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# Fiduciary Law and the Preservation of Trust in Business Relationships

Brian Broughman, Elizabeth Pollman and D. Gordon Smith

## 1 Introduction

Fiduciary law has remarkably wide application, as scholars have shown in recent years, extending the fiduciary principle to elected officials, jurors, voters and other public law contexts. This chapter explores the application of fiduciary law in the more traditional private law context of business relationships, specifically examining the preservation of trust between business parties as an underexplored justification for fiduciary obligations.

It does so by engaging in a simple thought experiment, first inquiring into what the relationship between an entrepreneur and investor would look like without fiduciary law, where the parties rely solely on contract to govern their interactions. Because contracts are inevitably incomplete, after investment there is a risk of opportunistic behavior by whichever party controls the business. While the parties could try to draft a more detailed agreement prohibiting various forms of opportunism, the very act of drafting such an agreement and requesting such protections can undermine whatever trust existed between the parties at the outset of their relationship. Against this backdrop, a vulnerable party may decide to forgo important protections against opportunism rather than signal its distrust of the other party.

From there, we introduce state-imposed fiduciary law into the business relationships to see its impact on both the contract and underlying trust that exists between the parties. Our analysis highlights an overlooked point: the development of trust between contracting parties may depend on whether the parties are required to negotiate for protection against opportunism or whether that protection is provided by the legal system. Negotiation over protection may signal distrust, eliciting costly reactions (defensive measures/hedging/lack of intrinsic motivation) in the counterparty. By contrast, a prohibition limiting opportunism in state-imposed fiduciary

obligations removes the invocation of distrust by either party to the agreement. We further observe that while fiduciary protections can help prevent distrust among a small number of contracting parties, fiduciary protections may prove inadequate in some settings, especially in addressing horizontal conflicts between beneficiaries.

This chapter unfolds as follows. Section 2 examines contractual incompleteness, using as an example the relationship between an entrepreneur and an outside investor to explore how parties cannot contract for all future contingencies, and governance arrangements will still leave noncontrolling parties vulnerable to opportunism due to the exercise of ex post discretion. Further, the relationship between trust and contract is not straightforward. Trust and contract sometimes function as economic substitutes in that the need for contractual detail may arise because the business parties lack sufficient trust at the outset of the relationship, while at other times a party's attempt to push the boundary of contractual completeness can itself undermine trust. Section 3 introduces fiduciary law, first demonstrating its traditional purview in business settings and then explaining how mandatory fiduciary obligations can preserve trust between contracting parties. This section concludes by exploring areas in which fiduciary law is unable to provide effective protection, including situations in which there is a horizontal conflict among vulnerable parties and settings where a fiduciary has other business interests or operates within overlapping roles. The chapter concludes by observing that the limits of contract and fiduciary law leave a residual zone of vulnerability in which trust and other mechanisms of risk reduction play a significant role.

## **2 Contract and Incompleteness**

To isolate the role of trust in business relationships, it is helpful to first imagine a world without fiduciary law. For purposes of this thought experiment, assume the primary parties – an entrepreneur and an outside investor – can enter into a contract to govern their relationship but that such agreement is not backstopped by fiduciary protections. The investor's primary concern is that the financing terms provide sufficient protection to assure the investor that it will – at least in expectation – get a sufficient

economic return to justify the original outlay of capital.<sup>1</sup> Payout to the investor, however, is indeterminate at the time of contracting as it depends on future events and strategies pursued by the firm's management sometime after investment. This setting is a classic agency problem, in which the investor wants to design a contract that causes the agent (i.e., management) to take actions that maximize the investor's economic return.<sup>2</sup>

In a frictionless world with perfect information, the parties might draft a complete contract that specifies exactly what the firm will do and each party's cash flow entitlement for each possible contingency that could arise. With a complete contract, there would be no need for trust because the agreement (by assumption) would anticipate every contingency, and neither the entrepreneur nor the investor would be vulnerable to opportunistic behavior by the other.

Unfortunately, real-world contracts are incomplete. Many future situations cannot be foreseen *ex ante*, and relevant events (even if anticipated) may be unverifiable to a judicial fact finder *ex post* and consequently cannot be the subject of a legally enforceable contract. Furthermore, the real world is not frictionless and drafting a more detailed contract brings with it increasing transaction costs.

Instead of trying to contract directly over *actions* that a business will take in future scenarios, a more realistic approach is to contract over governance structure, namely *who* gets to make decisions when unplanned contingencies arise. As noted by Oliver Hart: "The financial contracting literature takes the view that although the contracting parties cannot specify what decisions should be made as a function of (impossible) hard-to-anticipate-and-describe future contingencies, they can choose a decision-making process in advance."<sup>3</sup> For example, an equity financing contract may give the investor voting rights. An investor can contract for representation on the board of directors and the ability to replace the entrepreneur as CEO. Similarly, the investor may insist on protective

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<sup>1</sup> See, e.g., A. Shleifer and R. W. Vishny, "A Survey of Corporate Governance" (1997) 52 *J. Fin.* 737 (describing the basic problem of corporate governance).

<sup>2</sup> See generally Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *J. Fin. Econ.* 305 (noting that the value of a firm is not fixed but depends on management's consumption of nonpecuniary benefits at the expense of economic returns to investors).

<sup>3</sup> Oliver Hart, "Financial Contracting" (2001) 39 *J. Econ. Lit.* 1079, 1084.

provisions (or negative covenants), requiring investor consent before the firm can take specified actions. Indeed, empirical research documenting financing agreements shows that parties actively bargain over governance rights and that such rights are sometimes decoupled from the underlying financial claims.<sup>4</sup>

Despite the ability to contract over the governance process, the resulting agreement remains incomplete, and the parties remain vulnerable to abuse of discretion by whoever holds decision-making power. The best a contract can hope to accomplish is to assign residual control (i.e., decision-making power) for an issue to the party whose interests are most closely aligned with collective welfare.<sup>5</sup> But it may often be the case that neither the entrepreneur's nor the investor's preferred outcome is the best choice for the firm as a whole. If the entrepreneur is assigned control, she has an incentive to cause the firm to pursue strategies that benefit her personal interest, possibly to the detriment of the investor and other constituents of the firm. If the contract were to instead assign control to the investor, this would merely flip the problem, making the entrepreneur vulnerable to the investor's choice of action. To be sure, various shared control arrangements – such as sharing control with an independent third party – may reduce the risk of opportunistic holdup by a controlling party.<sup>6</sup>

Even so, because of contractual incompleteness, the core problem remains. Ex post, someone must decide on actions for the firm for any contingency not contemplated by the contract.<sup>7</sup> The party (or parties) assigned decision-making rights will often have

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<sup>4</sup> Steven N. Kaplan and Per Strömberg, "Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts" (2003) 70 *Rev. Econ. Studies* 281.

<sup>5</sup> For the purpose of discussion, we use interchangeably the terms "control rights," "governance rights," and "decision-making rights."

<sup>6</sup> For a discussion of how sharing control of the board with a third-party independent director could improve outcomes and reduce ex post holdup, see Brian Broughman, "Independent Directors and Shared Board Control in Venture Finance" (2013) 9 *Rev. L. & Econ.* 41; Brian J. Broughman, "The Role of Independent Directors in Startup Firms" (2010) *Utah L. Rev.* 461; D. Gordon Smith, "The Exit Structure of Venture Capital" (2005) 53 *UCLA L. Rev.* 315; William W. Bratton, "Venture Capital on the Downside: Preferred Stock and Corporate Control" (2002) 100 *Mich. L. Rev.* 891.

<sup>7</sup> Margaret Blair and Lynn Stout described the role of the board of directors as a mediating hierarchy that would resolve disputes between corporate stakeholders. Margaret M. Blair and Lynn A. Stout, "A Team Production Theory of Corporate Law" (1999) 85 *Va. L. Rev.* 247.

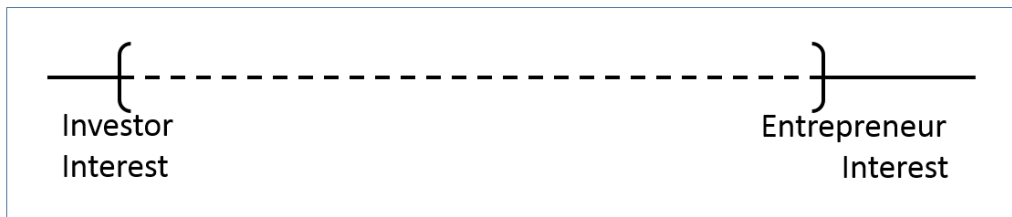
considerable discretion in the choice of action, highlighting vulnerability for noncontrolling parties.

[Figure 1](#) illustrates the issue of ex post discretion under a hypothetical contract between an entrepreneur and an investor. The horizontal line represents a set of strategies/actions that a firm might pursue, arranged from left to right, with strategies on the left benefiting the investor's interests and strategies on the right benefiting the entrepreneur's interest. In both Panel A and B, the dashed line between the brackets represents a "zone of discretion." The controlling party (or parties) can choose any action within the zone of discretion but cannot choose actions that fall outside the bracketed area, as these would be prohibited by contract. For example, the agreement may prohibit the entrepreneur from causing the firm to issue additional debt (or equity) that is senior to (or on par) with the claims held by the original investor without first obtaining the consent of the original investor, or the agreement may prevent substantial changes in the type of assets held by the firm without prior investor consent.

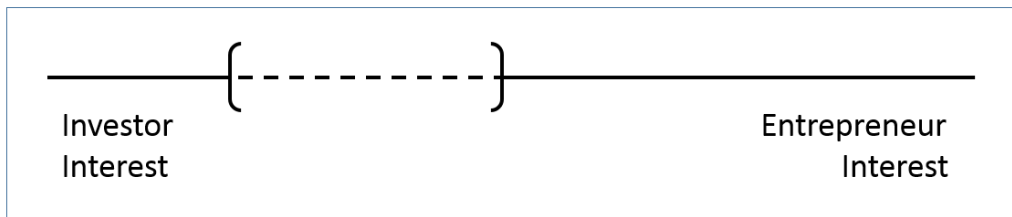
We can think of more detailed contracting as an effort to shrink or reshape the zone of discretion by prohibiting certain actions or putting the entrepreneur on an incentive scheme that reduces the conflict between actions favored by one party as opposed to the other. Panel A represents a simple contract that does little to constrain the controlling party's exercise of its discretion, while Panel B represents a detailed contract that attempts to limit the zone of discretion by prohibiting actions that might benefit one party (especially the entrepreneur) at the expense of the other.

Figure 1: Zone of Discretion Allowed by Contract

Panel A: Simple Contract



Panel B: Detailed Contract



The zone of discretion helps illustrate the role of trust in contract settings. Trust occurs when a party in a position of vulnerability willingly places its fate or well-being in the hands of another (the controlling party).<sup>8</sup>

The interaction between trust and contract is complex. On the one hand, trust and contract function as economic substitutes that are both used to facilitate a business transaction.<sup>9</sup> Trust can remove the need to draft detailed contracts, and a detailed

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<sup>8</sup> On this limited conception of trust, see Larry E Ribstein, "Law v. Trust" (2001) 81 *BU L. Rev.* 553, 555 ("'Trust' differs from the decision to rely. It refers to the willingness to make oneself vulnerable to another without costly external constraints. Trust is socially valuable, and thus society should encourage it. Law relates only to the external constraints that lead to the decision to rely, rather than to trust."); *ibid.* at 568–71 (arguing that law can "crowd out" trust); D. Gordon Smith, "The Critical Resource Theory of Fiduciary Duty" (2002) 55 *Vand. L. Rev.* 1399, 1418 ("[T]o the extent that parties rely on legal constraints for protection, they are not trusting at all, but instead relying on the law of fiduciary duty for protection. Such reliance displaces trust."); Oliver E. Williamson, "Calculativeness, Trust, and Economic Organization" (1993) 36 *JL & Econ.* 453, 463 (It "can be misleading to use the term 'trust' to describe commercial exchange for which cost-effective safeguards have been devised in support of more efficient exchange. Calculative trust is a contradiction in terms."). Of course, contracts are not merely used to regulate ex post behavior in settings of vulnerability but can also clarify shared understandings and even illustrate topics on which the contracting parties do not feel vulnerable. To illustrate, the existence of a contract itself may be predicated (in part) on a shared belief that the parties to the agreement are law abiding.

<sup>9</sup> To be sure, while they are substitutes, trust and contract are not mutually exclusive. For a given transaction, a party may elect to contract over certain issues/risks, while at the same time trusting that their counterparty will not abuse its discretionary power on other topics left unaddressed by the contract.

contract can reduce the need for trust by narrowing the zone of discretion and thereby reducing the risk of opportunistic conduct. As noted by Larry Ribstein, “[t]rust is a kind of social glue that allows people to interact at low transaction cost.”<sup>10</sup> A trusting counterparty may decide to use a simple contract with few legal protections. Trust does not remove the risk of opportunism (especially in a world without fiduciary duties), but it does facilitate simpler contracts and can reduce transaction costs.

On the other hand, the act of drafting, interpreting and enforcing a contract can interfere with trust, suggesting that trust and contract are not merely economic substitutes but different modes of analyzing a problem. To illustrate, consider the challenges in drafting an earn-out clause for a merger agreement. An earn-out is a contingent payment made to the shareholders of a target company based on defined performance measures (e.g., earnings, net income, units sold, etc.) or defined milestones (e.g., creating a market-ready product, passing regulatory hurdles, etc.), which are observed postclosing. For example, management of a target firm may argue that their firm is worth \$30 million, while a prospective acquirer believes the business is only worth \$20 million. Rather than simply *trusting* that the target management forecasts are accurate, the acquirer could offer to pay \$20 million at closing and draft an earn-out clause that will pay up \$10 million extra to the target firm (or an escrow account set up for this purpose) a couple of years after the transaction closes based on a defined measure of postclosing performance.

In theory, an earn-out is a great strategy for addressing price disagreements and solving bargaining problems related to asymmetric information.<sup>11</sup> Yet in practice, earn-outs can magnify postclosing disputes. Control over how the seller’s business is operated after closing may affect the defined performance measure, and consequently the earn-out payment can be manipulated by the controlling party.<sup>12</sup> Contracting over how a business will be run postclosing reflects deep distrust of the acquirer and consequently

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<sup>10</sup> Larry E. Ribstein, “Law v. Trust” (2001) 81 *BUL. Rev.* 553. See also Margaret M. Blair and Lynn A. Stout, “Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law” (2000) 149 *U. Pa. L. Rev.* 1735.

<sup>11</sup> Albert H. Choi, “Facilitating Mergers and Acquisitions with Earnouts and Purchase Price Adjustments” (2017) 2 *J. L. Fin. & Acctg.* 1.

<sup>12</sup> See [ibid.](#)



drafting a detailed earn-out clause to constrain the acquirer's actions or to verify accounting inputs can quickly destroy any trust the parties may have had going into the deal. Practitioners caution that earn-outs "are a nightmare to draft, negotiate and ... to live with" and suggest that often everyone will be better off if the parties "simply compromise on the price."<sup>13</sup>

As the above example illustrates, attempts to push the boundary of contractual completeness can introduce "distrust." Indeed, scholars have noted that the extent of contractual incompleteness is hard to explain based on standard optimal contracting models:

According to standard results in contract theory, an optimal contract should be conditional on all verifiable information containing statistical information about an agent's action or type. Most real-world contracts, however, condition only on few contingencies, and often no explicit contract is signed at all. The costs of writing a complete contract, or the limited ability to foresee all relevant contingencies, can only partially explain the observed contractual incompleteness. There remain many relationships in which a simple contract could help to avoid potentially severe incentive problems at relatively low costs. Nonetheless, many people abstain from writing a complete contract.<sup>14</sup>

While seeming less than optimal, this contractual incompleteness can be understood in the context of the crucial importance of trust in relationships. Because lengthy and detailed contracts, particularly with punishments and other explicit incentives, may signal distrust and add cost or risk, parties may prefer to propose a less complete contract.<sup>15</sup> Of course, social norms surrounding the contracting process also matter, and we think the signal of distrust is likely to be strongest when the proposed changes deviate from market norms.

The notion of distrust as an added cost associated with drafting a detailed contract is also consistent with common intuition in a variety of settings. To illustrate, a prenuptial agreement may be a sensible way to limit vulnerability upon entering into a marriage,

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<sup>13</sup> L. Kling and E. Nugent, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* (LJ Press 2013).

<sup>14</sup> Florian Herold, "Contractual Incompleteness as a Signal of Trust" (2010) 68 *Games & Econ. Behav.* 180. See also M. Halonen-Akatwijuka and O. D. Hart, "More Is Less: Why Parties May Deliberately Write Incomplete Contracts" (2013) *Nat'l Bureau Econ. Res.* (No. w19001) ("Transaction costs and bounded rationality cannot be a total explanation since states of the world are often describable, foreseeable, and yet are not mentioned in a contract.").

<sup>15</sup> Florian Herold, "Contractual Incompleteness as a Signal of Trust" (2010) 68 *Games & Econ. Behav.* 180.

but proposing such an agreement (without regard for specific terms) could be very damaging to trust that might otherwise exist between the individuals.

Various related arguments are sometimes given for why a detailed contract can undermine trust. First, if a contract party requests detailed language to cover certain risks, this may have undesirable signaling effects on the other party. In particular, it may cause the other party to worry that such risks are much greater than originally thought and may even cause the other party to take countermeasures to insure against such risks. Kathryn Spier shows that this can cause the original concerned party to leave such terms out of the agreement, increasing the level of contractual incompleteness rather than signaling its concern and distrust to the other party.<sup>16</sup> Second, a number of experimental studies suggest that adding detailed incentives and prohibitions to a contract can crowd out intrinsic motivations,<sup>17</sup> and – particularly relevant for the current project – the risk of crowding out is heightened if one of the parties to the contract created the particular scheme of sanctions and prohibitions.<sup>18</sup>

### 3 Fiduciary Law and Incompleteness

What can be done to improve upon a world of incomplete contracts and distrust? This is where fiduciary law enters the picture. As noted in the introduction, one underappreciated benefit of fiduciary law is that it is imposed by the state. This fact allows the contracting parties to have some protection against opportunism without either party having to specifically ask for the protection and thereby reveal its distrust of the other. This section first examines the traditional realm of fiduciary law in business relationships and then lays out our core argument for how state-imposed mandatory fiduciary obligations can help solve the distrust problem in an incomplete contract

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<sup>16</sup> K. E. Spier, “Incomplete Contracts and Signalling” (1992) 23 *RAND J. Econ.* 432–43.

<sup>17</sup> E. Fehr and B. Rockenbach, “Detrimental Effects of Sanctions on Human Altruism” (2003) 422 *Nature* 137–40; E. Fehr and K. M. Schmidt, “Adding a Stick to the Carrot? The Interaction of Bonuses and Fines” (2007) 97 *Amer. Econ. Rev.* 177–81; B. Frey, *Not Just for the Money: An Economic Theory of Personal Motivation* (Edward Elgar 1997); U. Gneezy and A. Rustichini, “A Fine Is a Price” (2000a) 29 *J. L. Stud.* 1; U. Gneezy and A. Rustichini, “Pay Enough or Don’t Pay at All” (2000b) 115 *Q. J. Econ.* 791.

<sup>18</sup> See Florian Herold, “Contractual Incompleteness as a Signal of Trust” (2010) 68 *Games & Econ. Behav.* 180.

setting. Finally, this section concludes by acknowledging the limitations of fiduciary law as a solution to distrust. Just as contracts are limited in the effectiveness of their protection, and gaps or incompleteness are inevitable, so too fiduciary law solves some trust-related problems yet ultimately leaves others outside its reach.

## A The Traditional Realm of Fiduciary Law in Business

Certain relationships are not contractual in nature or are not purely contractual, but are “fiduciary.”<sup>19</sup> Every fiduciary relationship has two parties, a fiduciary and a beneficiary, each of which may be an individual, an organization or a group of individuals or organizations. Scholars have set forth numerous theories of the fiduciary relationship.<sup>20</sup> As one of us has argued, “fiduciary relationships form when one party (the ‘fiduciary’) acts *on behalf of* another party (the ‘beneficiary’) while exercising *discretion* with respect to a *critical resource* belonging to the beneficiary.”<sup>21</sup>

In such relationships, the fiduciary acts primarily for the benefit of another and exercises discretion in carrying out an assigned task.<sup>22</sup> The fiduciary may have greater

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<sup>19</sup> D. Gordon Smith, “The Critical Resource Theory of Fiduciary Duty” (2002) 55 *Vand. L. Rev.* 1399, 1402, 1487–91 (explaining that fiduciary duty requires loyalty to the beneficiary, whereas good faith and fair dealing requires loyalty to the deal); Deborah DeMott, “Beyond Metaphor: An Analysis of Fiduciary Obligation” (1988) *Duke LJ* 878, 880 (arguing that equating fiduciary obligation with contract law is erroneous).

<sup>20</sup> See, e.g., Paul D. Finn, *Fiduciary Obligations* (Federation Press 1977); Tamar Frankel, “Fiduciary Law” (1983) 71 *Cal. Rev.* 795; Tamar Frankel, *Fiduciary Law* (Oxford University Press 2011); Deborah DeMott, “Beyond Metaphor: An Analysis of Fiduciary Obligation” (1988) *Duke LJ* 878; Frank H. Easterbrook and Daniel R. Fischel, “Contract and Fiduciary Duty” (1993) 36 *J. L. & Econ.* 425; Robert Cooter and Bradley J. Freedman, “The Fiduciary Relationship: Its Economic Character and Legal Consequences” (1991) 66 *NYU L. Rev.* 1045; Paul B. Miller and Andrew S. Gold, “Fiduciary Governance” (2015) 57 *Wm. & Mary L. Rev.* 455.

<sup>21</sup> D. Gordon Smith, “The Critical Resource Theory of Fiduciary Duty” (2002) 55 *Vand. L. Rev.* 1399, 1402.

<sup>22</sup> Some scholars define the fiduciary relationship in terms of trust and entrustment. See, e.g., Tamar Frankel, “Fiduciary Law in the Twenty-First Century” (2011) 91 *BU L. Rev.* 1289, 1293 (“[F]iduciary relationships involve a crucial component of entrustment.”); Deborah DeMott, “Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences” (2006) 48 *Ariz. L. Rev.* 925, 940 (arguing a fiduciary relationship arises when “the course of the parties’ dealings over time should justify an expectation of loyalty when the relationship has deepened into one in which one party is invited to and does repose substantial trust in the other’s fidelity to the trusting party’s interests or joint interests of the parties.”).

expertise or more time to devote.<sup>23</sup> However, in carrying out the task, the possibility arises that the fiduciary may act opportunistically in exercising discretion or abuse the power bestowed.<sup>24</sup> Furthermore, the beneficiary may lack the time or skill to monitor the fiduciary.<sup>25</sup> With an incomplete contract between the parties, the beneficiary is vulnerable.

Rooted in equity, fiduciary law steps into this relationship to assert certain duties are owed by the fiduciary to the beneficiary.<sup>26</sup> Most importantly, the fiduciary owes the beneficiary a duty of loyalty, a distinctive legal obligation that requires a fiduciary to sacrifice her own self-interest on behalf of her beneficiary, which scholars have described as an obligation to behave in an “other-regarding” fashion.<sup>27</sup> The duty of loyalty does not require complete selflessness on the part of the fiduciary,<sup>28</sup> but it requires that the fiduciary “refrain from self-interested behavior that constitutes a wrong to the

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<sup>23</sup> Frank H. Easterbrook and Daniel R. Fischel, “Contract and Fiduciary Duty” (1993) 36 *JL & Econ.* 425, 437.

<sup>24</sup> See Tamar Frankel, “Fiduciary Law” (1983) 71 *Cal. L. Rev.* 795, 809 (“[W]hile the fiduciary must be entrusted with power in order to perform his function, his possession of the power creates a risk that he will misuse it and injure the entrustor.”).

<sup>25</sup> Larry E. Ribstein, “Fencing Fiduciary Duties” (2011) 91 *BUL Rev.* 899, 904.

<sup>26</sup> Deborah DeMott, “Beyond Metaphor: An Analysis of Fiduciary Obligation” (1988) *Duke LJ* 878, 880–81 (discussing the equitable origins of fiduciary obligation); Henry E. Smith, “Why Fiduciary Law Is Equitable” in Andrew S. Gold and Paul B. Miller (eds.), *Philosophical Foundations of Fiduciary Law* (Oxford University Press 2014) (discussing equity as a safety valve to counter opportunism and as the historical root of fiduciary law).

<sup>27</sup> Margaret M. Blair and Lynn A. Stout, “Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law” (2000) 149 *U. Pa. L. Rev.* 1735, 1783; see also *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) (“[A]n undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.”).

<sup>28</sup> Perhaps the most cited judicial formulation of the duty of loyalty is Justice Cardozo’s opinion in *Meinhard v. Salmon*, in which he described the “duty of finest loyalty” owed by one joint venturer to another in terms of selflessness: “Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation.” 164 NE 2d 545, 548 (NY 1928). As one of us has noted elsewhere, this statement of the duty of loyalty goes too far. See D. Gordon Smith, “The Critical Resource Theory of Fiduciary Duty” (2002) 55 *Vand. L. Rev.* 1399, 1410 n. 43. Indeed, the notion of loyalty may imply something quite the opposite of selflessness – namely, an egocentric motivation for action. See Andrew Oldenquist, “Loyalties” (1982) 79 *J. Phil.* 173, 175 (“Normative judgments based on egoism and normative judgments based on loyalties share the characteristic of containing uneliminable egocentric particulars”).

beneficiary as a result of the fiduciary exercising discretion with respect to the beneficiary's critical resources."<sup>29</sup>

In the business context, persons with managerial power – partners, directors, officers and so forth – are fiduciaries because they exercise discretion over the resources that belong to the business organization.<sup>30</sup> Through statutory and judge-made law, fiduciaries owe the duties of care and loyalty, to act with certain standards of care and to avoid self-interested conduct that wrongs the beneficiary.<sup>31</sup>

In light of this ability of fiduciary law to address the spaces that contracts leave incomplete, business law scholars and economists have described fiduciary duties as “gap fillers.”<sup>32</sup> In business relationships, this gap-filling role of fiduciary law can act as a fail-safe that ex ante specifies standards of fiduciary obligation that will apply in future states of the world that the parties may not foresee.<sup>33</sup> It plays a special role in protecting

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<sup>29</sup> D. Gordon Smith, “The Critical Resource Theory of Fiduciary Duty” (2002) 55 *Vand. L. Rev.* 1399, 1407.

<sup>30</sup> *Ibid.* at 1412 (describing “formal” and “informal” fiduciary relationships).

<sup>31</sup> See, e.g., James D. Cox and Thomas Lee Hazen, 2 *Treatise on the Law of Corporations* § 10 (2018). Some scholars have distinguished the duty of care as not distinctively fiduciary in nature. Deborah DeMott, “Beyond Metaphor: An Analysis of Fiduciary Obligation” (1988) *Duke LJ* 878, 915; Larry E. Ribstein, “Fencing Fiduciary Duties” (2011) 91 *BUL. Rev.* 899, 908.

<sup>32</sup> See, e.g., John C Coffee Jr., “Privatization and Corporate Governance: The Lessons from Securities Market Failure” (1999) 25 *J. Corp. L.* 1, 28 (“[T]he common law’s concept of fiduciary duty both enables and instructs the common law judge to fill in the gaps in an incomplete contract.”); Frank H. Easterbrook and Daniel R. Fischel, “Contract and Fiduciary Duty” (1993) 36 *J. L. & Econ.* 425, 429 (“To say that express contracting is allowed is to say that the law is designed to promote the parties’ own perception of their joint welfare. That objective calls for filling gaps in fiduciary relations the same way courts fill gaps in other contracts.”); Johnathan R. Macey, “An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties” (1991) 21 *Stetson L. Rev.* 23, 25 (“[F]iduciary duties should properly be seen as a method of gap-filling in incomplete contracts.”). For a discussion of fiduciary law as “terms which are expressed or implied into voluntary (contractual and non-contractual) undertakings,” see James Edelman, “When Do Fiduciary Duties Arise?” (2010) 126 *L. Quarterly Rev.* 302.

<sup>33</sup> Robert H. Sitkoff, “The Economic Structure of Fiduciary Law” (2011) 91 *BUL. Rev.* 1039, 1044 (“[T]he loyalty and care standards empower the court to complete the parties’ contract as regards the facts and circumstances as they in fact unfolded ... the fiduciary obligation fills the gap.”).

against vulnerabilities and harms that the beneficiary cannot protect against through contract, regulation or other means.<sup>34</sup>

## B Fiduciary Law as Trust Preservation

The notion of fiduciary obligations as a “gap filler” is inherently a contractual mode of analysis and often leads to discussion of whether fiduciary duties are a default term that the parties can modify if they desire.<sup>35</sup> Even for noncontractarian scholars, fiduciary duties are often premised on the idea that the beneficiary is unable to adequately protect herself through contract or other means.<sup>36</sup> In either case, inadequacy of contract is part of the story. Traditional accounts of fiduciary law as a gap filler rely on transaction costs, inability to foresee future contingencies or lack of verifiable information as reasons that the underlying contract is incomplete and thus in need of a fiduciary backstop.

By contrast, our analysis shows that even if transaction costs are low and relevant events are foreseeable, the parties may nonetheless leave important protections out of the agreement to avoid signaling distrust of their counterparty. It is important to note that our argument for fiduciary law as a device that preserves trust between contracting parties does not depend on contract being *unable* to address the risk of opportunism; rather, it depends on distrust that could arise if the parties were to bargain over

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<sup>34</sup> Tamar Frankel, “Fiduciary Law” (1983) 71 *Cal. L. Rev.* 795, 811 (“If the entrustor can protect himself from abuse of power, there is no need for the intervention of fiduciary law.”); D. Gordon Smith, “The Critical Resource Theory of Fiduciary Duty” (2002) 55 *Vand. L. Rev.* 1399, 1424–25.

<sup>35</sup> Scholars have examined the elimination or waiving of fiduciary duties in a variety of contexts, including LLCs, director exculpation of the duty of care and corporate opportunity carve-outs. See Andrew S. Gold, “On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Entities” (2006) 41 *Wake Forest L. Rev.* 123; Leo E. Strine Jr. and J. Travis Laster, “The Siren Song of Unlimited Contractual Freedom” in Robert W. Hillman and Mark J. Lowenstein (eds.), *Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organization* (Edward Elgar 2015); R. Franklin Balotti and Mark J. Gentile, “Elimination or Limitation of Director Liability for Delaware Corporations” (1987) 12 *Del. J. Corp. L.* 5; E. Norman Veasey and Christine T. Di Guglielmo, “What Happened in Delaware Corporate Law and Governance from 1992–2004: A Retrospective on Some Key Developments” (2005) 153 *U. Pa. L. Rev.* 1399; Gabriel Rauterberg and Eric Talley, “Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers” (2017) 117 *Colum. L. Rev.* 1075.

<sup>36</sup> Tamar Frankel, “Fiduciary Law” (1983) 71 *Cal. L. Rev.* 795, 811.

provisions designed to limit opportunism. This distinction helps explain why fiduciary protection needs to be mandatory if it is to preserve trust.<sup>37</sup>

The following example is illustrative. In settings where fiduciary obligations are simply default rules – as in an LLC – an awkward conversation comes up. Imagine an LLC is formed between two parties: A and B. Party A suggests that they opt out of all fiduciary obligations in their operating agreement. B would prefer to keep the duty of loyalty as part of the agreement, as she is concerned that A may use his discretion to benefit himself at her expense. Further suppose that B's preference for keeping the duty of loyalty is stronger than A's preference for opting out.

If this were an optimal contract, the parties would agree to keep the duty of loyalty in the operating agreement. Yet, if B insists on retaining the duty of loyalty, that could emphasize to A that she does not trust him and thinks of him as the sort of person who takes advantage of others. Signaling this type of distrust is damaging as it (i) can crowd out intrinsic motivations to work on behalf of someone else<sup>38</sup> and (ii) may cause the distrusted party to update his beliefs regarding the character/trustworthiness of his counterparty in return. Following the logic in Spier (1992), B may simply concede to A's request to opt out of the duty of loyalty rather than revealing her distrust. Paradoxically, the freedom of contract (i.e., the ability to opt out) can lead to suboptimal contract terms. The parties are better able to reach a truly optimal agreement if the state makes fiduciary obligations mandatory.<sup>39</sup>

Returning to the illustration in [Figure 1](#), mandatory fiduciary obligations can be understood as an alternative way to narrow the zone of discretion. The controlling party

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<sup>37</sup> To be sure, other arguments have been proposed for why some aspects of fiduciary law are mandatory. See, e.g., John C Coffee Jr., "The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role" (1989) 89 *Colum. L. Rev.* 1618. Our analysis here focuses exclusively on distrust as a separate reason for making (at least some) fiduciary duties mandatory.

<sup>38</sup> See, e.g., Ernst Fehr and Simon Gächter, "Do Incentive Contracts Undermine Voluntary Cooperation?" (2002), Zurich IEER Working Paper No. 34, available at <http://dx.doi.org/10.2139/ssrn.313028>; Dirk Sliwka, "Trust as a Signal of a Social Norm and the Hidden Costs of Incentive Schemes" (2007) 97 *American Economic Rev.* 999.

<sup>39</sup> This suggests that fiduciary opt-outs may be overused in LLC agreements because no one wants to signal distrust. Whether that in fact occurs is an empirical question that (to our knowledge) has not yet been explored by scholars.

(i.e., the fiduciary) is prohibited from engaging in self-dealing or other conduct that might violate the duty of loyalty. To be sure, fiduciary protections are a crude mechanism. Because of the business judgment rule and challenges in bringing a derivative claim in the corporate context, management retains considerable discretion, suggesting that even with mandatory fiduciary obligations, the zone of discretion may be closer to the “simple contract” pictured in Panel A than the “detailed contract” in Panel B.<sup>40</sup>

Nonetheless, business parties benefit from this arrangement to the extent that common-law fiduciary obligations approximate a set of protections that the parties would have requested but for concerns about introducing distrust into the relationship. Our sense is that fiduciary law works quite well at preserving interparty trust in simple settings. For example, fiduciary law is a generally good fit for situations in which there is a single beneficiary or where all beneficiaries have the same interest (e.g., a single class of liquid stock owned by holders with the same terms and without other affiliations with the corporation). State-imposed duties are likely to closely resemble what the parties would have bargained for if they could do so without costs and without damaging trust. Notably, however, many business settings involve horizontal conflicts between beneficiaries or a fiduciary with multiple business interests. The next section addresses this challenge to the ability of fiduciary law to preserve interparty trust.

## **C Limitations of Fiduciary Law as a Solution to Incomplete Contracts and Trust Preservation**

As the above discussion explores, fiduciary law plays a foundational role in business law, which many see as filling gaps in an incomplete contract and which we suggest can help to preserve trust in business relationships. Fiduciary protections are incomplete in some regards, however, and do not provide a perfect solution. In particular, although fiduciary duties can usefully constrain opportunism and protect the development of trust in vertical relationships, such as in a simple principal-agent

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<sup>40</sup> See Melvin Aron Eisenberg, “The Divergence of Standards of Conduct and Standards of Review in Corporate Law” (1993) 62 *Fordham L. Rev.* 437; William T. Allen et al., “Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem” (2002) 96 *Nw. U. L. Rev.* 449.



arrangement, other situations involve complexity that fiduciary duties cannot easily resolve.

Returning again to our example of an entrepreneur and an outside investor, imagine the latter is a venture capital firm that uses a portfolio model for its investments, deploying capital from a fund into multiple start-up companies.<sup>41</sup> Investing in risky innovative start-ups involves problems of uncertainty, information asymmetry, incomplete contracting and agency costs.<sup>42</sup> In response, venture capitalists typically engage in a range of mechanisms to screen, monitor and control their start-up investments.<sup>43</sup> As part of these efforts, venture capitalists often negotiate for designated board seats.<sup>44</sup>

This common practice gives rise to the well-known “dual fiduciary” problem: the venture fund directors have fiduciary duties to the fund itself and its partners, as well as to the start-up corporation and its shareholders.<sup>45</sup> Strategic investors in start-ups that take board seats likewise confront conflicting fiduciary duties. When acting in their roles as directors sitting on the start-up board, courts hold these outside investors to their fiduciary duties owed to the corporation and its shareholders.<sup>46</sup>

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<sup>41</sup> See Ronald J. Gilson, “Engineering a Venture Capital Market: Lessons from the American Experience” (2003) 55 *Stan. L. Rev.* 1067, 1071.

<sup>42</sup> See, e.g., William A. Sahlman, “The Structure and Governance of Venture-Capital Organizations” (1990) 27 *J. Fin. Econ.* 473; Paul Gompers and Josh Lerner, “The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements” (1996) 39 *JL & Econ.* 463, 465; Steven N Kaplan and Per Strömberg, “Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts” (2003) 70 *Rev. Econ. Studies* 281.

<sup>43</sup> For example, venture capitalists stage their financing, use convertible preferred stock that comes with protective terms and contract for covenants to guard against certain unfavorable outcomes. D. Gordon Smith, “The Exit Structure of Venture Capital” (2005) 53 *UCLA L. Rev.* 315, 318–55; Paul A. Gompers, “Optimal Investment, Monitoring, and the Staging of Venture Capital” (1995) 50 *J. Fin.* 1461, 1464; Michael Klausner and Kate Litvak, “What Economists Have Taught Us about Venture Capital Contracting” in Michael J. Whincop (ed.), *Bridging the Entrepreneurial Financing Gap* (Ashgate Pub. Ltd. 2001); William W. Bratton and Michael L. Wachter, “A Theory of Preferred Stock” (2013) 161 *U. Pa. L. Rev.* 1815, 1878–82.

<sup>44</sup> D. Gordon Smith, “The Exit Structure of Venture Capital” (2005) 53 *UCLA L. Rev.* 315, 318–19.

<sup>45</sup> Steven E. Bochner and Amy L. Simmerman, “The Venture Capital Board Member’s Survival Guide: Handling Conflicts Effectively While Wearing Two Hats” (2016) 41 *Del. J. Corp. L.* 1.

<sup>46</sup> *In re Trados Inc. Shareholder Litigation* 73 A.3d 17 (Del. Ch. 2013).

A key area of vulnerability is left regarding other business that investors may pursue, which has the potential to affect the start-up's success. To the extent that an opportunity arises to which the start-up corporation itself has a claim, directors have a fiduciary duty of loyalty not to take it for their own purposes. Fiduciary law does not provide a remedy if the opportunity is not one that belongs to the corporation but rather concerns investment in an entirely different corporation. For example, the duty of loyalty would not constrain a venture capital firm that sits on company A's board from investing in company B, even if both companies were in the same industry and even if it meant that company B might be advantaged.<sup>47</sup>

A related issue that commonly arises is the fiduciary with multiple obligations. Although a fiduciary is prohibited from taking a position adverse to her beneficiary, the law does little to constrain an individual from entering multiple fiduciary relationships with different beneficiaries that are not in direct conflict. The time and resources of the fiduciary are, however, naturally limited. The fiduciary's loyalties may be formally undivided, but she still must make decisions about how to deal with each of the separate beneficiaries, whose interests are competing for her time and attention. One recent report identified twenty-four venture capitalists who hold nine or more directorships at technology start-ups, including one VC who sits on eighteen boards.<sup>48</sup>

Furthermore, the "dual fiduciary" problem also leads to conflicts of interest that do not fit within the traditional framing of loyalty claims. For example, because venture capital is based on a business model that depends on having a few "home runs" in the portfolio,<sup>49</sup> in some instances a venture capital firm would prefer a suboptimal sale or

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<sup>47</sup> Michael Blanding, "What Happens When the Interests of the VC and the Startup Don't Align?" (*Forbes*, June 16, 2016), <https://www.forbes.com/sites/hbsworkingknowledge/2016/06/16/what-happens-when-the-interests-of-the-vc-and-the-startup-dont-align/#388f031ee048> (discussing examples).

<sup>48</sup> See Alfred Lee, "How Many Board Seats Is Too Many?" (*The Information*, Jan. 17, 2018), <https://www.theinformation.com/articles/how-many-board-seats-is-too-many>; see also Bob Zider, "How Venture Capital Works" (*Harv. Bus. Rev.*, Nov.-Dec. 1998), <https://hbr.org/1998/11/how-venture-capital-works> ("The popular image of venture capitalists as sage advisors is at odds with the reality of their schedules. The financial incentive for partners in the VC firm is to manage as much money as possible. The more money they manage, the less time they have to nurture and advise entrepreneurs.").

<sup>49</sup> Bob Zider, "How Venture Capital Works" (*Harv. Bus. Rev.*, Nov.-Dec. 1998), <https://hbr.org/1998/11/how-venture-capital-works> ("Given the portfolio approach and the deal

liquidation of a company rather than its continued operation, which would take ongoing time and resources without providing a large-enough return from the venture capital firm's perspective. Abraham Cable has termed the incentive to withdraw human and financial capital for redeployment an "opportunity-cost conflict."<sup>50</sup> In a similar vein, William Bratton and Michael Wachter have highlighted the conflicts that can arise between the common and preferred shareholders in the "moderate downside" scenario, in which a start-up is not a huge success nor hopelessly insolvent.<sup>51</sup>

These examples of fiduciaries with other business arising from their overlapping roles as investors, the multiple obligations of dual fiduciaries and opportunity-cost conflicts could be characterized as horizontal in nature as they are not traditional, vertically oriented principal-agent relations. A further expansion of fiduciary duties to attempt to solve these kinds of horizontal conflicts is likely undesirable because there is no compelling reason to favor one vulnerable party over the other. In contrast to vertical principal-agent relationships in which mandatory state-imposed duties can approximate what the parties would have bargained for absent cost or concern about signaling distrust; in the horizontal setting, with webs of relationships, it is less clear how to do so. Instead, a significant risk exists that any trust-preserving benefit that the state might provide is potentially outweighed by the possibility of forcing the parties away from the agreement they would have reached in a frictionless world.

An important Delaware decision, *In re Trados*, illustrates the difficulties of applying fiduciary law to business relationships with horizontal conflicts.<sup>52</sup> The case arose in the context of a start-up board composed of two company executives, three venture capital directors with dual fiduciary duties and preferred stock, one preferred stock investor with ties to one of the venture capital directors and one industry expert.

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structure VCs use, however, only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate. ... In fact, VC reputations are often built on one or two good investments.").

<sup>50</sup> Abraham J. B. Cable, "Opportunity-Cost Conflicts in Corporate Law" (2015) 66 *Case W. Res. L. Rev.* 51, 53.

<sup>51</sup> William W. Bratton and Michael L. Wachter, "A Theory of Preferred Stock" (2013) 161 *U. Pa. L. Rev.* 1815; William W. Bratton, "Venture Capital on the Downside: Preferred Stock and Corporate Control" (2002) 100 *Mich L. Rev.* 891.

<sup>52</sup> 73 A.3d 17 (Del. Ch. 2013).

The company had neither failed nor succeeded, and the board decided to enter into a transaction to sell the company at a price that returned capital to the preferred shareholders and funded a management incentive plan, leaving no return for the common shareholders. The court held that directors owe a fiduciary duty to the common shareholders as the residual claimants and applied this rule despite the fact that the preferred shareholders had negotiated ex ante for board seats as constituency directors.<sup>53</sup> This ruling could have the effect of constraining a director's opportunism against certain shareholder beneficiaries, but it potentially comes at the expense of enterprise value maximization, which reflects the interests of all participants.<sup>54</sup> Furthermore, in the start-up context that has evolved past our simple thought experiment of an entrepreneur and an investor in a vertical agency relationship, it is not clear that a fiduciary duty to the common shareholders represents the optimal contract that would be arrived at absent a desire to avoid creating distrust through the bargaining context. Venture-capital-backed start-up companies typically involve founders, executives, investors and employees that have diverging interests in light of their equity with different terms and other affiliations with the corporation.<sup>55</sup> The *Trados* ruling goes beyond filling gaps in an incomplete contract and instead mandates a set of fiduciary obligations that do not fit easily with the bargains made and the aggregate value of interests represented by the corporation.

## 4 Conclusion

In this chapter, we have examined the traditional realm of fiduciary law in business relationships, and we suggest a new explanation for such fiduciary protections being supplied on a mandatory basis by the law – the preservation of trust that might otherwise be eroded through the bargaining process. Fiduciary protections do not provide a perfect solution in all business relationships, however. Although fiduciary

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<sup>53</sup> *Ibid.* at 40–41.

<sup>54</sup> William W. Bratton and Michael L. Wachter, “A Theory of Preferred Stock” (2013) 161 *U. Pa. L. Rev.* 1815, 1885–87, 1904–06; Robert P. Bartlett III, “Shareholder Wealth Maximization as Means to an End” (2015) 38 *Seattle U. L. Rev.* 255.

<sup>55</sup> Elizabeth Pollman, “Startup Governance” (2019) 168 *U. Pa. L. Rev.* 155.

duties can usefully constrain opportunism and preserve trust in vertical business relationships, such as in a simple principal-agent arrangement, other situations involve complexity that pose challenges for fiduciary duty law. We illustrate this observation with examples of various horizontal conflicts, or diverging interests, in the venture-capital-backed start-up context. To the extent that contract and fiduciary law are each incomplete, a residual domain for trust and other mechanisms for risk reduction or self-help remains.