

BREACH OF FIDUCIARY DUTY: ON JUSTIFIABLE EXPECTATIONS OF LOYALTY AND THEIR CONSEQUENCES

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I. INTRODUCTION

Writing in 1908, the American philosopher Josiah Royce characterized loyalty as the ethical principle that unifies and animates all other virtues. Royce defined loyalty as “[t]he willing and practical and thoroughgoing devotion of a person to a cause.”¹ Loyalty in his account necessarily requires submission of other desires to the object of loyalty, which then guides an actor’s conduct.² Royce’s claim was expansive: “Justice, charity, industry, wisdom, spirituality, are all definable in terms of enlightened loyalty.”³ Indeed, Royce believed that many people need loyalty⁴ and that only loyalty to something or someone animates individuals to look outside themselves to take action in the world.⁵

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1. JOSIAH ROYCE, *THE PHILOSOPHY OF LOYALTY* 9 (Vanderbilt Univ. Press 1995) (1908) (italics removed). I am grateful to Eric Orts, who urged me to read Royce’s book.

2. *Id.* at 10.

3. *Id.* at 9.

4. *Id.* at 11 (“Loyalty is a good thing for them.”). Royce’s claim is unusual in focusing on the benefits of loyalty to an actor and not simply the recipient of the actor’s loyal service.

5. *Id.* at 21. Royce also argued that both loyal and disloyal actions have consequences beyond an individual transaction. In the commercial world, an act of

My thesis is much more modest than Royce's. I argue in this Article that the law applicable to fiduciary duty can best be understood as responsive to circumstances that justify the expectation that an actor's conduct will be loyal to the interests of another. Although generally formulated, this understanding of fiduciary duty makes it possible to identify at least tentative patterns in which courts should—and usually do—subject an actor to fiduciary duties to another party in a relationship not conventionally characterized as fiduciary. Focusing on loyalty as the distinctive and unifying element of fiduciary relationships lends a degree of intellectual structure to a large body of cases characterized both by relationships that differ in many other ways and by judicial formulations that may be unenlightening.

Loyalty for the law's purposes, unlike Josiah Royce's, does not mandate an all-embracing "thoroughgoing devotion" to the beneficiary of a fiduciary duty. Its demands neither disregard the autonomy of an actor subject to fiduciary duties nor require an all-encompassing subordination of the actor's interests to those of the beneficiary. Instead, within the scope of their relationship, the fiduciary duty of loyalty proscribes self-dealing by the actor and other forms of self-advantaging conduct without the beneficiary's consent. Fiduciary duties may apply in commercial settings to constrain parties who otherwise are free to pursue or prefer their own interests. Fiduciary duties may also operate to protect parties who are sophisticated and cagy. The legal consequences of disloyalty are distinctive, perhaps reflecting the more general recognition that betrayal is not a mere instance of disappointment.⁶ And the law may protect an expectation that an actor will refrain from treachery when it would be unreasonable to expect "thoroughgoing devotion" from that actor.

Adopting loyalty as the central focus also illuminates the nature and range of remedies available for breach of fiduciary duty. The Article begins by exploring the function served by characterizing breach of fiduciary duty as a tort. This function, which in my assessment is remedial, is significant in situations in which a breach of fiduciary duty causes loss to a beneficiary but no measurable or identifiable profit for the fiduciary. The Article concludes by considering the remedial implications of the fact that many actors subject to fiduciary duties are themselves corporations or other organizations that necessarily must take action through individual agents of their own. Underlying these implications are principles derived from tort law, from agency law, and from principles of

business fidelity is an act of loyalty to that general confidence of man in man upon which the whole fabric of business rests. On the contrary, the unfaithful financier whose disloyalty is the final deed that lets loose the avalanche of a panic, has done far more harm to general public confidence than he could possibly do to those his act directly assails.

Id. at 66–67.

6. ROBERT C. SOLOMON & FERNANDO FLORES, *BUILDING TRUST* 6 (2001). The authors identify discrete categories of disappointment, ranging from "things that didn't work out," mistakes stemming from human error, and disappointments happening by chance, to "blameworthy acts that really are breaches of trust," including the consequences of pretending to have a competence that one lacks and other forms of lying. *Id.* at 130–36.

restitution. The robustness of the remedial response to breach of fiduciary duty reflects the complexity of loyalty's demands and the legal response to disloyalty.

II. BREACH OF FIDUCIARY DUTY AS A TORT

A. Restatement (Second) of Torts

1. Taxonomy and Function

Legal scholars who focus on areas of law in which fiduciary obligation plays a significant role may be surprised by its marginal and sparse treatment within the classificatory scheme of Restatement (Second) of Torts. The scheme itself is intriguing. Despite its limitations as a mode of explanation or justification, legal taxonomy often affords a useful point of departure for further analysis and reflection. Restatement (Second) of Torts section 874 situates breach of fiduciary duty within Chapter 43, on "Rules Applicable to Certain Types of Conduct," a component of Division Eleven, which states "Miscellaneous Rules." The Division covers a wide range of torts and topics, including interference with voting rights,⁷ harm to an unborn child,⁸ and contributing tortfeasors.⁹ Moreover, it is not evident what differentiates the content of Chapter 43 from the preceding Chapter 42, on "Interference with Various Protected Interests."¹⁰

Under section 874, "[o]ne standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation." Comment *b* suggests that the drafters conceptualized in remedial terms the function to be served by characterizing breach of fiduciary duty as a tort, viewing it as a mechanism that enables a plaintiff to recover money damages to compensate for harm done by the breach. According to Comment *b*,

The remedy of a beneficiary against a defaulting or negligent trustee is ordinarily in equity; the remedy of a principal against an agent is at law. However, irrespective of this, the beneficiary is entitled to tort damages for harm done by the breach of [a] duty arising from the relation¹¹

7. RESTATEMENT (SECOND) OF TORTS § 865 (1979).

8. *Id.* § 869.

9. *Id.* ch. 44.

10. Chapter 42 includes § 865 (Interference with a right to vote or hold public office), § 866 (Failure to furnish facilities to a member of the public), § 868 (Interference with dead bodies), and § 869 (Harm to unborn child). Section 867 (Interference with privacy) is omitted as the subject is treated in §§ 652A to 652I. Chapter 43 includes § 870 (Liability for intended consequences—General principle), § 871 (Intentional harm to a property interest), § 871A (Intentionally causing liability), § 872 (Tort liability based on estoppel), § 874 (Violation of fiduciary duty), and § 874A (Tort liability for violation of legislative provision). Section 873 (Causing harm by intentionally false statement) is omitted, as the subject is treated in § 623A.

11. RESTATEMENT (SECOND) OF TORTS § 874 cmt. b (1979). On the available measure of damages for intentional misrepresentation by a fiduciary, see *Fragale v. Faulkner*, where the court noted the lack of uniformity in California cases applying the relevant statutory provisions and held that a beneficiary could recover benefit-of-the-bargain damages and was not limited to out-of-pocket losses. 1 Cal. Rptr. 3d 616, 621–22

Thus, a tort claim for breach of fiduciary duty may require that a plaintiff show harm as part of the prima facie case, as the court held recently in *News America Marketing In-Store, Inc. v. Marquis*.¹² In *Marquis*, a vice president for marketing took copies of e-mails and store lists with him when he resigned from the plaintiff to work for another company. The court found no evidence of use of the plaintiff's confidential information or of any other harm to the plaintiff stemming from the vice president's unquestioned breach of fiduciary duty.¹³ Analogizing to tortious interference with a business relationship, the court held that the plaintiff's failure to prove "an actual or specific quantifiable loss" was fatal to its tort claim.¹⁴ The court also held that monies spent by the plaintiff in investigating its former vice president were not "directly connected to [the vice president's] breach of the duty of loyalty" but were mere preparations for a lawsuit that should not be characterized as a recoverable loss.¹⁵

The tort claim for breach of fiduciary duty may also supplement other remedies available to a plaintiff, ones that do not require any showing of harm. Comment *b* to section 874 recognizes that a plaintiff may be entitled to "restitutionary recovery," to capture "profits that result to the fiduciary from his breach of duty and to be the beneficiary of a constructive trust in the profits."¹⁶ In some circumstances, the plaintiff may recover "what the fiduciary should have made in the prosecution of his duties."¹⁷ Comment *b* concludes on a deferential note, referring the reader to specialized treatment in the Restatements of Agency, Trusts, and Restitution, while noting that "[t]he same underlying principles apply to the liability of other fiduciaries, such as administrators and guardians."¹⁸ In all

(Ct. App. 2003). Under the RESTATEMENT (SECOND) OF TORTS § 549(2) (1977), "[t]he recipient of a fraudulent misrepresentation in a business transaction is also entitled to recover additional damages sufficient to give him the benefit of his bargain with the maker, if these damages are proved with reasonable certainty." In addition, the recipient is entitled to recover "pecuniary loss," defined by section 549(1) to include the difference between the value received and the value given in exchange, plus pecuniary loss "suffered otherwise as a consequence" of relying on the misrepresentation. According to Comment *g*, "the great majority of American courts" make the benefit of the bargain "the normal measure" of damages in deceit actions. In contrast, the "also" in subsection (2) makes the out-of-pocket measure the baseline upon which the plaintiff may additionally seek benefit-of-the-bargain damages.

12. 885 A.2d 758 (Conn. 2005), *aff'g* 862 A.2d 837, 842–45 (Conn. App. Ct. 2004).

13. The vice president, as an agent, breached a duty of loyalty to his principal by taking or using confidential information of the principal without its consent. *See* RESTATEMENT (THIRD) OF AGENCY § 8.05(2) (2006).

14. 862 A.2d at 843 (analogizing to *Appleton v. Board of Educ.*, 757 A.2d 1059 (Conn. 2000)).

15. *Id.* at 843–44.

16. RESTATEMENT (SECOND) OF TORTS § 874 cmt. b (1979).

17. *Id.*; *see also* 2 DAN B. DOBBS, *THE LAW OF REMEDIES* 670 (2d ed. 1993) (noting that a fiduciary who wrongfully takes an opportunity, if "treated as a fiduciary for the profits as well as for the initial opportunity," would "owe[] a duty to maximize their productiveness within the limits of prudent management and might be liable for failing to do so").

18. RESTATEMENT (SECOND) OF TORTS § 874 cmt. b (1979).

cases, “the liability is not dependent solely upon an agreement or contractual relation between the fiduciary and the beneficiary but results from the relation.”¹⁹

Comment *b*'s sketch of the remedial consequences of breach of fiduciary duty appears to assume that references to “in equity” and “at law” will resonate more deeply than they may presently do. The sketch is also noticeably incomplete. As is widely recognized, and as stated in Restatement (Second) of Contracts section 173, a fiduciary's contract with a beneficiary may be voidable by the beneficiary unless the contract both “is on fair terms” and has been assented to by “all parties beneficially interested . . . with full understanding of their legal rights and of all relevant facts that the fiduciary knows or should know.”²⁰ Moreover, a fiduciary may forfeit commissions or other compensation paid or otherwise due during a period of disloyal service, although, at least in the agency context, courts qualify the availability of forfeiture by requiring that the breach have had a deliberate character, often that it have been “wilful” or “egregious.”²¹

As a consequence, it is not unusual that a plaintiff may recover several distinct forms of relief in the wake of a defendant's disloyal action. In the standard agency-law illustration, *Tarnowski v. Resop*, a principal retained an agent to investigate and negotiate the purchase of a business.²² Influenced perhaps by a secret commission paid by the sellers, the agent inspected the businesses only superficially and misrepresented material facts to the principal, then advised the principal to make the purchase. Once the facts came to light, the principal rescinded the sale, offered to return the businesses to the sellers, and demanded the return of his down payment. When the sellers refused, the principal sued and recovered a judgment against them. The principal then sued the agent to recover: (1) the secret commission received by the agent from the sellers; and (2) his losses, including attorney's fees and other expenses incurred in his suit against the sellers, plus costs incurred in operating the businesses prior to rescission. The court held all to be recoverable from the disloyal agent, noting that the principal's rescission

19. *Id.*

20. RESTATEMENT (SECOND) OF CONTRACTS § 173 (1981).

21. For a well-known recent agency case, see *Phansalkar v. Andersen Weinroth & Co.*, 344 F.3d 184 (2d Cir. 2003). In *Phansalkar*, an investment-bank employee assigned to work on a series of transactions accepted stock options and other investment opportunities from clients without the bank's knowledge. *Id.* at 191–93. The court held that the employee forfeited compensation for the entire period, although he received no side benefits through work on a contemporaneous deal, because the employment agreement did not allocate compensation on deal-by-deal basis. *Id.* at 188. On forfeiture generally, see, for example, RESTATEMENT (THIRD) OF AGENCY § 8.01 reporter's note d(2) (2006); RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 36 cmt. e (Tentative Draft No. 3, 2004); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 37 (2000). According to Comment *a* of the RESTATEMENT (SECOND) OF TRUSTS § 243 (1959), the reduction or denial of compensation to trustee who commits breach of trust “is not in the nature of an additional penalty for the breach of trust but is based upon the fact that the trustee has not rendered or has not properly rendered the service for which compensation is given.” And according to Comment *d*, compensation is ordinarily denied to a trustee who misappropriates trust property or “intentionally or negligently mismanages the whole trust.” RESTATEMENT (SECOND) OF TRUSTS § 243 cmt. d (1959).

22. 51 N.W.2d 801 (Minn. 1952).

of the contract with the sellers affected neither the principal's right to recover the side-payment received by the agent nor the principal's right to recover damages from the agent for harm caused by the agent's disloyalty, characterized by the court as tortious.²³

Despite its omissions, section 874 usefully provides a doctrinal anchor for the availability of compensatory damages for breach of fiduciary duty. This may be the sole available remedy when a fiduciary's disloyal conduct is not (or is not very) profitable to the fiduciary in a provable or traceable way but results in measurable harm to the plaintiff.²⁴ In the classic English example, *Nocton v. Lord Ashburton*,²⁵ a solicitor encouraged his client to release a prior lien on property being developed into flats by the client's brother, representing that the result would be "very satisfactory," but did not disclose that he knew that the client's remaining security would be insufficient relative to the amount of the debt owed the client by the developer of the flats. Although the court found that the solicitor "did not consciously intend to defraud his client,"²⁶ the consequence of his client's release was to elevate the priority of a lien held by the solicitor himself on the same property. All might have ended well had the developer not defaulted, leading to loss all around, not profit. The court upheld the client's claim against his solicitor for damages sustained by virtue of the release.²⁷

The remedial principle underlying *Nocton*, often termed "equitable compensation" by English²⁸ and Commonwealth²⁹ authorities in acknowledgment of equity's historical ability to award compensatory monetary relief, underlies section 874 as well. Additionally, by classifying breach of fiduciary obligation as a tort, section 874 recognizes the possibility that in some circumstances, extra-compensatory or punitive damages may become available. While this is not a possibility within traditional conceptions of equitable doctrines and remedies, it is one realized in many U.S. cases when a fiduciary's conduct satisfies local law that determines when punitive damages may be available. These are often cases in which the fiduciary's breaches of loyalty are compounded by other forms of

23. *Id.* at 803–05.

24. Assertion of a tort-based claim for a damages remedy has been characterized as less common than assertion of a right to restitutionary remedies. *See* DOBBS, *supra* note 17, at 668.

25. [1914] A.C. 932 (H.L.) (appeal taken from Eng.).

26. *Id.* at 945.

27. *Id.* at 958 ("The proper mode of giving relief might have been to order Mr. Nocton to restore to the mortgage security what he had procured to be taken out of it, in addition to making good the amount of interest lost by what he did."). Solicitor's counsel failed to object to the lower court's order of assessment of damages sustained by the client through release of security, so the question was "of form only." *Id.* By characterizing Lord Ashburton's claim as one for equitable compensation, the court made the statute of limitations inapplicable. *Id.* at 957 ("The Statute of Limitations would not apply when the person in a confidential relationship had got the [beneficiary's] property into his hands." (citing *Burdick v. Garrick*, [1870] 5 Ch. App. 233)).

28. *See* FRANCIS M.B. REYNOLDS, BOWSTEAD & REYNOLDS ON AGENCY 175 (17th ed. 2001).

29. *See* R.P. MEAGHER ET AL., EQUITY: DOCTRINES AND REMEDIES 636 (3d ed. 1992).

intentionally tortious conduct.³⁰ Characterizing a breach of fiduciary duty as a tort may also enable a plaintiff to press ahead to litigate a claim of breach, despite an arbitration clause in an agreement with the defendant, when the breach concerns conduct and duties apart from the agreement.³¹

2. Nature of the Tort

As situated and as drafted, section 874 does not characterize breach of fiduciary duty as an intentional tort, comparable to the intentional torts encompassed by Restatement Second's Division One, "Intentional Harms to Persons, Land, and Chattels." On reflection, it is unsurprising that breach of fiduciary duty is not characterized as an intentional tort and that it is relegated to an uncharacterized category of miscellany. Many actors who breach fiduciary duties do so without intending to cause harm or without knowing that harm is substantially certain to result.³² A fiduciary may credibly believe that no harm will befall the beneficiary as a consequence of conduct that constitutes a breach of fiduciary duty, such as self-dealing to which the beneficiary does not consent. Nor is a breach of fiduciary duty necessarily an intentionally-inflicted injury, that is an invasion of another's legally protected interest as opposed to infliction of a harm on the person to whom the duty is owed.³³ Indeed, a fiduciary duty may be breached inadvertently or through a failure to exercise care, whether or not that failure can be characterized as negligent. For example, an organization or other principal may breach its fiduciary duty by neglecting adequately to monitor conflicts that may arise between transactions conducted on its own behalf and actions taken on behalf of its principals or other clients.

It's important to distinguish between the elements requisite to establishing a breach of fiduciary duty—which do not include the actor's intention—and how courts may characterize breach of fiduciary duty for other purposes. At least one jurisdiction, Wisconsin, characterizes all claims of breach of

30. *E.g.*, *Gov't of Rwanda v. Johnson*, 409 F.3d 368, 376 (D.C. Cir. 2005) (holding that the district court's determination that a lawyer's "serious fiduciary breaches" warranted an award of punitive damages was not abuse of discretion, but remanding for reconsideration of amount in light of reduction of underlying liability); *Asa-Brandt, Inc. v. ADM Investor Servs., Inc.*, 344 F.3d 738, 746–47 (8th Cir. 2003) (holding that the operator of a grain elevator, which had fiduciary duty to farmers who relied upon it for advice, was subject to liability for compensatory and punitive damages for fraudulently misrepresenting the nature of hedge-to-arrive contracts).

31. *See Episcopal Diocese v. Prudential Sec., Inc.*, 925 So. 2d 1112, 1116 (Fla. Dist. Ct. App. 2006) (holding that fiduciary breach claim did not have to be arbitrated where plaintiff's loss occurred after the termination of its contracts with brokerage firm and after the transfer of its accounts).

32. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 1 (Proposed Final Draft No. 1, 2005) states the circumstances under which a person acts with "intent" to produce a consequence as "the person acts with the purpose of producing that consequence; or . . . the person acts knowing that the consequence is substantially certain to result."

33. RESTATEMENT (SECOND) OF TORTS § 7 (1965) distinguishes between *harm* and *injury*. *Harm* denotes "the existence of loss or detriment in fact of any kind to a person resulting from any cause." *Id.* *Injury* denotes "the invasion of any legally protected interest of another." *Id.*

fiduciary duty as intentional tort claims for limitations purposes, even when the plaintiff alleges that the breach stemmed from negligent conduct.³⁴ This characterization is difficult to rationalize. In *Zastrow v. Journal Communications, Inc.*, in which the plaintiffs alleged that trustees negligently breached duties of disclosure, a majority of the Wisconsin Supreme Court characterized the trustees' conduct as a breach of their fiduciary duty of loyalty.³⁵ The *Zastrow* majority differentiated between such breaches and breaches of duties of ordinary care on the basis of a fiduciary's "conscious assumption of the role of fiduciary, on which the law imposes an obligation of absolute loyalty in all matters relating to the object of the duty"³⁶ Having consciously assumed a fiduciary role, a trustee's negligent breach of any duty constitutes an intentional tort in the majority's analysis. One difficulty with this line of reasoning is that it seems equally applicable to torts committed by any actor who "consciously assumes" a role with fiduciary elements, including many professionals. Indeed, given that "role" is not a legal term of art, perhaps all actors who consciously undertake a course of conduct in which an intentional tort may be committed—such as driving a car—have assumed a role that converts all torts committed into intentional ones. Other courts, in contrast, look to the nature of the tort underlying the plaintiff's claim to determine the applicable limitations period.³⁷

34. See *Zastrow v. Journal Commc'ns, Inc.*, 718 N.W.2d 51 (Wis. 2006); *Beloit Liquidating Trust v. Grade*, 677 N.W.2d 298, 382 (Wis. 2004); see also *Halkey-Roberts Corp. v. Mackal*, 641 So. 2d 445, 447 (Fla. Dist. Ct. App. 1994) (characterizing breach of fiduciary duty as "an intentional tort" for purposes of statute of limitations; employer alleged its former president committed fraud and breached fiduciary duty through improper use of corporate assets).

35. *Zastrow*, 718 N.W.2d at 53.

36. *Id.* at 61. The concurring opinion in *Zastrow* cautions that the majority opinion reaches more broadly than required to decide the case, noting in particular that the majority opinion "might be interpreted as herding some or all fiduciary duties into the pasture of the duty of loyalty." *Id.* at 66. The concurring opinion also notes that the majority ignores the fact that some duties owed by a trustee "are not fiduciary duties at all, but are duties owed by many persons, such as the duty of ordinary care" *Id.* at 69.

37. See *Healey v. Pyle*, No. 89 CIV. 6027, 1992 WL 80775 at *2 (S.D.N.Y. Mar. 31, 1992) (holding that limitations periods applicable to each claim against building manager with whom plaintiff invested money for property's rehabilitations depended on whether plaintiff alleged intentionally or negligently inflicted harm); *Hall v. Nichols*, 400 S.E.2d 901, 905 (W. Va. 1990) (holding that malpractice action against lawyer stemming from erroneous title search was controlled by two-year limitations period applicable to property damage, not one-year period applicable to personal damage). When the applicable limitations period begins to run is a separate question. Compare *Caraluzzi v. Prudential Sec., Inc.*, 824 F. Supp. 1206, 1214 (N.D. Ill. 1993) (holding that, under Connecticut law, limitations period applicable to fiduciary duty claim commenced when plaintiff "discover[ed], or in the exercise of reasonable care should have discovered, the essential elements of his cause of action"), and *Clearwater Trust v. Bunting*, 626 S.E.2d 334, 340 (S.C. 2006) (holding that, under statute applicable to claim against corporate officer, action must be brought within two years after time breach "is discovered, or should reasonably have been discovered," and when breach has not been fraudulently concealed, statute's three-year outer limit is applicable), with *Doe v. Harbor Schs., Inc.*, 843 N.E.2d 1058, 1065–66 (Mass. 2006) (only beneficiary's actual knowledge of fiduciary's breach of duty begins limitations period).

3. Definition of Fiduciary Relationships

The sparse blackletter of section 874 does not itself define the circumstances under which parties are tied by a “fiduciary relation.” According to Comment *a*, “A fiduciary relation exists between two persons when one of them is under a duty to act for or give advice for the benefit of another upon matters within the scope of the relation.”³⁸ Read perhaps more closely than it was intended to be, the Comment *a* definition is potentially both under- and over-inclusive. For starters, the definition has the effect of excluding established categories of actors who are subject to fiduciary duties as a consequence of their status or the position they occupy.³⁹ The directors of a corporation owe fiduciary duties to the corporation and, at least in some situations, to its shareholders.⁴⁰ Directors, however, are not trustees.⁴¹ Directors also are not agents of the corporation on whose board they serve, nor are they agents of the corporation’s shareholders.⁴² This is because a director as such does not serve in a representative capacity with power to affect legal relations between third parties and the corporation or its shareholders and subject to the control of the corporation or its shareholders. If an actor subject to “a duty to act . . . for the benefit of another” is equivalent to the agency-law requirement that an agent consent to “act on behalf of” a principal and subject to the principal’s control,⁴³ the definition appears to exclude directors. Moreover, the formulation in Comment *a* does not capture the status of a corporation’s controlling shareholders, who are subject to fiduciary constraints in transactions with the corporation.⁴⁴ Although a controlling shareholder may act as

38. RESTATEMENT (SECOND) OF TORTS § 874 cmt. a. (1979) (quoting RESTATEMENT (SECOND) OF TRUSTS § 2 (1959)). According to the Restatement (Second) of Trusts itself,

A trust, as the term is used on the Restatement of this Subject, when not qualified by the word “charitable,” “resulting” or “constructive,” is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.

RESTATEMENT (SECOND) OF TRUSTS § 2. The counterpart definition in RESTATEMENT (THIRD) OF TRUSTS § 2 (2003) is comparable, but encompasses charitable trusts.

39. The range of fiduciary actors may explain why many definitions are not exclusive. See, for example, UNIFORM FIDUCIARIES ACT § 1(1) (1922):

“Fiduciary” includes a trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer, or any other person acting in a fiduciary capacity for any person, trust, or estate.

40. See 1 JAMES D. COX & THOMAS L. HAZEN, COX & HAZEN ON CORPORATIONS § 10.01, at 476–78 (2d ed. 2003).

41. See RESTATEMENT (THIRD) OF TRUSTS § 5(g) & cmt. g (2003).

42. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(2) (2006).

43. See *id.* § 1.01.

44. For a general statement of the constraints, see PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.10 (Am. Law Inst. 1994). Delaware cases have long required that a controlling shareholder demonstrate the “entire” or

a corporation's representative and may serve in an advisory role to the corporation or its other shareholders, those capacities are not necessary incidents of holding a controlling interest in a corporation's equity securities.

On the other hand, having "a duty to act . . . for the benefit of another" potentially includes many relationships that do not result in the imposition of fiduciary duties. Any party to a contract who renders performance may arguably act "for the benefit" of the party who receives the performance, whether the performance consists of paying money or tendering services, goods, or anything else of value. And the service of some fiduciaries, like Mr. Nocton, the solicitor, may not in the end *be* beneficial to the person to whom fiduciary duties are owed.

Relatedly, Comment *a*'s definition does not provide much guidance when a plaintiff argues that a particular relationship, albeit not one to which fiduciary duties conventionally apply, nonetheless requires their imposition. The Comment *a* definition, like section 874 as a whole, is also uninformative about the content of the duties owed by a fiduciary. There's no suggestion that fiduciary duty requires an actor to subordinate the actor's pursuit of self-interest in preference to that of the person who receives the performance or to refrain from self-dealing or competing with the person who receives the performance, all conventional elements of fiduciary duty. Comment *a* is also unilluminating on whether all duties owed by a fiduciary should be termed "fiduciary duties," as contemporary partnership legislation characterizes a partner's duties of care,⁴⁵ or whether distinctions should be drawn among a fiduciary's duties, however labeled, and the consequences that follow a breach.

III. JUSTIFIABLE EXPECTATIONS OF LOYALTY

A. Defining Characteristics of Fiduciary Relationships

Over the last few decades, academic scholars have attempted to isolate one defining criterion to specify the circumstances or define the relationships that warrant the imposition of fiduciary duties.⁴⁶ The difficulty is that the

"intrinsic" fairness of a transaction benefiting that shareholder at the expense of non-controlling shareholders. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

45. See REVISED UNIF. P'SHIP ACT § 404(a) (2005) ("The only fiduciary duties a partner owes to the partnership are the duty of loyalty and the duty of care set forth in subsections (b) and (c)."). To the same substantive effect is Uniform Limited Liability Company Act of 1996 section 409(a) (members in member-managed LLC) and section 409(h) (managers in manager-managed LLC).

46. On the characteristics of fiduciary duties and circumstances that warrant their imposition, see Tamar Frankel, *Fiduciary Duties*, in 2 NEW PALGRAVE DICTIONARY OF ECONOMICS AND LAW 127, 128 (1998); J.C. SHEPHERD, *THE LAW OF FIDUCIARIES* (1981); Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 CORNELL L. REV. 767 (2000); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1784 n.129 (2001); Andrew Burrows, *We Do This at Common Law but That in Equity*, 22 OXFORD J.L. STUD. 1, 8–9 (2002); Matthew Conaglen, *The Nature and Function of Fiduciary Loyalty*, 121 L.Q. REV. 452 (2005); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (1988); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993); Lawrence E. Mitchell, *The Death of Fiduciary*

characteristics of even the standard or conventional fiduciary relationships—these include trustee–trust beneficiary, agent–principal, lawyer–client, guardian–ward, director–corporation, and partner–fellow partner and partnership⁴⁷—are too varied to enable one to distill a single essence or property that unifies all in any analytically satisfactory way, as the preceding analysis of section 874 suggests. Emphasizing instead the vulnerability and trusting behavior that a fiduciary relationship may engender does not adequately furnish a basis on which to differentiate among relationships or actors.

Most recently, Professor Gordon Smith articulated a unified theory of fiduciary duty in which the differentiating factor is whether an actor acts “on behalf of another party” and exercises “discretion over a critical resource belonging to the beneficiary.”⁴⁸ Although Professor Smith’s account explicitly ranges more widely than does the trust paradigm, it is tied to property-based accounts of fiduciary relationships; “something lies at the core of the fiduciary relationship and binds the fiduciary to the beneficiary,” a something that is “valued by the beneficiary” albeit “not ordinarily considered property.”⁴⁹ But identifying the core “critical resource” within some conventional fiduciary relationships taxes the theory considerably. For example, an agent possesses power to affect the principal’s legal relations and thereby has “discretion over the principal’s critical resources.”⁵⁰ To fit within the agency context, it is necessary to assign a meaning to the term “resource” distinct from its more intuitive meaning in contexts in which a fiduciary necessarily controls property for the benefit of another. Within the scope of an agent’s actual or apparent authority, the agent has power to take action that results in the imposition of liability on the principal, as well as the imputation of knowledge to the principal in most circumstances, consequences not so naturally captured by the term “resource.”⁵¹

Moreover, when an advisory relationship constitutes the basis for imposing fiduciary duties, Professor Smith’s account emphasizes the advisor’s possession of confidential information imparted by the advisee.⁵² This fails to explain why an advisor’s breach of fiduciary duty may, as in *Nocton*, consist of

Duty in Close Corporations, 138 U. PA. L. REV. 1675, 1682–88 (1990); Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1 (1975).

47. *But see* Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 251 (arguing that the mere status of partners does not subject them to fiduciary duties; partners are subject to fiduciary duties “only as agents or as managers of centrally managed firms”). Professor Ribstein acknowledges that his analysis is at odds with Revised Uniform Partnership Act section 404(a), which subjects all partners to fiduciary duties of care and loyalty, whether or not they are acting as managers or agents. *See* Ribstein, *supra*, at 245.

48. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002).

49. *Id.* at 1404.

50. *Id.* at 1456.

51. Professor Smith acknowledges that “[t]he critical resources at the core of agency relationships are less visible than in trusts and guardianships.” *Id.* On the bases on which the legal consequences of an agent’s conduct are attributed to the principal, see RESTATEMENT (THIRD) OF AGENCY ch. 2 (2006). On imputation of an agent’s knowledge to the principal, see RESTATEMENT (THIRD) OF AGENCY ch. 5.

52. Smith, *supra* note 48, at 1461–62.

self-serving conduct that itself involves no misuse of the advisee's confidential information. Of course, it may be that an advisor's possession of confidential information concerning an advisee renders the advisee more vulnerable to self-serving conduct by the advisor, even conduct not dependent on possession of the information.⁵³ But an actor's possession of another person's confidential information is often not the sole explanation for that person's vulnerability to the actor.⁵⁴ Something else (or more) is needed to explain the well-settled doctrine that *Nocton* exemplifies.

B. Expectations of Loyal Conduct

My suggestion is that the definition of fiduciary relationship be cast in terms general enough to encompass the range of well-established circumstances in which fiduciary duties are conventionally applied, while also providing some analytic guidance to help a court determine whether the circumstances of a particular relationship also justify the imposition of fiduciary duties. The defining or determining criterion should be whether the plaintiff (or claimed beneficiary of a fiduciary duty) would be justified in expecting loyal conduct on the part of an actor and whether the actor's conduct contravened that expectation. This test turns on what is distinctive about fiduciary duties—duties framed to safeguard loyalty to the interests of the beneficiary—as opposed to the wider range of duties recognized by the law, including the wider set of duties—such as an agent's duties of performance⁵⁵ or a trustee's duty of prudence⁵⁶—to which a person who occupies a fiduciary role may also be subject. The approach suggested should also enable a court to examine the fit or relationship between an expectation of loyalty and the specifics of the actor's conduct.

This definition is preferable to the formulations articulated in many cases for two reasons. First, although the definition is stated in general terms, it contains more analytic content. In contrast, less specific formulations applied in cases to determine whether the facts of a particular relationship warrant the imposition of fiduciary duties include whether (1) “justifiable trust” was confided in an actor with “a resulting superiority and influence”;⁵⁷ (2) “influence has been acquired and

53. See *id.* at 1462 (observing that a lawyer “will often be privy to extensive information about a client's assets and investment preferences that would typically not be disclosed in an arm's-length transaction”).

54. In any event, to establish that a lawyer breached a fiduciary duty owed to a client does not require that the client establish the lawyer's possession or misuse of confidential information of the client. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 49 (2000). A lawyer's fiduciary duties as stated in section 16(3) require that the lawyer “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.”

55. See RESTATEMENT (THIRD) OF AGENCY §§ 8.07 to 8.12 (2006). In the Restatement (Second) of Agency, the counterpart duties were termed ones of “service and obedience.” RESTATEMENT (SECOND) OF AGENCY ch. 13, tit. B (1958).

56. See RESTATEMENT (THIRD) OF TRUSTS § 77 (2005).

57. *Alaimo v. Royer*, 448 A.2d 207, 209 (Conn. 1982); see also *Williams v. Dresser Indus., Inc.*, 120 F.3d 1163, 1168 (11th Cir. 1997). In *Williams*, as a matter of law, facts did not establish that the relationship between a manufacturer and a distributorship

betrayed”;⁵⁸ (3) a “special confidence” has been “reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence”;⁵⁹ (4) one party “has gained the confidence of the other and purports to act or advise with the other’s interest in mind,”⁶⁰ or (5) one party has a duty “*created by his own undertaking*, to act primarily for another’s benefit in matters connected with such undertaking.”⁶¹ Indeed, perhaps acknowledging the limitations of definitions formulated at such high levels of generality, some courts themselves reformulate these general standards into statements of more specific patterns of conduct or characteristics,⁶² or emphasize the significance of more specific factors.⁶³ Second, some of the formulations

purchaser was confidential. *Id.* By Georgia statute, a confidential relationship exists “where one party is so situated as to exercise a controlling influence over the will, conduct, and interest of another or where, from a similar relationship of mutual confidence, the law requires the utmost good faith, such as the relationship between partners, principal and agent, etc.” GA. CODE ANN. § 23-2-58 (2006).

58. *Schmidt v. Bishop*, 779 F. Supp. 321, 325 (S.D.N.Y. 1991) (quoting *Penato v. George*, 383 N.Y.S.2d 900, 902 (App. Div. 1976)).

59. *Curl v. Key*, 316 S.E.2d 272, 275 (N.C. 1984) (quoting *Link v. Link*, 179 S.E.2d 697, 704 (N.C. 1971)); *see also* *Fox v. Encounters Int’l*, 318 F. Supp. 2d 279 (D. Md. 2002). In *Fox*, the client of a marriage broker alleged sufficient facts to constitute a fiduciary relationship with the broker. *Id.* at 289. Under Virginia law, a fiduciary relationship exists “when special confidence has been reposed in one who in equity and good conscience is bound to act in good faith and with due regard for the interests of the one reposing the confidence.” *Id.* (quoting *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 595 (Va. 1984)).

60. *Bloomfield v. Neb. State Bank*, 465 N.W.2d 144, 149 (Neb. 1991) (quoting *Boettcher v. Goethe*, 85 N.W.2d 884, 892 (Neb. 1957)).

61. *Martinez v. Assocs. Fin. Servs. Co.*, 891 P.2d 785, 790 (Wyo. 1995) (quoting BLACK’S LAW DICTIONARY 625 (6th ed. 1990)).

62. Massachusetts cases tend to find the existence of a fiduciary relationship when: (1) there is “great disparity or inequality” in the parties’ relative positions; or (2) a disparity in a relationship “has been abused to the benefit of the more powerful party, particularly where unjust enrichment would result.” *See Indus. Gen. Corp. v. Sequoia Pac. Sys. Corp.*, 44 F.3d 40, 45 (1st Cir. 1995). In a commercial context, if the plaintiff has reposed trust and confidence in the defendant, Massachusetts courts “look to the defendant’s knowledge of the plaintiff’s reliance and consider the relation of the parties, the plaintiff’s business capacity contrasted with that of the defendant, and the ‘readiness of the plaintiff to follow the defendant’s guidance in complicated transactions wherein the defendant has specialized knowledge.’” *Id.* (quoting *Broomfield v. Kosow*, 212 N.E.2d 556, 560 (Mass. 1965)). In Texas cases, pattern-derived characteristics include whether (1) the parties sought to profit from a shared risk or the sale of a particular property, or (2) the parties’ relationship was “close, personal [or] family-like.” *Lee v. Wal-Mart Stores, Inc.*, 943 F.2d 554, 558–59 (5th Cir. 1991). *Lee* notes that when the parties’ interests are “inherently at odds,” Texas cases reject “a fiduciary finding.” *Id.* at 559.

63. For a recent example, *see Wal-Mart Stores, Inc. v. AIG Life Insurance Co.*, 901 A.2d 106 (Del. 2006), *aff’g* 872 A.2d 611 (Del. Ch. 2005). In assessing whether a fiduciary relationship existed between an insurance broker and its customer when the broker did not act as the customer’s agent, the court applied the general formulation that “[a] fiduciary relationship is a situation where one person reposes special trust in another or where a special duty exists on the part of one person to protect the interests of another.” *Id.* at 113 (quoting *Wal-Mart Stores*, 872 A.2d at 624). The court noted the broker’s and its

articulated in cases may appear to exclude the possibility that an actor may owe a fiduciary duty to a relatively sophisticated party. For example, the requirement of “resulting superiority and influence” may be understood to deny the protection of fiduciary duties to parties who exercise caution, as may a requirement that trust in an actor be “complete.”⁶⁴ Emphasizing whether a beneficiary is in a position to “monitor” an actor may incorrectly exclude fiduciary duties in a commercial context in which the parties agree that an actor shall be subject to reporting and auditing requirements.⁶⁵

C. Fiduciary Roles and Expectations of Loyalty

A justifiable expectation of loyalty is often based on the fact that the actor in question occupies a role in which the law conventionally imposes fiduciary duties. The parties themselves may create a relationship embodying such a role, as would a settlor who establishes a trust with regard to property held by a trustee.⁶⁶ Creating a fiduciary role may, separately, require action by an official state actor, such as judicial appointment of a guardian or administrator.⁶⁷ However, justifiable expectations of loyalty may arise outside such conventional categories. Circumstances specific to a particular relationship may justify an expectation of loyal conduct from an actor, as explored more fully in Section IV.

Assessing whether a plaintiff’s expectations of loyalty are justifiable is related to, but not identical to, assessing whether they are reasonable.⁶⁸ Focusing on justifiability reinforces the point that fiduciary duties, although necessarily often shaped by or related to any contract between the parties or their conduct more generally, are imposed by the law. Moreover, a plaintiff’s expectation of loyal conduct may be justifiable even when the plaintiff has some basis to doubt whether an actor will fulfill that expectation. This would be so, for example, when an actor occupies one of the conventional fiduciary roles and the plaintiff is aware of patterns of fiduciary transgressions in the actor’s industry or profession.⁶⁹ In

customer’s interests were not aligned, the broker exercised neither dominion nor control over its customer, and the broker did not self-deal. *Id.* at 114. A “finder” who identifies or introduces prospective parties but does not negotiate on either party’s behalf is not an agent. *See Ne. Gen. Corp. v. Wellington Adver., Inc.*, 624 N.E.2d 129 (N.Y. 1993).

64. *See* *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992).

65. On inability to monitor as a defining element, *see id.* at 1381.

66. *See* RESTATEMENT (THIRD) OF TRUSTS § 2 (2003) (defining circumstances requisite to creating trust).

67. *See id.* § 5 cmt. c (contrasting trusts with guardianships and decedents’ estates).

68. The reasonableness of a plaintiff’s expectations is the criterion endorsed by recent scholarship from the Commonwealth. *See* Andrew Tuch, *Investment Banks as Fiduciaries: Implications for Conflicts of Interest*, 29 MELB. U. L. REV. 478, 482–83 (2005); Paul Finn, *The Fiduciary Principle*, in *EQUITY, FIDUCIARIES AND TRUSTS* 1, 26 (T.G. Youdan ed. 1989). Many judicial opinions from Australian courts refer with approval to this criterion “as the theoretical basis of the fiduciary principle.” Tuch, *supra*, at 482 n.24.

69. For an example that did not result in litigation, consider the incident recounted in WARREN A. SEAVEY & DONALD B. KING, *A HARVARD LAW SCHOOL PROFESSOR: WARREN A. SEAVEY’S LIFE AND THE WORLD OF LEGAL EDUCATION* 58 (2005). In 1926, during Professor Seavey’s service as Dean of the law school at the University of

contrast, focusing on whether a plaintiff “reasonably” expected loyal conduct from an actor may implicate the plaintiff’s probabilistic projections of whether an actor in even a conventional fiduciary role will in fact act loyally. This implication overlooks the entitlement to loyal conduct created by fiduciary duties when an actor is subject to them.⁷⁰

Many connections tie duties of loyalty to other duties owed by a fiduciary. Self-interest may bias how other duties are performed, as appears to have been the case with the solicitor’s advice in *Nocton*.⁷¹ As a consequence, some scholars assign an exclusively subsidiary function to duties of loyalty. In these accounts, fiduciary duties’ sole function is to assist in securing the performance of other duties. More specifically, duties of loyalty play an insulation role that attaches adverse legal consequences to conduct by an agent or other fiduciary who undertakes a distracting interest or influence.⁷² Although this generalization helps explain much about the consequences that follow breaches of duties of loyalty, its explanatory force has limits. For example, it is not a defense to an agent or trustee who breaches a duty of loyalty that the agent or trustee can establish that other duties owed the principal were performed with good outcomes for the principal. If duties of loyalty have purely subsidiary functions, it’s odd that the law consistently denies an affirmative defense based on establishing due performance of a fiduciary

Nebraska, he sought a roomier house for his growing family in Lincoln, Nebraska. *Id.* Having found a suitable house, Seavey writes,

I made an offer to the real estate man handling the deal and [seller] told him what she would take, which, unknown to us, was \$500 less than I had offered. With the ethics of the usual real estate dealer, he took the \$500 difference. Later, he was chagrined when I charged him with it and was angered when I told him he had forfeited his commission and owed \$500 to [seller] and \$500 to me. He was willing to settle for \$500 for both and out of consideration for his family I didn’t sue, as that would have ruined him.

Id. It’s not evident from this account whom the “real estate man” represented and, if he represented the seller as her listing agent, on what basis he would be subject to liability to the purchaser as well as to his principal, the seller. Perhaps he misrepresented the seller’s reservation price to the purchaser, Professor Seavey, by that time already an established scholar of the law of agency.

70. “Novices in the stock market may have simple or even blind trust in their brokers, but experienced investors know better. That they remain wary does not mean that they trust less, however. They trust more wisely. They recognize the need to combine trust with information and vigilance.” SOLOMON & FLORES, *supra* note 6, at 100.

71. For an example of the interrelationship between breaches of contract and breaches of fiduciary duty in an agency context, see *Monumental Life Insurance Co. v. Nationwide Retirement Solutions, Inc.*, 242 F. Supp. 2d 438, 449–50 (W.D. Ky. 2003).

72. See Conaglen, *supra* note 46, at 472 (stating that the function of duties of loyalty is “to insulate fiduciaries against situations where they might be swayed from providing such proper performance”); Steven Elliott, *Fiduciary Liability for Client Mortgage Frauds*, 13 TRUST LAW INT’L 74, 81 (1999) (“Directors and trustees are held to fiduciary standards in order to ensure that they are not distracted from their primary duties.”).

actor's duties of performance.⁷³ Thus, a principal may justifiably expect loyal service, not simple due performance of the agent's other duties.

This point has consequences for contractual relations between principal and agent. An agent's disloyalty may constitute a material failure in performance that constitutes the nonoccurrence of a constructive condition of the principal's remaining duties of performance and justifies suspension of the principal's performance under the contract.⁷⁴ If the contract contains a provision requiring that, prior to termination, the principal give the agent notice of and an opportunity to cure any breaches, the "notice and cure" provision protects the agent only if the agent's breach is determined to be curable.⁷⁵ Disloyalty may, in other words, supersede or displace contractual rights that an actor would otherwise have.

IV. NON-CONVENTIONAL, ATYPICAL, FACT-BASED, AND INFORMAL FIDUCIARY RELATIONSHIPS

Without slighting the rich variety of circumstances in which a justifiable expectation of loyal conduct may arise outside the conventional fiduciary categories, an analysis of relatively recent cases suggests the characteristics of relationships and patterns of conduct in which such expectations are likely to arise. It then becomes possible to draw general lines of demarcation to identify circumstances that should justify expectations of loyal conduct. In particular, 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.⁷⁶ Whether an expectation of loyalty is justified may also be a function of an actor's evident allegiances.⁷⁷ If it is evident that any loyalties owed by the actor are oriented elsewhere, an expectation of loyal conduct is not likely to be justifiable. Finally, an expectation of loyal conduct may be justified within a relationship that is closely analogous to a conventional fiduciary relationship.⁷⁸ The force of the analogy often turns on the inability of a party once

73. It has been argued that trust law should embrace such an affirmative defense, which it presently does not. Compare John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929 (2005), with RESTATEMENT (THIRD) OF TRUSTS § 78(a)–(b) & cmt. b (Tentative Draft No. 4, 2005). For developments in corporate law, see AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 5.02 (1994), on the duty of fair dealing of a director or senior officer in transactions with the corporation.

74. On circumstances under which termination of the contract may be justified, see E. ALLAN FARNSWORTH, CONTRACTS § 8.18 (4th ed. 2004).

75. See *Larken, Inc. v. Larken Iowa City Ltd.*, 589 N.W.2d 700, 704–05 (Iowa 1999) (holding that notice and cure provision in hotel management contract did not restrict owner's right to terminate contract when manager engaged in series of self-dealing transactions "so serious that they frustrated one of the principal purposes of the management arrangement, which was to manage the hotel in the best interests of the owner and to be honest and forthright in its dealings").

76. See *infra* text accompanying notes 80–94.

77. See *infra* text accompanying notes 95–101.

78. See *infra* text accompanying notes 102–23.

in the relationship to take self-protective measures to guard against self-dealing and other forms of self-advantaging conduct by the other party.⁷⁹

As the title of this section suggests, terminology for these relationships is far from uniform. Some descriptors may carry connotations that are inaccurate. For example, “informal” may imply that in no respect does a contract or other written instrument define the parties’ relationship. The descriptor “fact-based” may imply that factual determinations are irrelevant to finding that parties have formed a conventional fiduciary relationship. Thus, “non-conventional” or “atypical” may be preferable.

A. The Course of the Parties’ Relationship Over Time

The character or texture of parties’ dealings with each other over time may form a basis that justifies an expectation of loyal conduct. This may be so even though, in the absence of such dealings, either no expectation of loyal conduct would be justifiable or its scope would be much narrower.⁸⁰ Consider in this light the duties of a stock broker upon whom a client has not conferred discretion to engage in transactions in the client’s account without the client’s specific authorization. A broker who requires the client’s specific authorization to execute a transaction on the client’s behalf acts as the client’s agent. As such, unless the client agrees otherwise, the broker’s duty is to act with the care, competence, and diligence exercised by comparably-situated stock brokers and to use any special skills or knowledge that the broker claims to possess.⁸¹ The broker also has a duty to comply with lawful instructions received from the client.⁸² If the broker does not comply with a lawful instruction, the broker is subject to liability for loss caused the client and, additionally, has a duty to inform the client of the unauthorized action and of the courses of action reasonably open to the client, including any right of the client to reject an unauthorized transaction.⁸³ As an agent, a broker also owes duties of loyalty to the client that would be breached if the broker front-runs an order given by the client by trading in advance of executing the order, perhaps in anticipation of its impact on the market price,⁸⁴ or makes other unauthorized use of information furnished by the client, including the fact of the client’s order.⁸⁵

79. See *infra* text accompanying notes 102–04, 115–19.

80. For an illustration of a relationship’s evolution over time, see *Pottenger v. Pottenger*, 605 N.E.2d 1130, 1138–39 (Ill. App. Ct. 1992) (noting no allegation that fiduciary relationship existed between aunt and nephew and his spouse prior to aunt’s granting power of attorney to nephew’s spouse, and holding that nephew and spouse failed to rebut presumption of undue influence afterwards).

81. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).

82. *Id.* § 8.09(2); see also *Pavlovich v. Nat’l City Bank*, 435 F.3d 560, 567 (6th Cir. 2006) (characterizing agent-bank’s duty when account is nondiscretionary as “primarily the very narrow fiduciary duty not to make unauthorized distributions”).

83. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 901 F.2d 1124, 1128–29 (D.C. Cir. 1990).

84. See *Brandeis Brokers Ltd. v. Black*, (2001) 2 Lloyd’s Rep. 359 (Q.B.).

85. For a concrete example, see *infra* text accompanying notes 135–136.

But most cases do not impose on a broker any wider set of fiduciary duties to a client with a nondiscretionary account.⁸⁶ The broker owes the client no duty to warn against improvident transactions, even those large in amount.⁸⁷ However, a broker's duty becomes more robust when the broker elicits a client's trust and urges specific investments upon the client.⁸⁸ A broker's duties may expand in scope when the broker represents itself as especially expert⁸⁹ or the client is especially unsophisticated and reposes confidence in the broker.⁹⁰ Finally, that an account is formally characterized as nondiscretionary is not dispositive when the broker in fact exercises discretionary control over trading in the account.

Similarly, a customer with a deposit account in a bank would not ordinarily be justified in expecting that an overlay of loyalty will supplement the bank's duties incident to the debtor-creditor relationship created by the account. The bank's relationship with its depositor may nonetheless be transformed through the specifics of dealings on behalf of the bank by its agents.⁹¹ For example, in *Estate of DiCesare*, a bank's branch manager and assistant branch manager befriended an elderly customer who visibly appeared to be less than fully competent.⁹² The managers helped the customer open a trust account at the bank naming them as the customer's sole beneficiaries upon his death. The bank's president approved the account without independently investigating to verify the

86. See, e.g., *De Kwiatkowski v. Bear Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002) (holding that broker's ordinary duty to client with nondiscretionary account is to execute orders received from client with competence and diligence).

87. *Id.* at 1302, 1308 (noting that the magnitude of the client's holdings in foreign-exchange futures was comparable to that of some sovereigns).

88. See, e.g., *Hughes v. SEC*, 174 F.2d 969, 971, 976 (D.C. Cir. 1949); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436-37 (2d Cir. 1943).

89. See *Patsos v. First Albany Corp.*, 741 N.E.2d 841, 850 (Mass. 2001). On the range of relationships between brokers and their clients, see JAMES D. COX ET AL., *SECURITIES REGULATION* 1093-95 (2d ed. 1997).

90. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck*, 377 N.W.2d 605, 614 (Wis. 1985) (Abrahamson, J., concurring).

91. See, e.g., *Conte v. U.S. Alliance Fed. Credit Union*, 303 F. Supp. 2d 220 (D. Conn. 2004). In *Conte*, the court held that it was an issue of fact whether a credit union assumed a fiduciary relationship with a long-term customer that would require notifying him prior to liquidating an account for under-collateralization. *Id.* at 227. The customer used a broad range of the credit union's services over 30 years, received and accepted advice of a union employee on a prior occasion of under-collateralization, and all loan receipts over 30 years stated that demand loans were "CALLABLE ON 7 DAYS NOTICE." *Id.* at 228. *Conte* also suggests that the credit union's employment of dual employees with its brokerage subsidiary might be an additional basis for a fiduciary duty owed by the credit union, given the fiduciary duty created by the common-law agency relationship between a customer and a broker. See *id.* at 228-29. For another example of circumstances under which a lender's relationship with a borrower metamorphoses into a fiduciary relationship, see *Capital Bank v. MVB, Inc.*, 644 So. 2d 515, 519-20 (Fla. Dist. Ct. App. 1994). In *Capital Bank*, a loan officer urged a customer to trust him and reassured the customer that he was part of bank's "family." *Id.* at 519. At the loan officer's recommendation, the customer purchased assets of another borrower, thereby relieving bank of the non-performing loan, and the bank did not inform purchaser that the appraisal on which he relied was inaccurate. *Id.*

92. No. 83, 2003 WL 22053336, at *2-3 (Pa. C.P. May 5, 2003).

customer's intentions. The court held the managers and the bank jointly and severally liable to the customer's estate for the amounts removed from the trust account by the officers following the customer's death. The court characterized as confidential the bank's relationship with this particular customer, engendered through his trusting relationship with the two managers, with the consequence that the transactions through which the officers benefited were presumed to be the product of undue influence.⁹³ The court additionally held that the bank breached its duty of reasonable care in training its personnel in dealings with elderly or mentally impaired customers as well as its duty to maintain reasonable internal compliance mechanisms,⁹⁴ points to which I return in Section V.

B. An Actor's Evident Allegiances

The evident direction of an actor's allegiances may either undermine or support a plaintiff's subsequent argument that the plaintiff justifiably expected loyalty to the plaintiff's interests on the part of the actor. This factor may explain divergent outcomes in a pair of cases with investment banks as defendants. In *Walton v. Morgan Stanley & Co.*, a company's management cooperated with the investment bank retained by a potential acquiror, allegedly furnishing the bank with confidential internal earnings projections and instructing the bank to return the information if the acquisition did not occur.⁹⁵ After the bank's original client decided not to proceed to acquire its acquiescent target, two other companies made bids for the target, the bank allegedly having shared the target's confidential projections with one bidder to induce it to raise its bid. Meanwhile, the bank's arbitrage department bought shares in the target for the bank's own account. A majority of the court held that the bank did not become a fiduciary of the target although it received confidential information from the target. At the point it received the information, the bank's allegiance was to its client, the initial potential acquiror. As the majority viewed the relationships in the case, the bank's arbitrage activity breached no duty it owed to the target. The dissent characterized the bank as an intermediary in a cooperative takeover charged with a duty not to use for its own profit information gained solely for that engagement. Even under the dissent's view, the evident focus of the bank's allegiances determines its duties.

The bank's evident allegiance is the factor that distinguishes *Walton* from a more recent case, *EBC I, Inc. v. Goldman, Sachs & Co.*⁹⁶ The company formerly known as eToys, Inc. engaged the bank as the managing lead underwriter for its initial public offering ("IPO"). The final underwriting agreement required eToys to sell 8.32 million shares to the bank for \$18.65 per share, with an option to the bank to buy a fixed number of additional shares to cover overallotments. Under the

93. *Id.* at *10. The court also held that the bank's officers owed fiduciary duties to their customer, which obliged them to act with "the utmost good faith" for the customer's benefit and to "take no advantage for themselves from their acts relating to" the customer. *Id.*

94. *Id.* at *14.

95. 623 F.2d 796, 797 (2d Cir. 1980). Although the bank could have returned the documents containing the projections, it is hard to see how the bank could have returned the underlying information.

96. 832 N.E.2d 26 (N.Y. 2005).

agreement, the bank would offer the shares for public sale at the price stated in the prospectus, which was \$20/share. This structure set the bank's potential profit at 6.75% of the proceeds from the offering. When public trading in eToys, Inc. opened, the stock opened at \$79/share; by the end of the year, the stock closed at \$25/share and, two years later, eToys, Inc. filed a voluntary bankruptcy petition. The complaint brought by its committee of unsecured creditors against the bank alleged that the bank advised eToys without disclosing a material conflict of interest. The undisclosed interest stemmed from an alleged agreement between the bank and favored customers who received allocations of IPO shares requiring the customers to kick back to the bank a portion of any profits they made by selling eToy shares after the IPO. Such arrangements gave the bank an incentive to underprice the IPO to generate higher profits for the favored customers and for itself through the customers' kickback payments, which allegedly amounted to 20–40% of the clients' profits.⁹⁷

The court held that the complaint alleged a breach of fiduciary duty. Ordinarily, the court acknowledged, an underwriting agreement creates only an arm's-length commercial relationship. But a fiduciary relationship may arise when "apart from the terms of the [underwriting] contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone."⁹⁸ The components of that relationship were an "advisory relationship that was independent of the underwriting agreement," in which the client "was induced to and did repose confidence in" the bank's "knowledge and expertise to advise it as to a fair IPO price and engage in honest dealings with [the client's] best interests in mind."⁹⁹ The bank breached its duty of loyalty to its underwriting client by concealing its interest in underpricing the IPO, while advising the underwriting client how best to price its IPO.

What differentiates the relationship in *EBC I* from the relationship in *Walton* is the evident allegiance of the bank as advisor to its underwriting client. Induced as the client in *EBC I* allegedly was to rely on the bank's knowledge, and in the absence of any reason to believe the bank's advice would be directed other than to serving the client's best interests, the client justifiably expected loyal service from the bank. In *Walton*, in contrast, the bank served either as a representative and advisor to companies interested in acquiring a target, or, on the

97. The practices alleged in *EBC I* led to other consequences. *See, e.g., In re eBay, Inc. S'holders Litig.*, 2004 WL 253521, at *5 (Del. Ch. Feb. 11, 2004) (finding that plaintiffs stated a claim for relief when directors of company doing business with investment bank may have breached fiduciary duty to company by accepting preferential allocations of stock in other company's IPOs underwritten by investment bank); *see generally* Therese H. Maynard, *Spinning in a Hot IPO—Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023 (2002). For an example of biased advice by a fiduciary outside the securities context, see *Church of Scientology International v. Eli Lilly & Co.*, 848 F. Supp. 1018, 1020 (D.D.C. 1994), involving a public relations firm that represented both church and pharmaceutical-industry clients who threatened to terminate representation because of church's well-known opposition to anti-depressants. The court held that it was an issue of fact whether the public relations firm breached a fiduciary duty by giving distorted advice to church. *Id.* at 1027–28.

98. *EBC I*, 832 N.E.2d at 31.

99. *Id.*

dissent's account, as a neutral intermediary. Either way, the target lacked justification for believing that the bank would be loyal to its interests as opposed to those of other known clients or that it would refrain from self-advantaging conduct.¹⁰⁰

The alleged consequences of the bank's conduct in *EBC I* also differ from those in *Walton*, in which the target alleged no harm stemming from the bank's risk arbitrage. In contrast, in *EBC I*, the plaintiff's allegation that the bank deliberately underpriced eToy's IPO implies that the post-IPO trading gains realized by the bank's favored customers came at the expense of eToys. Although the court's opinion does not address what remedies might be appropriate,¹⁰¹ in *EBC I*, unlike *Walton*, the bank's profit appears to be directly correlated to the plaintiff's loss. To be sure, an issuer might well anticipate that the underwriter will typically distribute IPO shares to its institutional and retail clients, who invest in the anticipation that the IPO stock will rise in after-market trading, and thus realize that the underwriter may tend to underprice. However, that realization doesn't foreshadow the prospect that an underwriter who undertakes to advise on how best to price IPO shares has deals with IPO investors in place to receive direct pay-offs in amounts proportional to the investors' trading profit.

C. Inability to Self-Protect

A plaintiff may justifiably expect loyal conduct from an actor when either the nature of their relationship or of the specific role occupied by the actor leaves the plaintiff unable to self-protect against the actor's misconduct once the relationship is formed or the actor assumes the specific role. Either explicitly or implicitly, the justification for such expectations turns on an analogy to a consequence of the structure of conventional fiduciary relationships. Once a principal and an agent form a relationship of agency, just as once a settlor creates a trust relationship with respect to property, the principal and the trust's beneficiaries, however sophisticated they may be, are no longer able to self-protect against misconduct by the agent or the trustee, at least until it comes to light. As a principal has power to terminate an agent's actual authority at any time, even when the termination may breach a contract between the principal and the agent,¹⁰² a

100. Likewise, a subsequent case holds that *EBC I* does not support a fiduciary relationship between an issuer of securities and the underwriter's counsel. *See HF Mgmt. Servs. LLC v. Pistone*, 818 N.Y.S.2d 40, 42–44 (App. Div. 2006). Given the underwriter's statutory due diligence defense, based on its counsel's work, the court found no basis on which to conclude that the underwriter's counsel acted on the issuer's behalf. *Id.* at 44.

101. The plaintiff additionally claimed "additional damages incurred by eToys as a result of Goldman Sachs' misconduct causing the failure of the business and its eventual bankruptcy." *EBC I*, 832 N.E.2d at 30 n.3. The court affirmed the lower court's determination that "the 'proximate cause of the damages claimed is an issue of fact inappropriate for determination at this juncture.'" *Id.* (quoting *EBC I v. Goldman Sachs & Co.*, 777 N.Y.S.2d 440, 444 (App. Div. 2004)).

102. *See* RESTATEMENT (THIRD) OF AGENCY § 3.10(1) (2006).

principal may reduce its jeopardy from subsequent misconduct by the agent.¹⁰³ A trust's beneficiaries, in contrast, lack a comparable power of ready termination.¹⁰⁴

Although a justifiable expectation of loyalty on this basis often stems from the necessity to impart valuable information not otherwise generally available to an actor so that the actor may fulfill a specific role, in some cases the information in question may already be known to both parties. For example, in *Chou v. University of Chicago*, a graduate student and research assistant in molecular genetics and cell biology became obligated to assign her inventions to the university when she accepted her appointment.¹⁰⁵ Her supervising professor (also the department's chair) assured her he would use care to protect her inventions, with proper credit to her. Instead, patent applications filed by the professor stemming from the student's research either listed him as the sole inventor or did not name the student as a co-inventor. Economic consequences followed. Under the university's patent policy, inventors received a percentage share of gross royalties and the stock in new companies formed to exploit their inventions, and the supervising professor eventually held stock in a licensee and sublicensee of resultant patents. The court held that the facts alleged in the student's complaint were adequate to plead a fiduciary duty applicable to her supervising professor "with respect to her inventions," given the "disparity of their experience and roles and [professor's] responsibility to make patenting decisions regarding [student's] inventions."¹⁰⁶

What does the work in *Chou* are the professor's role and the student's consequent vulnerability, not simply the professor's access to confidential information. The professor already had legitimate access to information about the student's inventions. His role is analogous to that of an agent; the student justifiably could believe that her professor, acting in some sense as her representative in preparing patent applications, would not use that role in a self-serving manner that excluded her interests. The court additionally held that university itself subject to liability on respondeat superior grounds for the professor's breach of fiduciary duty and for his fraudulent concealment of his misappropriation of his student's inventions, a point to which I return in Section V.

An analogy to the consequences of an agency relationship may also engender justifiable expectations of loyal conduct when confidential information must be relayed to an actor to enable the actor to carry out a delimited function. The plaintiffs in *Groob v. Keybank* sought a bank loan to enable them to buy a business.¹⁰⁷ The loan application required disclosure of due-diligence information concerning the business. The applicants met with two bank officers who, after

103. But an agent may continue to act with apparent authority following termination of actual authority. *See id.* § 3.11.

104. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b (Tentative Draft, 2006) (noting that a justification for trustees' unyielding duty of loyalty is the fact that "unlike many other fiduciary situations, trust beneficiaries are neither readily able to dispose of their interests nor able to fire or vote out their fiduciaries").

105. 254 F.3d 1347, 1356–57 (Fed. Cir. 2001).

106. *Id.* at 1362–63.

107. 843 N.E.2d 1170, 1172 (Ohio 2006), *rev'g* 801 N.E.2d 919 (Ohio Ct. App. 2003).

allegedly congratulating the applicants for finding “the goose that laid the golden egg,”¹⁰⁸ turned down the loan application. Subsequently, the spouse of one of the bank officers, armed with the applicants’ due-diligence information, made an offer on essentially the same terms to acquire the business, which the seller accepted. Although an arm’s-length relationship between a bank and a loan applicant does not create a fiduciary relationship,¹⁰⁹ the loan applicants in *Groob* gave their own due-diligence information to the bank’s officers without expecting that the officers would use their information to buy the very business the applicants sought a loan to acquire. By a 4–3 majority, the Ohio Supreme Court held that the bank did not owe the loan applicants a fiduciary duty.¹¹⁰ Only “special circumstances,” not present on the *Groob* facts, create a fiduciary duty between a bank and a prospective borrower, in the majority’s view; that the loan applicants trusted the bank to keep their due diligence information confidential does not create any obligation not to use the information other than for the applicant’s interests. The dissent, characterizing the facts as “outrageous,”¹¹¹ emphasized the expectation held by bank customers that the bank is obliged to treat the sensitive information they provide the bank as confidential, an expectation paralleled in the conduct of most banks.

But what justifies this expectation? As *Walton* illustrates, not every instance in which a person relays confidential information to a financial institution engenders a justifiable expectation of loyal conduct. In the analysis of the *Groob* dissenters, once a loan applicant discloses information to the bank as required by the application process, the bank attains a position of superiority and becomes subject to “a limited fiduciary duty” that makes it improper for the bank to use the information for its own benefit.¹¹² In contrast, the *Groob* majority finds an expectation that an actor’s conduct will be loyal unwarranted unless it can be shown the actor was “aware” that special trust had been reposed in it.¹¹³ Like the

108. *Groob*, 801 N.E.2d at 922.

109. *Id.* at 924. In Ohio, this is so even if the bank gives advice to the applicant. See *Umbaugh Pole Bldg. Co. v. Scott*, 390 N.E.2d 320, 323 (Ohio 1979) (cited in *Groob*, 801 N.E.2d at 924).

110. *Groob*, 843 N.E.2d at 1175–76. Cases from other jurisdiction reach the opposite result on relatively similar facts. See *Pigg v. Robertson*, 549 S.W.2d 597, 598–99 (Mo. Ct. App. 1977) (holding that confidential relationship could be found where loan applicant went to bank and explained acquisition proposal to defendant who turned out not to be a bank employee and purchased the property himself); *Djowharzadeh v. City Nat’l Bank & Trust Co.*, 646 P.2d 616 (Okla. Civ. App. 1982) (purchase made by spouses of bank’s chair and president). In other cases, it is less evident whether the bank or its agents benefited by revealing a loan applicant’s confidential information in a manner allegedly injurious to the applicant. See *Jordan v. Shattuck Nat’l Bank*, 868 F.2d 383 (10th Cir. 1989); *Dolton v. Capitol Fed. Sav. & Loan Ass’n*, 642 P.2d 21 (Colo. Ct. App. 1981). A bank that offers to handle financing for a customer to retain the customer’s loan but neglects to do so and affirmatively misleads the customer to forestall her departure may be subject to liability on several grounds, including breach of a confidential relationship. See *Brandriet v. Norwest Bank, N.A.*, 499 N.W.2d 613, 618 (S.D. 1993).

111. *Groob*, 843 N.E.2d at 1180 (Pfeifer, J., dissenting).

112. *Id.*

113. *Id.* at 1175 (“A bank does not owe a fiduciary duty to a prospective borrower unless it is aware of a *special* repose or trust.”).

approach of the majority in *Walton*, the *Groob* majority makes it attractive for parties who transmit confidential information to financial institutions to do so only pursuant to explicit agreements that articulate the recipient's duties with precision. If the *Groob* dissent correctly assesses the expectations with which most bank customers surrender information to the bank, creating incentives for agreements that explicitly define duties of confidentiality and loyalty only adds to lending transactions the cost of formalizing expectations on the basis of which most lending relationships already proceed. It is also hard to see how a bank would not be "aware" of the likely consequences of how it structures its business dealings with customers, which necessarily require that loan applicants surrender sensitive information to the bank's agents.

Moreover, the relationships in *Groob* differ from those in *Walton*. The loan applicants in *Groob* chose the commercial bank to which they applied for a loan. The bank lacked the evident allegiance to another client present in *Walton*. And the business to be acquired in *Groob* was a small private venture, unlike the target in *Walton*, which was visibly in play in a public securities market. Separately, the relationships in *Groob* consist of a mixture of "true" agency and agency-like elements. The officers who received the loan application on behalf of the bank acted as its agents even though they also hijacked the applicants' due-diligence information and business opportunity for their own purposes.¹¹⁴ But the officers also arguably served a quasi-agency role in relationship to the loan applicants as well. Loan officers function as necessary intermediaries between loan applicants and lending institutions, such that a loan applicant may justifiably believe that confidential information transmitted to the institution via its loan officer will not be diverted to the officer's own purposes.

In contrast, a plaintiff's position in a particular relationship may enable it readily to self-protect against subsequent disloyalty by the other party to the relationship and may suggest no basis on which the party's failure to self-protect would be explicable by a justifiable expectation of loyalty. If so, the analysis advanced in this Article does not support a claim based on breach of fiduciary duty. Consider in this light the facts of *Steelvest, Inc. v. Scansteel Service Center, Inc.*, a Kentucky case in which a corporate officer arranged financing for his competitive venture prior to resigning.¹¹⁵ Although it is blackletter agency law that an agent may take otherwise lawful actions to prepare to compete once the agency relationship is terminated,¹¹⁶ Kentucky appears to apply a more stringent rule to corporate officers and directors that has the effect of requiring resignation prior to

114. *Groob* also holds that the bank could not be subject to vicarious liability as a consequence of its officers' conduct because their self-serving motivations placed their conduct outside the scope of employment. *Id.* at 1178. The officers did not act with apparent authority because the evidence did not show that the bank represented to the applicants that the officers were "authorized to use their information for purposes other than reviewing their loan request." *Id.* at 1179. This treatment of apparent authority is in conflict with long-established authority elsewhere. *See infra* note 130.

115. 807 S.W.2d 476, 478–79 (Ky. 1991).

116. RESTATEMENT (THIRD) OF AGENCY § 8.04 (2006).

preparatory activities.¹¹⁷ The *Steelvest* court upheld the former employer's claim against the bank with which the officer arranged financing because, perhaps unsurprisingly, the bank also served the former employer.¹¹⁸ The court held that the bank acted disloyally toward its prior customer by agreeing to finance its officer's prospective competitive venture. But what would have justified the employer's expectation that the bank would not finance a prospective competitor? Nothing evident in the *Steelvest* opinion suggests that the bank either committed to any exclusivity in its banking relationship with the employer¹¹⁹ or that the bank otherwise acted wrongfully, as by misusing information about its prior customer. Unlike the bank officers in *Groob*, that is, the *Steelvest* bank did not hijack or otherwise misuse information furnished by its customer to advantage itself.

D. Further Analogies

An agency relationship is not the sole basis of analogical support for an expectation of loyal conduct by an actor. For example, analysis in some cases depends on assessing the aptness of an analogy between the facts of the parties' relationship and the structure and duties implicit in a partnership relationship.¹²⁰ A difficulty posed by these cases is the inescapable question of why the parties' relationship should warrant the imposition of a partner's fiduciary duties on a participant in the relationship when legally determinative earmarks of partnership are missing, such as a definite agreement to share profits stemming from an

117. *Steelvest*, 807 S.W.2d at 483–84 (reversing summary judgment for defendants, noting that former corporate officer “sought legal and accounting advice, made active efforts to acquire bank financing, and recruited investors, two of whom, coincidentally, were chief executive officers of major customers of [employer]”). Only recruiting senior officers of customers as investors, if seen as a proxy for recruiting customers, would breach a soon-to-be-former agent's fiduciary duty in most jurisdictions, because it would constitute competition with the principal. See RESTATEMENT (THIRD) OF AGENCY § 8.04 cmt. b.

118. *Steelvest*, 807 S.W.2d at 485–86.

119. The absence of a non-compete provision in an agreement with an actor who is not otherwise subject to fiduciary duties may be indicative that the actor is not subject to a loyalty-based duty to refrain from competition. See, e.g., *Tousa Homes Inc. v. Phillips*, 363 F. Supp. 2d 1274, 1280–81 (D. Nev. 2005).

120. See, e.g., *Flight Concepts Ltd. v. Boeing Co.*, 38 F.3d 1152, 1158 (10th Cir. 1994) (applying Kansas law and holding that aircraft manufacturer did not owe fiduciary duty in absence of showing that manufacturer agreed to act for benefit of licensor of experimental aircraft design or “deliberately assumed” fiduciary responsibilities); *Lee v. Wal-Mart Stores, Inc.*, 943 F.2d 554, 558 (5th Cir. 1991) (noting that one characteristic in Texas cases finding fiduciary relationship is parties' attempt to profit from a shared risk or from the sale of particular property); *Zackiva Commc'ns Corp. v. Horowitz*, 826 F. Supp. 86 (S.D.N.Y. 1993). In *Zackiva*, the court held that it was a material issue of fact whether a minority shareholder failed to disclose a conflict of interest to a fellow minority shareholder. *Id.* at 91. The shareholders agreed to share confidential information and adopt a common negotiating strategy in the sale of stock. *Id.* at 88. During negotiations with a stock acquiror, the defendant shareholder was allegedly simultaneously engaged in negotiations with the same party about compensation stemming from a separate transaction. *Id.*

ongoing business, or a joint venture, that is a partnership relationship whose scope is limited to a single project.¹²¹

One answer might be credible-seeming assurances of loyalty to shared interests given by one party to others in the relationship that induced the others not to press for greater formalization and specification in its terms. In such cases, the admissibility of parol evidence to show the parties' intentions matters greatly when the parties have also entered into a contract that on its face does not support the existence of a partnership or joint venture relationship. In the best-known recent case, *Krantz v. BT Visual Images, L.L.C.*,¹²² a distributor alleged that its relationship with a supplier of video conferencing units constituted a joint venture and that the supplier breached its fiduciary duties when it shut the distributor out of participation in an especially valuable contract. The distributor alleged that it had fostered the relationship with the customer, developed a customized system for that customer, then proposed to the supplier that they bid jointly when the customer solicited proposals for a large contract. Despite alleged oral assurances by the supplier that the distributor would profit through supplying other brand name components for the systems, which the distributor would also assemble and install, the parties' written "teaming agreement" did not articulate any definite division of profits anticipated from servicing the customer. The court agreed with the distributor that contradictions among provisions in the "teaming agreement" could fairly be supplemented by parol evidence explanatory of the parties' intention.¹²³

Fiduciary duties are also conventionally based on the existence of a relationship of trust and confidence when one party undertakes to give advice to another in more than an incidental or casual manner. Thus, the trust that a client may repose in a lawyer underpins the restrictions imposed on business dealings between lawyer and client.¹²⁴ Although parties are assumed to deal at arms length in connection with the formation of a fiduciary relationship—for example, in negotiating the terms under which an agent will represent a principal—it's possible that a relationship of trust and confidence may precede formation of the eventual fiduciary relationship, with the consequence of enhancing duties of disclosure and other duties of fair dealing. In commercial settings, such relationships may arise when one actor has unique access to information highly material to the other party's decisions. In the leading agency case, *Martin v. Heinold Commodities, Inc.*, the plaintiff opened an account to trade in a then-unusual and complex type of overseas commodities option contract. He received a document from the brokerage firm informing him that each contract would have three components: (1) a premium for the option contract itself; (2) a commission; and (3) a "foreign service fee" equal to 20% of the premium.¹²⁵ The court held that the brokerage firm had a duty to inform the plaintiff that the "foreign service fee" represented, not any

121. A partnership is formed by "the association of two or more persons to carry on as co-owners a business for profit." UNIF. P'SHIP ACT § 202(a) (1997).

122. 107 Cal. Rptr. 2d 209, 212–13 (Ct. App. 2001).

123. *Id.* at 218–19.

124. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 126 cmt. b (2000).

125. 643 N.E.2d 734, 738 (Ill. 1994).

additional expense it would incur to execute orders for the plaintiff, but an additional commission to be retained by the firm. In the court's assessment, the plaintiff's inability to assess the nature and relative magnitude of the fee made him dependent on the brokerage firm for this information. Or, as stated in a subsequent case, "even in the absence of any general fiduciary duty resulting from discretionary authority," a broker has a duty to disclose that its fee and commission structure would result in "exorbitant commissions" bearing no relationship to those charged in a competitive market.¹²⁶

V. ORGANIZATIONS IN FIDUCIARY ROLES

Many actors subject to fiduciary duties are themselves organizations, including corporations, partnerships, and other forms of legally-recognized entities or persons. Such actors necessarily deal with parties external and internal to the organization through employees and other agents. It is helpful to consider briefly the implications of the fact that, when such a principal breaches a fiduciary duty it owes to a third party, the conduct that constitutes the breach on the ground level is the conduct of an employee or other agent that is attributed to the organization. As some of the cases discussed already illustrate, the agent's conduct may have been motivated solely by the agent's own self-serving purposes, as opposed to any purpose approved by the organization itself. It is, of course, possible that the agent responded to signals of all sorts generated within the organization in a manner not transparent to those outside the organization, even in the retrospective light cast by litigation, a fact reflected by the robust contemporary operation of the agency-law doctrine of apparent authority.¹²⁷ Among the agents discussed so far, the bank officers in *DiCesare* and *Groob*, and possibly the professor in *Chou*, appear to have been motivated solely by self-serving interests as opposed to furthering the interests of their organization, however misguided their actions might appear in retrospect to have been.

When an individual agent's conduct breaches a duty of loyalty owed to a third party by that agent's organizational principal but constitutes a frolic and detour of the agent's own, analytically distinct bases underlie the principal's accountability to the third party, potentially carrying somewhat different consequences for remedies available against the principal. One might frame the question as an inquiry defined by tort law, by agency law, and by restitutionary principles.

Framing the question as an inquiry dominated by tort law, one might turn first to whether an organizational fiduciary itself was at fault and thus subject to direct liability. Direct liability would result when the organization has failed to use reasonable care in selecting its agents or in monitoring compliance within its organization, as the court found to have been the case in *DiCesare*. When fault cannot be shown on the part of the organization itself, it may be determinative of the outcome whether the individual's conduct falls within the scope of

126. United States v. Szur, 289 F.3d 200, 212 (2d Cir. 2002).

127. See RESTATEMENT (THIRD) OF AGENCY § 2.03 cmt. c (2006).

employment for purposes of the employer's vicarious liability.¹²⁸ In most jurisdictions, an employee who intentionally acts in a wrongful manner and with no interest of serving the employer's interests is characterized as having acted outside the scope of employment,¹²⁹ which would mean that an organizational agent or other principal would not itself be accountable for a significant class of fiduciary transgressions on the part of its own employees and other agents and would not be subject to a duty to compensate their victims. However, a well-established doctrine in agency law has the effect of complementing and expanding the extent to which an organizational agent or other fiduciary may be subject to vicarious liability. If an employee or other agent, in dealing with another party, acts with apparent authority in taking action that constitutes a tort or enables the agent to conceal its commission, the principal is subject to vicarious liability to the third party. An agent acts with apparent authority when the third party with whom the agent interacts reasonably believes that the agent acts with actual authority on the basis of a manifestation of the principal, which may include placing the agent in a particular position or giving the agent a particular title.¹³⁰ That the agent acted without actual authority and that only the agent benefited from the tort are not defenses to the principal.

Agency law provides an additional perspective on the question in how it characterizes the relationship between an organizational agent or other fiduciary and the employees or other agents it engages to work on behalf of a particular principal or other client. Agency's perspective is that an agent's own employees and other agents assigned to a particular account are subagents; they owe fiduciary

128. The *Chou* court found that the professor's conduct fell within the scope of employment for purposes of respondeat superior. *Chou v. Univ. of Chi.*, 254 F.3d 1347, 1361–62 (Fed. Cir. 2001) (“While university faculty are not agents of the university with respect to the selection and conduct of their research projects, they may well be agents with respect to implementing policies of the university, including ownership of inventions and compensation therefor.”).

129. See RESTATEMENT (THIRD) OF AGENCY § 7.07. An employer's vicarious liability for punitive damages does not follow automatically in all jurisdictions. See *id.* § 7.03 cmt. e; RESTATEMENT (SECOND) OF TORTS § 909 (1979); see also *Capital Bank v. MVB, Inc.*, 644 So. 2d 515, 521 (Fla. Dist. Ct. App. 1994) (holding that the trial court incorrectly denied bank's motion for directed verdict on punitive damages). In *Capital Bank*, a bank officer who misled a customer lacked unilateral authority over lending decision and was neither the bank's managing agent or primary owner, nor a member of bank's board of directors or its loan committee. *Id.* The bank also was not independently at fault for the officer's conduct. *Id.*

130. See RESTATEMENT (THIRD) OF AGENCY § 2.03 (defining apparent authority); § 7.08 (principal's vicarious liability for tortious conduct committed with apparent authority). For a recent application, see *White v. Consolidated Planning, Inc.*, 603 S.E.2d 147, 157–59 (N.C. Ct. App. 2004), holding that a financial planning firm may be subject to liability for an employee's misappropriation of customer's funds in the course of activities that the employee was permitted to perform. English law recognized this basis for a principal's liability in *Lloyd v. Grace, Smith & Co.*, [1912] A.C. 716 (H.L.) (appeal taken from K.B.), in which a solicitor's managing clerk disposed of a client's properties for his own benefit, having been authorized by the solicitor to accept deeds to the properties from the client who wished to sell them. This well-established line of authority is ignored in *Groob*. See *supra* text accompanying note 114.

duties both to the agent who employs or otherwise appoints them—their appointing agent—and to the appointing agent’s own principal. An appointing agent is responsible to the principal for a subagent’s conduct, subject to the terms of any agreement between the appointing agent and the principal.¹³¹ The appointing agent’s responsibility stems from its delegation to the subagent of functions that it owes to the principal. In assessing the quality of performance received from the subagent, it may be helpful to the principal to know the terms of the appointing agent’s agreement with the subagent, including the basis on which the subagent will be compensated.¹³² An appointing agent may well resist furnishing this information because it may reveal information useful to the appointing agent’s competitors.¹³³ In any event, common-law agency does not generally mandate its disclosure.¹³⁴

131. See RESTATEMENT (THIRD) OF AGENCY § 3.15(1). A subagent, whether or not an employee, is subject to liability to the appointing agent for loss caused by the subagent’s breach of duty. See *Kramer v. Nowak*, 908 F. Supp. 1281, 1286 (E.D. Pa. 1995).

132. For this point in the context of relationships among managed care organizations (“MCOs”), physicians with whom they contract, and patients who determine whether to file medical-malpractice claims, see Kathryn Zeiler, *Turning from Damage Caps to Information Disclosure: An Alternative to Tort Reform*, 1 YALE J. HEALTH POL’Y L. & ETHICS 385, 394–97 (2005). Disclosure of whether an MCO compensates a physician on a fee-for-service basis or through a capitated arrangement keyed to payment of a fixed amount per month per patient may shape how the patient assesses the quality of the physician’s service. *Id.* at 395–96. Such disclosure, by signaling that care provided by an MCO will comply with norms of professional quality, may benefit the MCO because it may reduce the number of malpractice claims filed; knowing that the MCO compensated the physician on a basis that did not set the physician’s financial self-interest at odds with the patient’s interest in receiving care that complies with professional norms, a patient who experiences an adverse outcome is less likely to file an expensive malpractice suit against the MCO. *Id.* at 396.

133. *Id.* at 397.

134. But see RESTATEMENT (THIRD) OF AGENCY § 8.11 cmt. b (noting that a prospective agent’s duty to deal fairly with a principal “may require a prospective agent to furnish the prospective principal with information that is not otherwise reasonably available to the prospective principal and that is material to the principal’s decision whether to engage the agent”). Changes in the relationships between an organization and actors who furnish services to third parties may affect the quality of service provided when the changes reduce prior constraints on how actors perform their work. For example, it is reported that when hotels outsource the provision of concierge service from employees to third-party providers of concierge services, travelers who use the service may become skeptical when they learn that the actor providing it is not a hotel employee. Hannah Karp, *The Concierge’s Secret Agenda*, WALL ST. J., Sept. 8, 2006, at W1. This is because outsourcing shifts the actor’s incentives:

While old-style, hotel-employed concierges receive commissions of up to 15% on some bookings—say, from a limousine company—they have an incentive to keep guests happy so they’ll return to the hotel. By contrast, third-party concierges are employed by companies that make money on commissions from suppliers And because hotels are often being paid to host these outside concierges, analysts say they may be more lenient about the quality of service.

Although regulatory structures applicable to particular industries and relationships may articulate additional or alternative requirements, consider the application of common-law agency analysis to a recently reported incident of misconduct within the securities industry. The head of a firm of “day traders,” who engage in rapid buying and selling, induced brokers who worked at branch offices of large brokerage firms to leave their telephones off the hook so that, via telephone, the day traders could eavesdrop as information of large orders was disseminated within the brokerage firms. The firms’ practice was to broadcast large orders via a firm-wide “squawk box” prior to their execution. Thereby informed of the impending orders, the day traders could buy or sell the security in advance of execution of the order of the client who relayed it for execution to its agent, the brokerage firm.¹³⁵ In exchange for leaving their phones off the hook, the brokers received cash payments from the day trading firm, often disguised as commissions for securities trades. The brokers’ conduct contravened internal restrictions imposed by their firms on use of information conveyed by squawk box. The brokers’ conduct also contravened their duty of loyalty to the principals on whose behalf the firm received and executed orders by communicating the confidential information that the orders represented to a third party, the day-trading operation.¹³⁶ In common-law agency terms, the individual brokers were subagents appointed by brokerage firms, themselves agents acting on behalf of the clients as principals who placed orders for execution with a firm.

But characterizing the individual employees or other agents of an organizational agent or other fiduciary does not by itself determine what consequences should follow for the organization when individuals breach fiduciary duties owed to third parties. That an organizational agent or other fiduciary is subject to liability to compensate for harm stemming from a breach of fiduciary duty is a straightforward proposition. Principles of restitution help explain the availability of other remedies against the organization. One who benefits from her own breach, or in consequence of another’s breach, of a fiduciary duty is accountable for that benefit to the person to whom the fiduciary duty was owed.¹³⁷ It follows that a defendant’s liability on this basis is a function of the benefit that defendant received. If the defendant—such as an organizational agent or other fiduciary—did not benefit through an individual actor’s breach, it has no benefit to give up to the beneficiary.¹³⁸

Id. Interestingly, concierges employed by outsource services often “dress in hotel uniforms and are instructed not to identify their employer,” *id.*, perhaps suggesting that hotel guests would treat disclosure of the concierge’s employer as material to their decisions whether and how to use the concierge’s services.

135. See Aaron Lucchetti & Kara Scannell, *How Day Traders Turned Squawk-Box Chatter Into Profits*, WALL ST. J., Aug. 23, 2005, at A1.

136. See RESTATEMENT (THIRD) OF AGENCY § 8.05(2).

137. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 43(1) (Tentative Draft No. 4, 2005).

138. See RESTATEMENT (SECOND) OF AGENCY § 406 cmt. b, illus. 1 & 2 (1958):

1. P employs A, a real estate agent to sell Blackacre for him. A entrusts the transaction to B, one of his employees. Without A’s knowledge, B misrepresents to T, a prospective purchaser, the condition

Thus, in *Tarnowski v. Resop*, had the principal retained a firm to act as his agent in investigating and negotiating the purchase of a group of businesses, the subagent to whom the firm assigned the matter would breach both his own and the firm's duties of loyalty to the principal by secretly accepting a commission from the businesses' sellers. Both the firm and the subagent would be subject to liability to compensate the principal for his losses but only the subagent would be subject to liability to pay over the amount illicitly received from the sellers.

Agency law suggests one final perspective. If a firm ratifies its subagent's conduct, the firm's ratification creates the legal consequences of actual authority after the fact by assenting to be bound by the legal consequences of the subagent's conduct.¹³⁹ The subagent's conduct should be treated as that of the firm itself on the same principle that subjects a fiduciary to liability to account for profits made by third parties whose profit-making the fiduciary has made possible.¹⁴⁰ An agent

of the premises, and for this misrepresentation P is subject to liability to T. A is subject to liability to P for the loss to P caused by B's conduct.

2. Same facts as in Illustration 1, except that B is bribed by T to sell Blackacre at a low price. A is subject to liability to P for the loss to P thereby caused, but not for the amount of the bribe received by B unless it comes to A's hands.

139. See RESTATEMENT (THIRD) OF AGENCY § 4.02. An agent acts with actual authority when the agent reasonably believes, in accordance with manifestations of the principal, that the principal wishes the agent so to act. The consequences for the firm of ratifying a subagent's conduct should likewise follow if the subagent acted with initial actual authority.

140. See *SEC v. Warde*, 151 F.3d 42, 49 (2d Cir. 1998) (holding tippee gains are attributable to tipper "regardless of whether benefit accrues to the tipper" because prohibition on insider trading "would be virtually nullified if those in possession of such information, although prohibited from trading for their own accounts, were free to use the inside information on trades to benefit their families, friends, and business associates"); *Gelfand v. Horizon Corp.*, 675 F.2d 1108, 1111 (10th Cir. 1982) (finding that real-estate broker could be subject to liability for profits made by others as a consequence of broker's breach of fiduciary duty, on the theory "that the trustee is not to be free to authorize others to do what he is forbidden"); see RESTATEMENT (SECOND) OF TRUSTS § 225(2) (1957) (stating that trustee is subject to liability to beneficiary for act of an agent that would constitute a breach of trust if done by the trustee, if the trustee, *inter alia*, "directs or permits" or "approves or acquiesces in or conceals" the agent's act); 1 GEORGE E. PALMER, LAW OF RESTITUTION § 2.11, at 153 (1978) (stating that liability of corporate insiders for profits made by tippees of corporate information "can be based upon breach of the fiduciary's duty of loyalty, by using for his own benefit or disclosing for the benefit of others confidential information that should be used only in the interest of the corporation"). According to Bogert and Bogert,

If the disloyalty of the trustee consists in authorizing his agents to engage in disloyal transactions with respect to the trust property (for example, by purchasing claims against the trust at a discount and collecting them at a higher figure), the trustee may be compelled to pay into the trust fund an amount equal to the profits made by the agents, although the trustee did not profit in any way by their activities.

GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS & TRUSTEES § 543(V), at 449 (repl. vol. rev. 2d ed. 1993). The authors characterize this outcome as involving a

whose conduct is ratified by the principal, like an agent who acts with actual authority, acts rightfully as the principal's representative in interacting with third parties, making the agent's conduct the full legal counterpart of action taken directly by the principal itself.

One might wonder *why* a firm would ratify a subagent's breaches of fiduciary duty or even might—through its superior or managerial agents—manifest to a subagent that such misconduct will be acceptable prior to its occurrence. Condoning disloyal conduct by subagents directed toward a firm's clientele seems likely to injure the firm's business reputation over the long term. But managers' perspectives do not always embrace the long term, just as managers' incentives may not coincide well with the interests of the firm itself. In particular, a manager may believe that condoning fiduciary transgressions provides an attractive mechanism through which the firm may retain specific subagents, a mechanism that moreover shifts onto third parties burdens of compensation otherwise borne directly by the firm and charged against the manager's budget.

VI. CONCLUSION

Josiah Royce's book on loyalty, with which this Article begins, does not consider what role the law may play in nurturing or reinforcing the virtue of loyalty, except implicitly as the law may define outer limits on the acceptable objects of one's loyalty. The Article illustrates that although the law's demands on fiduciaries are not identical to Royce's "thoroughgoing devotion,"¹⁴¹ the law lends multidimensional support when one person is justified in expecting loyal conduct from another. Remedies for disloyal conduct come in many stripes and hues.¹⁴² Their amplitude both reinforces and helps define the legal character of duties of loyalty. Among the available remedies, the tort-based claim and its associated remedy enable recovery of damages for harm caused by a breach of fiduciary duty, thereby complementing and supplementing other remedies.¹⁴³ Moreover, the tort-based claim also underlies theories of liability that turn on whether an organization or other principal was itself at fault in connection with its agents' conduct and whether the agents acted with apparent authority in conduct that constituted a breach of fiduciary duty.¹⁴⁴

Focusing on loyalty as fiduciary duty's distinctive and animating force also lends some analytic structure to cases in which the question is whether an actor should be subject to a fiduciary duty outside the conventional or typical fiduciary categories. This focus frames the analysis of these cases around what's distinctive about fiduciary duty in all relationships to which it is applicable. Within this frame, general lines of demarcation can be drawn around circumstances in which one party should justifiably expect loyal conduct from another.

"penalty" that emphasizes "the preventative or deterrent features" of relief, as opposed to "the mere preservation of the trust property by an award of damages." *Id.*

141. See *supra* text accompanying note 1.

142. See *supra* text accompanying notes 17, 20–23, & 30.

143. See *supra* text accompanying notes 11–12, 24–29.

144. See *supra* text accompanying notes 128–30.