING A STANDARD: *MEINHARD V. SALMON*

Within fields of law, there is the occasional case that expresses a standard in such a succinct and powerful way that the influence of the case does not diminish with time. In the fiduciary law applicable to business associates, that case is *Meinhard v. Salmon*,[11] decided nearly eighty years ago. The facts of the case have been long forgotten but are quite straightforward. One participant in a joint venture attempted through secret dealings to appropriate for his own use the principal asset of the venture, a real estate lease.[12] The tactic was all the more offensive because it was employed by the participant who was managing the business.[13] Noting that "[l]ittle profit will come from a dissection of the precedents,"[14] Judge Cardozo proceeded to articulate a standard that would become the controlling precedent in fiduciary duty litigation:

> Joint adventurers, like copartners, owe to one another . . . the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. *Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.* As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[15]

The statement, if anything, is elegant and uplifting. But is it simply a rhetorical flourish that is too effusive and naïve to command respect as "law"? One need not study for long the conduct of individuals associated in business to conclude that business partners often fall short of the ideal expressed by Cardozo. Even an "unbending and inveterate" standard must show some give when applied to the complex relationships

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11. 164 N.E. 545 (N.Y. 1928).

12. *Id.* at 545–46.

13. *Id.* at 548 (noting that "[a] different question would be here if there were lacking any nexus of relation between the business conducted by the manager and the opportunity brought to him as an incident of management" (citations omitted)).

14. *Id.* at 547.

15. *Id.* at 546 (emphasis added, citation omitted). The phrasing was certainly original with Cardozo, although nearly one hundred years earlier the North Carolina Supreme Court showed its own flair with a punctilio:

> The punctilios of false honour, the law regards as furnishing no excuse for homicide. He who deliberately seeketh the blood of another, in compliance with such punctilios, acts in open defiance of the laws of God and of the State, and with that wicked purpose which is termed malice aforethought.

State v. Hill, 1839 WL 605 at *5 (N.C. Dec. 1839).

that exist among business partners, and "uncompromising rigidity" in contemporary times typically is viewed more as a fault than as a virtue.

So, is *Meinhard* a period piece reflecting the values of an imagined innocent and prosperous society, or does it continue to have relevance and power in law? Not surprisingly, the answer depends on whom you ask.

III. *MEINHARD* IN THE ACADEMY

Meinhard does not fare well in the community of legal commentators, principally but not exclusively academics. Although those looking to law as the source of a moral mandate applicable to business relationships may embrace the opinion, legal realists as well as academics who advance an economic model of the firm see little of real value in *Meinhard*.[16]

The varying views of the case reflect fundamental disagreements on the role of fiduciary duties in ordering business relationships. On one side are contractarians who see fiduciary norms as bargain substitutes that facilitate contracting by relieving parties of the need to reach definitive agreements covering all aspects of their relationships.[17] On another side are those who regard fiduciary norms as moral mandates applicable regardless of actual or presumed intent of the parties.[18] This debate ran its course in the drafting of RUPA and is most evident in RUPA's muddled treatment of the core issue of whether the content and application of fiduciary duties are proper subjects of bargaining.[19]

The colorful phrase "galloping Meinhardism" aptly conveys a contemporary skepticism concerning the usefulness of the opinion.[20] One commentator finds fiduciary duty grounded in religious, rather than economic, norms and describes *Meinhard*'s expression as "at best an aspiration, at worst a costly and confusing distraction, and in no case a legally enforceable rule."[21] Such a statement, of course, assumes legitimacy of a

16. For an interesting exchange of views, see Symposium, *Symposium on the Future of the Unincorporated Firm*, 54 Wash. & Lee L. Rev. 389 (1997).

17. *See e.g.* J. Dennis Hynes, *Freedom of Contract, Fiduciary Duties, and Partnerships: The Bargain Principle and the Law of Agency*, 54 Wash. & Lee L. Rev. 439, 443 (1997) (describing fiduciary duties as reflecting unspoken expectations and rejecting the view of such duties as "natural law").

18. *See e.g.* Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795, 829–30 (1983) ("Courts regulate fiduciaries by imposing a high standard of morality upon them. This moral theme is an important part of fiduciary law. Loyalty, fidelity, faith, and honor form its basic vocabulary." (footnote omitted)); *cf.* Lawrence E. Mitchell, *The Naked Emperor: A Corporate Lawyer Looks at RUPA's Fiduciary Provisions*, 54 Wash. & Lee L. Rev. 465, 471 (1997) (arguing fiduciary standards address a societal interest in business conduct and affairs and should not be subject to contractual waiver).

19. *See e.g.* RUPA § 103(b)(3) (partnership agreement may not eliminate the duty of loyalty but "may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable"); *id.* at § 103(b)(4) (partnership agreement "may not unreasonably reduce the duty of care"); *see also id.* at § 103(b)(5) (partnership agreement may not "eliminate the obligation of good faith and fair dealing [but] may prescribe the standards by which the . . . obligation is to be measured, if the standards are not manifestly unreasonable"); *see generally* Robert W. Hillman, Allan W. Vestal & Donald J. Weidner, *The Revised Uniform Partnership Act* 33–50 (West 2005).

20. *See* Barbara Ann Banoff, *Company Governance Under Florida's Limited Liability Company Act*, 30 Fla. St. U. L. Rev. 53, 59 (2002) (commenting "[w]hether in fact what might be called 'galloping Meinhardism' produced tough liability standards or merely tough rhetoric, and whether fiduciary duties should be all that tough in the first place, was and is open to debate" (footnote omitted)).

21. Dennis J. Callahan, *Medieval Church Norms and Fiduciary Duties in Partnership*, 26 Cardozo L.

norm may only be tested under efficiency parameters and categorically rejects the consideration of noneconomic criteria in developing law. Although the critique lacks elegance, it carries a message nicely articulated by Justice Holmes more than a century ago:

> Nowhere is the confusion between legal and moral ideas more manifest than in the law of contract. . . . The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else. If you commit a tort, you are liable to pay a compensatory sum. If you commit a contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it is advantageous to get as much ethics into the law as they can.[22]

On a personal note, the author acknowledges his own doubts about *Meinhard* in his early academic writings. The doubts were predicated on the apparent gap between the strength of the loyalty standard stated by Cardozo and the extent to which the pursuit of private advantage is tolerated or even encouraged in business relationships even though the gain is at the expense of business partners.[23] The difficulties associated with invoking the protections of fiduciary standards are substantial and serve to undermine the legitimacy of any strong statement of what those standards are. Such a skeptical view of *Meinhard* is shared by many in the academy. Still, the skepticism is difficult to reconcile with the apparent robustness of citations to *Meinhard* in reported opinions.

IV. *MEINHARD* IN THE COURTS

To test the durability of *Meinhard*, a search of both state and federal cases since 1928, the date of the opinion, was conducted. *Meinhard* has been cited in more than one thousand reported opinions.[24] Moreover, there is no indication that the appeal of the opinion is waning, and it continues to enjoy a healthy rate of citations in both state and federal court opinions (see fig. 1).

Rev. 215, 285 (2004) (footnote omitted); *see also* John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L.J. 625, 658 (1995) (noting "Cardozo's incessantly cited opinion"). Langbein further comments:

> Courts sermonize about fiduciary duties without paying adequate attention to the question of whether and why the particular person is a fiduciary and what standards the fiduciary relationship imports in the particular circumstances. When an indignant court follows Cardozo and limits its analysis to sounding off about fiduciary standards being 'stricter than the morals of the marketplace' and 'the punctilio of an honor the most sensitive,' the court is neglecting to discuss whether the underlying deal supports the level of fiduciary obligation that the court invokes.

Id. (footnotes omitted).

22. Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 462 (1897).

23. *See e.g.* Robert W. Hillman, *Private Ordering within Partnerships*, 41 U. Miami L. Rev. 425, 458 (1987) ("Although colorful, the judicial rhetoric inevitably overstates the standard of conduct the law actually imposes on partners. . . . Partners are not disinterested trustees, and the likelihood that most partners operate under a 'punctilio of an honor the most sensitive' standard is remote." (footnotes omitted)).

24. *Infra* app. tbl. 1, at col. 1. A Shepard's search through LexisNexis on January 3, 2006 revealed more than 1,600 citations, including 572 law review articles and seventy-four treatises. For earlier periods covered by this survey, some reported opinions are not in the database and, therefore, are not reflected in these numbers. In response to a telephone inquiry, a LexisNexis representative indicated that the "federal and state combined" search parameter may not be totally inclusive of all reported cases. Although the federal cases may be fully represented, the completeness of the database varies with each state.

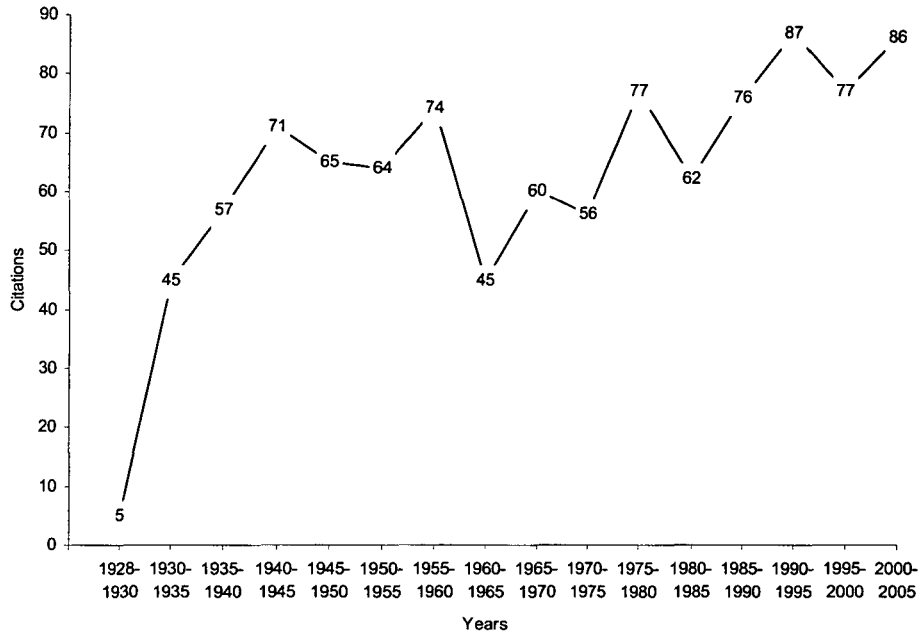

Fig. 1. Federal and state cases citing "*Meinhard v. Salmon*" from 1928 to 2005.

More than forty percent of the opinions citing *Meinhard* not only cite the case but also quote the most enduring language in the opinion referencing a "punctilio of an honor the most sensitive."[25] Again, Cardozo's vivid expression of the standard of conduct expected of fiduciaries spans generations (see fig. 2). Note that fifty-two of these citations occurred in the most recent five-year period (2000 to 2005). The data suggest that the citation frequency has been increasing. Whether this is true, however, is difficult to determine because the search results likely are underinclusive as to cases during earlier periods.[26]

25. *Infra* app. tbl. 1, at col. 2. The search parameters included only the "punctilio" portion of the phrase. For a breakdown of the cases mentioning Cardozo by name, see *infra* app. tbl. 1, at col. 3. For cases referencing partnerships, see *infra* app. tbl. 1, at col. 4.

26. *Supra* n. 24 and accompanying text.

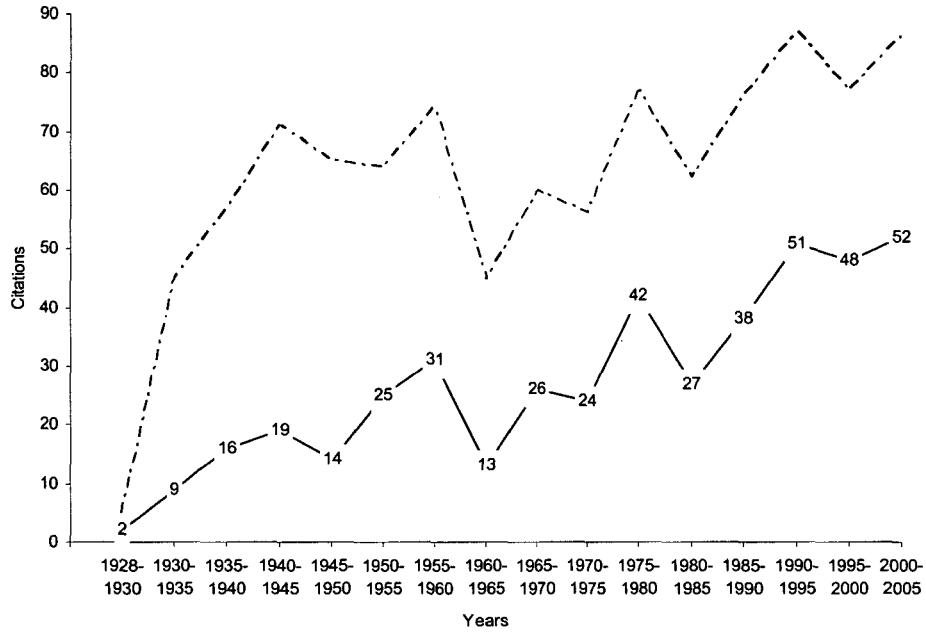

Fig. 2. Federal and state cases citing "*Meinhard v. Salmon*" and "punctilio" from 1928 to 2005.[27]

Forty-four of the quoting opinions during this same period identified Cardozo as the source of the standard, which may suggest an attempt to emphasize the authority underlying the statement of the norm (see fig. 3). The data shown in figure 3 actually understate the vitality of *Meinhard*, as measured by the search parameters employed. With some frequency, the message of *Meinhard* is invoked even though the case itself is not cited.[28] Moreover, even when the case is identified, its name is sometimes misspelled.[29] Undoubtedly, more sophisticated models for empirical research may be

27. The dashed line indicates the total federal and state cases citing "*Meinhard v. Salmon*" during this same period.

28. *Infra* app. tbl. 1, at col. 5. Using the search parameter of "punctilio" within five words of "honor" and not "Salmon," "Meinhard," or "Cardozo" produces sixty cases, many of which are inspired by *Meinhard* even though they do not credit the decision. *E.g. Reoux v. Reoux*, 163 N.Y.S.2d 212, 216 (N.Y. App. Div. 3d Dept. 1957), *aff'd*, 152 N.E.2d 543 (N.Y. 1958) (discussing a confidential relationship between an attorney and a client (the attorney's mother) and noting that the attorney "was bound by the highest punctilios of honor"); *Claude Neon Lights, Inc. v. Fed. Electric Co.*, 295 N.Y.S. 1, 22 (N.Y. App. Div. 1st Dept. 1937) (describing the duties of corporate directors—"[t]he morals of the mart of trade will not do" and "[a] punctilio of highest honor is the inveterate demand of equity").

29. Some spelling discrepancies occur between LexisNexis reports (incorrect) and hard copy reporters (correct). *Compare Tenn. v. Barton*, 1946 Ark. LEXIS 440 at *14 (Ark. Dec. 2, 1946) ("Minehardt"); *Behrman v. Egan*, 1953 N.J. Super. LEXIS 516 at *3 (N.J. Super. Ch. Div. Feb. 9, 1953) ("Neinhard"); *Griffin v. Griffin*, 1965 Vt. LEXIS 259 at *26 (Vt. Oct. 5, 1965) ("Minehard"), *with Tenn. v. Barton*, 198 S.W.2d 512, 517 (Ark. 1946); *Behrman v. Egan*, 95 A.2d 599, 601 (N.J. Super. Ch. Div. 1953); *Griffin v. Griffin*, 217 A.2d 400, 410 (Vt. 1965).

applied to *Meinhard*, but the raw citation evidence is sufficient to demonstrate that the opinion continues to have vitality.[30]

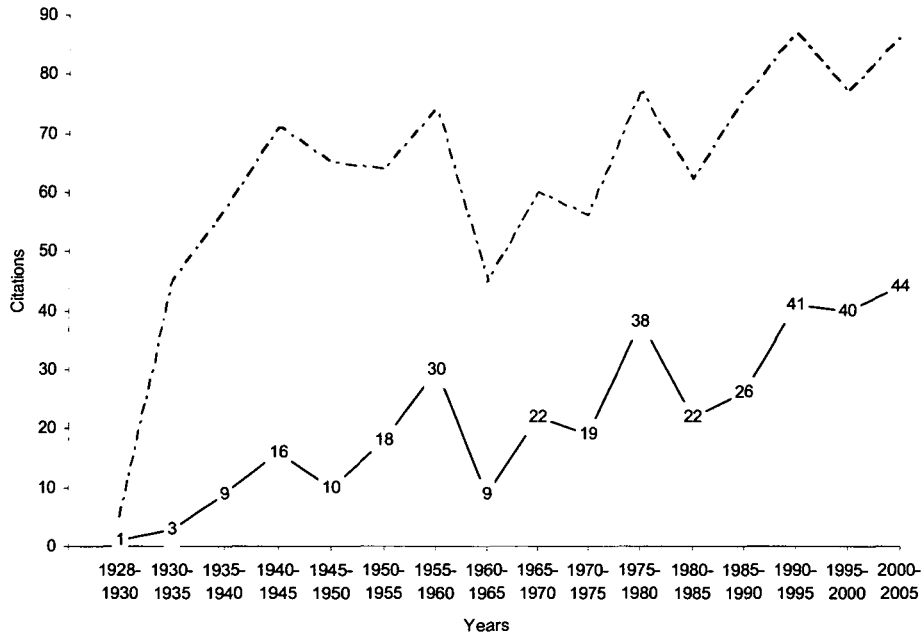

Fig. 3. Federal and state cases citing "*Meinhard v. Salmon*" and "punctilio" and "Cardozo" from 1928 to 2005.[31]

V. THE NORMATIVE QUALITY OF FIDUCIARY STANDARDS, OR WHAT EXPLAINS THE CONTINUING ATTRACTION OF *MEINHARD*?

Is *Meinhard*, as some contemporary academics suggest, simply an excess of rhetoric of little meaning today? The view of *Meinhard* as a relic of the past does find support in an approach that emphasizes efficiency and the use of fiduciary norms as bargain substitutes or gap fillers that can be easily waived or modified by contract. If fiduciary norms serve no function other than to supply missing terms to the bargain of the parties, then the message of *Meinhard* is more ornamental than substantive.

As discussed above, however, the contractarian view of the firm competes with a different approach to fiduciary duty that advances fiduciary norms as serving a function larger than filling gaps in contracts. The moral mandate approach finds in fiduciary duties normative principles to be applied to business relationships without regard to the presumed or fictionalized intent of the contracting parties. Under this view, fiduciary norms express standards of expected behavior that are so fundamental as to be beyond the scope of bargaining. As between the bargain substitute and moral mandate

30. No attempt was made to correlate the *Meinhard* citations with actual results in the cases, although such an empirical study certainly would be a worthwhile undertaking.

31. *See supra* n. 27.

approaches to fiduciary duty, the concept of a "punctilio of an honor the most sensitive" fits more comfortably with the latter.

Still, *Meinhard*'s continuing appeal may reflect its expression of something more than the *law* of fiduciary duty. Law alone does not define the limits of acceptable behavior. An action may be beyond the reach of law but still be wrongful under standards by which society measures conduct. Over time, *Meinhard* has become more an expression of normative ethics than of legal positivism, and those who underestimate its continuing appeal do so with the mistaken assumption that law defines the boundaries of ethical business conduct.

APPENDIX[32]

Years	"*Meinhard v. Salmon*" (1)	"*Meinhard v. Salmon*" & "punctilio" (2)	"*Meinhard v. Salmon*," "punctilio," & "Cardozo" (3)	"*Meinhard v. Salmon*," "punctilio," & "partnership" (4)	"punctilio" & not "*Meinhard*" (5)
1928–1930	5	2	1	2	3
1930–1935	45	9	3	3	1
1935–1940	57	16	9	4	4
1940–1945	71	19	16	2	5
1945–1950	65	14	10	3	7
1950–1955	64	25	18	9	3
1955–1960	74	31	30	9	7
1960–1965	45	13	9	5	6
1965–1970	60	26	22	7	8
1970–1975	56	24	19	8	14
1975–1980	77	42	38	16	20
1980–1985	62	27	22	13	17
1985–1990	76	38	26	14	23
1990–1995	87	51	41	26	25
1995–2000	77	48	40	20	25
2000–2005	86	52	44	25	25
Total	1007	437	348	166	193

Tbl. 1: Federal and state cases citing "*Meinhard v. Salmon*," "punctilio," and other search terms.

32. Based upon data from a search conducted on January 3, 2006 of LexisNexis combined federal and state cases database. Each five-year time window runs from January 1 of the starting year to January 1 of the ending year (e.g., date parameters 1/1/1925 and 1/1/1930). The total number of cases is the sum of the individual number of cases in each date parameter.