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# A Theory of Fiduciary Relationships: Non-Contractual Foundation of the Duty of Loyalty, Disgorgement Damages, and Strict Liability

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# A THEORY OF FIDUCIARY RELATIONSHIPS: NON-CONTRACTUAL FOUNDATION OF THE DUTY OF LOYALTY, DISGORGEMENT DAMAGES, AND STRICT LIABILITY

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<Abstract>

A fiduciary is a person who undertakes to act for the benefit of another person. He owes the duty of loyalty to beneficiary, is required to disgorge any unauthorized gain from his position, and has the burden of disproving his disloyalty in litigation. This article presents a theory that unifies a wide variety of human relationships as fiduciary relationships and explains how the law regulating these relationships works as a coherent legal system. Its theoretical foundation is the legal impossibility of self-contract, its analytical framework is a variant of trust game, and its justificatory principle is that of both corrective justice and Pareto optimality.

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## 1. WHAT IS FIDUCIARY RELATIONSHIP?

Among many legal concepts in Anglo-American law, one of the most alien and therefore the most mystifying to economists is the concept of “fiduciary relationships.”

> Who is a fiduciary? A fiduciary is a person who undertakes to act in the interest of another person. It is immaterial whether the undertaking is in the form of a contract. It is immaterial that the undertaking is gratuitous. Indeed, in England where the courts of equity have always been strict in the enforcement of fiduciary obligations of a trustee, a trustee is ordinarily entitled to no compensation for his services unless it is otherwise provided by the terms of the trust. (Austin W. Scott (1949): 540-41)

Examples of fiduciary relationships include guardian in relation to ward, trustee in relation to beneficiary, corporate manager in relation to corporation, agent in relation to principal, partner in relation to fellow partners, doctor in relation to patient, attorney in relation to client, priest in relation to penitent, and fund manager in relation to investor.

The American Law Institute’s *Restatement Third, Trusts* has characterized a fiduciary relationship as one in which a person is “under a duty to act for the benefit of the other.”[1] Its *Restatement Second* listed as many as seventeen specific duties a fiduciary owes to a

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[1] *Restatement Third, Trusts § 2, Comment b.* Part I of DeMott (1991) is a concise case book on fiduciary law. Some of the well-known works on fiduciary relationships are Maitland (1936), Vinter (1938), Scott (1949), Sealy (1962, 1963), Marsh (1966), Jones (1968), Weinrib (1975), Finn (1977, 1989), Shepherd (1981a, 1981b), Frankel (1983,1995); DeMott (1988), Bishop and Prentice (1983), Clark (1985), Flannigan (1989), Cooter and Freedman (1991), Easterbrooks and Fischel (1993), Hart (1993), Hoyano (1997), Langbein (1995), Macey (1999), Worthington (1999), Alexander (2000), Sitkoff (2004). Shepherd (1981a): 53-73 and (1981b): 51-91 provide a comprehensive survey of competing theorizations of fiduciary principle by classifying them into unjust enrichment, commercial utility, reliance, unequal relationship, contractual undertaking, discretionary power, and property theories. See also deMott (1988): 908-915.

beneficiary, but *Restatement Third* has managed to consolidate them into "mere" nine. Among those nine duties the most fundamental one is "the duty of loyalty" – a duty that dictates the fiduciary to act "solely in the interests of the beneficiary."[2] To borrow Benjamin Caldozo's famous dictum, a fiduciary is held to "something stricter than the morals of the market place." "Not honesty alone," he asserted, "but the punctilio of an honor the most sensitive, is then the standard of behavior."[3] Such "ethical" tone of the fiduciary law is in marked contrast with the "economic" orientation of the contract law.[4] The classical paradigm of contract law was the bargaining of autonomous parties competent to pursue their own interests all by themselves.[5] When parties entered into a contract voluntarily and informedly with each other, they were bound by its terms, however unwise or unbalanced or unjust it might appear from outside, simply because it was the outcome of their free will and mutual consent. It was only when the contract was procured by fraud or duress or misrepresentation, or one of the contracting parties was a minor or lunatic, or the object of the contract was an illegal activity, the court could pronounce its unenforceability. To be sure, the modern principles of good faith and unconscionability have now restricted the contracting parties' relentless pursuit of their own

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[2] *Restatement Third, Trusts* §78 (1) states that: "Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries". See, e.g., Scott and Fratcher (1987): "The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty. . . . A trustee is in a fiduciary relation to the beneficiaries of the trust" (311). A similar duty can be found in *Restatements* on Agency, Restitutions, Law Governing Lawyers as well as in *Uniform Partnership Act*, *Principles of Corporate Governance*, etc.

[3] *Meinhard* v. *Salmon*, 249, NY 458, 464, 164 N.E. 545, 546 (1928).

[4] See. e.g., Frankel (1983): 829-832, and Clark (1985): 75-79; deMott (1988): 882, 892-908.

[5] See generally Atiyah (1979).

interests within certain limits.[6] Yet, the contract law itself has never gone beyond "the morals of the market place." Each party to a contract is not expected to place the interests of the other above and over one's own. Within the realm of contract law, "the right to act self-interestedly is being curtailed, not denied."[7] In contrast, as soon as a person places oneself as a fiduciary towards another person, the right to act self-interestedly is not curtailed but denied. It is indeed the essence of the fiduciary law that a duty to be "loyal to another" is imposed on the fiduciary, not as a mere sermon, but as a "legal" duty enforced by courts.

*Keech v. Sandford* is the 1726 landmark English case in the history of fiduciary law. A trustee for an infant of a valuable lease sought to renew it but the lessor refused on the ground that an infant could not be bound by such a lease. The trustee then took the lease personally but was sued by the infant. Quoted below is the judgment of Lord King that the new lease must be held ]on trust for the infant on the same terms as the original one.

> I must consider this as a trust for the infant, for I very well see that if a trustee, on the refusal to renew, might have a lease to himself, few trust estates would be renewed to *cestui que use* (i.e., trust beneficiary). Although I do not say there is fraud in this case, yet the trustee should rather have let the lease run out than to have had it to himself. It may seem hard that the trustee is the sole person of all mankind who might not have the lease, but it is very proper that rules should be strictly pursued, and not in the least relaxed; for it is very

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[6] According to *Uniform Commercial Code*: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement" (§205), and "If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract." (§ 206).

[7] Finn (1989b): 82. See also deMott (1988): 892-908.

obvious what would be the consequence of letting trustees have the lease on refusal to renew to *cestui que use*. (*Sel. Cas. Ch.61, 2 Eq. Cas. Abr. 741.*)

*Keech v. Sandford* has since become the authority for the rule that fiduciaries cannot make a personal gain from their position. Lord King in effect obliged the trustee to surrender to the infant all the gain he earned from the lease, even if the infant himself could not take the lease and earn that gain by himself. This leads us to the second essential feature of the fiduciary law. When a party to a contract breaches his promise, he is liable to compensate the injured party her "lost expectation" -- the amount of money that would put the injured party in as good a position as she would have been in had the breach not occurred.[8] In contradistinction to this loss-based "compensatory rule," the remedial rule for fiduciary breach is characterized by the gain-based "disgorgement rule." When a fiduciary breaches the duty of loyalty, he is liable to disgorge to the beneficiary all the "unauthorized gain" -- the gain he has obtained from his fiduciary position without any authorization by beneficiary or courts or terms of arrangement.[9] Indeed, he has to disgorge all the gain, even if he has acted in good faith or with honest intentions, and even if his actions have not injured the beneficiary, nay, even if the beneficiary has gained as a result of his actions.[10]

In deciding *Keech v. Sandford* the court did not even bother to seek the objective evidence of the trustee's claim that he could not renew the original lease because of the beneficiary's

[8] See *Restatement Second, Contracts*: *§344 (a) and §347*; and *Uniform Commercial Code*: *§1-106*.

[9] See, e.g., Farnsworth (1985): "the disgorgement principle applies to breach of a fiduciary obligation while the expectation principle applies to a breach of contractual obligation." (1356).

[10] *Restatement Third, Trusts § 78, Comment on Subsections(1) and (2).*

infancy. The court simply accepted it, but nevertheless judged against the trustee on the ground that he placed himself in a situation that could conflict with the beneficiary's interests. Indeed, it is such "strictness" of fiduciary liability that constitutes the third distinguishing feature of the fiduciary law. In the case of contractual relationship, the whole burden of proving the fact of breach is on the side of the promisee. By contrast, as is aptly put by Robert Cooter and Bradley Friedman (1991), "fiduciary law … infers disloyalty from its appearance." (1055). Whenever a fiduciary is found to have earned an unauthorized gain or have placed him in a position that appears to compromise his duty to the beneficiary, he is held liable without further inquiry in courts or at least has the burden of disproving his disloyalty.[11]

The law of fiduciary relationships has evolved in a complex historical process that originated from the practice of "uses" (the original form of trusts) in medieval England, formulated first as a set of rules that regulated the conducts of trustees, and later applied to persons occupying a "trustee-like" position, such as guardians, corporate directors, agents, partners, solicitors, priests, doctors, and even bankers.[12] The law has long been established as an important division of Anglo-American private law, and in recent years there has even been a tendency among jurists to plead the breach of fiduciary duty as an alternative to the breach of tort liability or contract liability.[13] Yet, in spite of its long history and wide acceptance, it is a common claim among judiciary and academics that the notion of fiduciary relationships still

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11 See generally *Restatement Third, Trusts, §78*. It calls this "no further inquiry rule."

12 See, e.g., Maitland (1936), Vinter (1938), and Sealy (1962) for historical evolution of fiduciary law.

13 As has been reported and cautioned by, e.g. Sealy (1995), Hoyano (1997) and Worthington (1999).

lacks a unified theory.[14] In fact, a number of fiduciary law scholars have suggested that the search for a unified principle must be given up once and for all. Since "[i]t is obvious that we cannot proceed any further in our search for a *general* definition of fiduciary relationships," Len Sealy (1962) said in his classical paper on fiduciary relationship, "[w]e must define them class by class, and find out the rule or the rules which govern each class." (73). Deborah deMott (1988), another authority on fiduciary law, concurred: "Recognition that the law of fiduciary obligation is situation-specific should be the starting point for any further analysis." (878). Some in the school of economic approach to law have gone much further and even denied the very notion of fiduciary relationship as a distinct legal category.[15] For example, Frank Easterbrooks and Daniel Fischel (1993) argued that efforts to come up with a unifying approach are "doomed," because "there is nothing special to find … about fiduciary relations."

> There are only distinctive and independently interesting questions about particular consensual (and thus contractual) relations. When transactions costs reach a particularly high level, some persons start calling some contractual relations "fiduciary," but this should

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[14] There is no shortage of citations: "It is striking that a principle so long standing and so widely accepted should be the subject of the uncertainty that now prevails" (Finn (1989a): 25); "Fiduciary obligation is one of the most elusive concept n Anglo-American law" (DeMott (1988): 879); "[T]he precise nature of the fiduciary relationship remains a source of confusion and dispute"(Cooter and Freedman (1991): 1045); "[O]ne might have expected that … the nature, source and scope of the [fiduciary] principle were today well understood and the subject of widespread agreement. But this is not the case" (Flannigan (1989): 285); "Perhaps because the subject matter is so sprawling and elusive, there has been little legal analysis of the fiduciary concept that is simultaneously general, sustained, and astute" (Clark (1985): 71); "[T]he shape of the fiduciary concept remains uncertain, notwithstanding its deep historical tap root in equity" (Hoyano (1997) :179); "Also too well-known is the disappointing fact that none so far has satisfactorily defined the circumstances which give rise to the [fiduciary] obligation" (Worthington (1999): 506).

[15] See, e.g., Marsh (1966), Langbein (1995), Macey (1999), Alexander (2000), Sitkoff (2004), in addition to Easterbrook and Fischel (1993) to be quoted below.

> not mask the continuum. Contract law includes a principle of good faith in implementation--honesty in fact under *the Uniform Commercial Code*, plus an obligation to avoid (some) opportunistic advantage taking. Good faith in contract merges into fiduciary duties, with a blur and not a line." (438).

The present article is, however, yet another effort to develop a unified theory that is capable of combining a wide variety of fiduciary relationships into a distinct legal category. It is true that in order to mark "a line" between contractual and fiduciary relationships the mere extension of the principles of good faith or unconscionability in the law of contracts is not enough. As Paul Finn (1989b) has declared: "something more is needed." (31).

I now believe that there is a solid foundation upon which a unified theory of fiduciary relationships can be constructed -- it is a fundamental axiom in contract law that "one cannot form a contract with oneself."[16] A contract with oneself, or more generally, a contract that amounts to a contract with oneself is a mere "vow" that is not enforceable within the realm of contract law. In Chap. 2 that follows I will characterize the fiduciary law as a self-contained set of legal rules, separate and distinct from the contract law (as well as from the tort law), that regulates a socially desirable relationship between two or more parties when and insofar as any attempt to form a contractual relationship between these parties could degenerate, at least in part, into a contract by one of the parties with oneself or into a contract that amounts to a contract by one of the parties with oneself. At its core lies a legally enforceable duty called *the*

[16] See *Restatement, Second, Contracts* §9. "One may not contract with himself" – "this is," as Thomas Schelling (1984) exclaimed, "a stunning principle of social organization and legal philosophy." (99). See *n.19* for a fuller quotation.

*duty of loyalty* that dictates anyone, once he has agreed to enter into a relationship he is able to turn into his self-contract or its equivalent, to act solely for the benefit of the other. There is indeed a large class of human relationships that are socially desirable from the standpoint of the good of the general public or of the basic rights of individuals but that would easily turn into a self-contract by one of the parties if their formation were left to free bargains and contractual agreements. I count guardian/ward, trustee/beneficiary, corporate manager/corporation, agent/principal, partner/partner, doctor/patient, attorney/client, priest/penitent, and fund manager/investor relationships among them. It is the axiom of the legal impossibility of self-contract that enables us to unify a varied array of human relationships under the banner of the fiduciary relationship and draws a clear “line” between the law regulating these relationships and the law regulating contractual and other private legal relationships.

It is of course one thing to define what the fiduciary law is but another to explain how it works as a self-contained legal system. In the rest of the article I will make an attempt to provide a coherent theoretical account of the three distinguishing features of the fiduciary law – the imposition of the duty of loyalty on fiduciary, the disgorgement damages for its breach and the strictness of fiduciary liability. For this purpose I will present in Chap.3 a simple model of fiduciary relationships whose formal structure is similar to the so-called “trust game” -- a one-sided “prisoner’s dilemma game” that has been extensively used in economics and related social sciences.[17] The choice of a variant of trust game as the formalized paradigm of fiduciary relationships will enable us to analyze the structure of fiduciary relationships with the basic tools and concepts of economics and compare fiduciary law and contract law on the same footing. I will then formulate the duty of loyalty within such framework as an open-ended rule that obliges fiduciary to take whatever action a man of reasonable skill and judgment would be expected to take in maximizing the beneficiary's net benefit. I will also present a possible objection to such deontological formulation of the duty of loyalty by the economic approach to law, but leave an answer to that objection only in Chap. 7.

I will then examine in Chaps.4 and 5 the remedial rule for fiduciary breaches. Two alternative justifications have been offered in the past for the fiduciary law's disgorgement remedy – one on the basis of deterrence policy (to prevent future harms) and the other from the perspective of corrective justice (to rectify past injustice). While the policy of deterrence is certainly able to rationalize why a fiduciary should disgorge any unauthorized gain from his position as fiduciary, it is at a loss to explain why the beneficiary is the one who should receive all the damages at all. For the damages awarded to the beneficiary will have no deterring effect on future fiduciaries; worse, it may even deteriorate beneficiaries' incentives to take precautions against future breaches. The principle of corrective justice, on the other hand, is at home in justifying this side of the disgorgement damages, for its whole job is to rectify an injustice done. But, because of

[17] See, e.g., Kreps (1990) and Berg, Dickhaut and McCabe (1995). Cootner and Friedman (1991) have used a trust game in their theory of fiduciary duties.

its intrinsic association with compensatory rule, the idea of corrective justice appears at first sight wholly unpromising as a justification for fiduciary law's disgorgement rule. Yet, I will demonstrate that, once the duty of loyalty is accepted, its essentially open-ended nature automatically keeps disgorgement damages from exceeding compensatory damages. The gain-based appearance of disgorgement damages turns out to be a mere appearance, and the disgorgement rule is subsumed under the most venerable of all the remedial rules -- the loss-based compensatory rule.

Chap.6 will deal with the evidentiary procedure for fiduciary breach. It will be argued that the strictness of fiduciary liability is the fiduciary law's way to circumvent the inherent difficulty and in many cases the sheer impossibility of beneficiaries alleging and establishing the fact of fiduciary's breach. It will also be shown that the fiduciary's unauthorized gain still has a role to play in litigation, for its presence can serve not only as an incontestable evidence of fiduciary's breach but also as a lower bound measure of the beneficiary's lost expectation that is often hard to detect even by the injured beneficiary herself. I will close this chapter with a remark that, in spite of the exalting tone of Judge Caldozo's dictum, the fiduciary liability is "strict" not because the duty of loyalty is "ethical" but because it is "legal" through and through.

I will take up in Chap. 7 the economic approach's possible objection to the deontological formulation of the duty of loyalty. I will argue that a fiduciary should not be allowed to breach the duty of loyalty to the beneficiary, even if doing so would enhance their relationship's

Kaldor efficiency. It is because in that situation the society could have achieved an alternative allocation that is equal in terms of Kaldor efficiency but superior in terms of Pareto optimality, if the fiduciary had chosen to purchase a right to serve the beneficiary as an outside third party rather than having exploited his fiduciary position within the relationship. I believe that even die-hard adherents of the economic approach would not object to our basic axiom that, when two alternative allocations are equivalent in terms of Kaldor efficiency, it is "wrong" to choose the one that is not Pareto optimal over the one that is.

In the final Chap.8 I will call attention to the possibility of interpreting the notion of Pareto optimality as a deontological principle that every person has an equal right not to have his or her welfare be sacrificed as a mere means of increasing the welfare of someone else or of promoting the good of the general public. I will conclude the article by expressing a hope that the Pareto standard can serve as a common meeting ground between economic approach and corrective justice approach, more generally, between utilitarianism and deontologism in economic, legal, and other moral sciences.

## 2. LEGAL IMPOSSIBILITY OF SELF-CONTRACT AS *RAISON D'ÊTRE* OF FIDUCIARY LAW.

One cannot form a contract with oneself — this is a fundamental axiom in contract law.[18] A

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[18] *Restatement, Second, Contracts*: § 9 states that: "There must be at least two parties to a contract, a promisor and a promisee, but there may be any greater number." *Comment a* then adds that: "In one sense a person can make a

contract is an agreement between two or more parties creating obligations that are enforceable or at least recognizable at law. One is of course free to write a contract with oneself. But it takes two to tango. Within the realm of the contract law one cannot owe a legally enforceable obligation to oneself, since the second "one," the one imposing obligation, could always release the first "one," the one put under obligation, from the obligation, whenever one so wishes. A contract with oneself, or more generally, a contract that amounts to a contract with oneself is a mere "vow" that has "no standing at law."[19]

It is this legal impossibility of contracting with oneself that constitutes the fundamental *raison d'être* for fiduciary law. Indeed, I submit that the fiduciary law is a legal system that has evolved historically as *a set of legally enforceable duties that regulates a socially desirable relationship between two or more parties when and insofar as any attempt to form a contractual relationship between these parties could degenerate, at least in part, into a contract by one of the parties with oneself or into a contract that amounts to a contract by one of the parties with oneself*.

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promise to himself, but the law does not provide remedies for breach of such promises."

[19] Schelling (1984):"One may not contract with himself. This is a stunning principle of social organization and legal philosophy. One cannot make a legally binding promise to one-self. Or perhaps we should say that the second party can always release the first from a promise; and if I can promise myself never to smoke a cigarette I can legally release myself from that promise whenever I choose to smoke. It comes to the same thing. Charles Fried provided me with the name for what has no standing at law - the *vow.* The vow has standing if directed to a deity and is enforced by whatever authority the deity exercises. And the vow as an expression of intent can receive social and institutional support if it is recognized by an established church. Religious and fraternal orders differ from the common law in providing moral support, even coercive support, for vows like abstinence, celibacy, penury, and dedication to prayer, good works, and even heroism. But the vow has no standing at law." (99). Schelling was one of the few who saw the importance of this "impossibility" axiom in law, though he has not pursued its implications fully. See also Fried (1981) at 40-43.

There are indeed a variety of human relationships that can inevitably turn into a self-contract by one of the parties if their formation is left to free bargains. Examples include guardian in relation to ward, trustee in relation to beneficiary, corporate manager in relation to corporation, agent in relation to principal, partner in relation to other partners, and such professionals as doctor, attorney, priest, and fund manager in relation to their patient, client, penitent and investor. Let me explain them one by one, albeit briefly.

(1. Guardian/ward): The simplest form of fiduciary relationship is between guardian and ward. A guardian is a person who has the legal duty to care for the person or property of another person (ward) who is a minor or mentally incompetent to act for herself. The guardian is given legal powers to exercise any, some or all of the rights of a ward, so that any contract the guardian forms with a ward would necessarily degenerate into a contract the guardian forms with himself. In Anglo-American law the guardianship can never emerge as a contractual relationship.

(2. Trustee/Trust Beneficiary): The trust is the prototype fiduciary relationship. A trust arises where a person (the trustee) holds the legal title of property solely for the benefit of another person (the beneficiary). A trust may be created by an express intent of a third person (the settlor). But it can also arise without any settler. In the case of a self-declared trust a person declares himself a trustee for another person, and in the case of a self-settled trust a person can

ask another person to be a trustee for him.[20] Moreover, in the cases of resulting trusts and constructive trusts, a trust is created by the operation of law.[21] What is impossible is the trustee and the beneficiary being the same person, implying that the essential core of the trust relationship is a relationship between trustee and beneficiary.[22]

That a trustee/beneficiary relationship cannot be sustained as contract can be most readily seen if we take note the fundamental fact about the trust that for its creation neither the notice to nor the acceptance by the beneficiary is necessary.[23] The designated beneficiary may be in some unknown place, or may be a baby in arms, or even may yet be born, and no one is able to enter into contract with a person who is unaware of the fact that an offer is made to her or who is incapable of understanding the content of the offer or who is yet to exist in this world to receive the offer. To be sure that many of the trust beneficiaries are fully alive, mentally capable, and totally informed. But, even in those cases, the defining feature of trust relationship makes it impossible for the trustee to enter into a legally enforceable contract with his beneficiary. It is because the legal owner of the trust property is not the beneficiary but the trustee. The bargain principle of consideration in Anglo-American law of contracts postulates that only a contractual

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[20] *Restatement Third, Trust*: § 10 (c) and § 43. See also Bogert (1987): § 30 and § 35.

[21] *Restatement Third, Trust*: 7-9 and § 1 *Com. e*. See also Bogert (1987): § 71.

[22] Compare with Langbein (1995)'s contractarian theory of trust that has dismissed the self-declared trust as occupying "a relatively peripheral role in modern practice" (627) because it "dispenses" what he regards "the most desirable attribute of the trust." This of course amounts to assuming away the most critical attribute of the trust from his entire analysis from the beginning. As is asserted by Hayton (1996), "at the core of the trust" are "[t]he beneficiaries' rights to enforce the trust and make the trustee account for their conduct with the correlative duties of the trustees to the beneficiaries. . .." (47).

[23] See *Restatement Third, Trust*, *§14*.

promise that is bargained for something of value has “consideration,” hence legally binding.[24] The trust beneficiary is deprived of any means of bargain with the trustee with respect to the benefits accruing from trust property, so that any contract the trustee designates her as their recipient becomes a mere donative promise that is not enforceable within contract law.[25]

(3. Corporation/Manager): The law speaks of a business corporation as a “legal person,” as a subject of rights and duties capable of owning real property, entering into contracts, and suing and being sued in its own name.[26] Even if a corporation has a full-fledged personality in the system of law, it is in reality a mere legal construct that is incapable of performing any act, except through the act of natural persons. In order for a corporation as legal person to buy or sell, lease or mortgage, use or maintain its assets in actual life, it has to have a natural person or a group of natural persons that performs such acts on its behalf. The law of corporation thus mandates every corporation to have a board of directors as the holder of the power to act in its name, and the board members often delegate part or all of their power to corporate officers for

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[24] See, e.g., Eisenberg (1997) for the bargaining principle of consideration in the law of contract.

[25] Since a contract for the benefit of third parties can be understood as a gift contract offered jointly by the contracting parties (the promisor and the promisee) to the third parties (see Fried (1981): 44–45) and it can do a part of what the trust does, the Anglo-American legal system might not have been able to develop the trust law so distinctively had not the bargain principle been dominant. It is perhaps for this reason many of Civil Code countries, where only a lawful cause (*causa*), not a consideration, is required for a contract to be binding, have long felt little need for the concept of trust. Yet, the critical fact is that contracts for the benefit of third parties can cover only a part of the legal acts permitted in the trust law. Some civil code systems (of Quebec, Luisiana, Japan, Taiwan, China, etc.) have incorporated trust law into them.

[26] § 3.02 of *Revised Model Business Corporation Act* states that: “every corporation ... has the same power as an individual to do things necessary or convenient to carry out its business and affairs. . .”

the actual management of corporate activities.[27] (In what follows I will call both directors and officers as managers for short.) Can the corporation as legal person controls the performance of corporate managers by means of contractual arrangements alone? The answer is evidently "no," for any act performed by a corporation is in reality an act performed by its managers. A corporation is unable to arrange a monitoring mechanism or an incentive scheme with its managers, except through the very managers it is supposed to control. This is indeed the very reason for setting up the so-called corporate governance system in the law of corporations.[28]

(4. Principal/Agent): Agency arises when a person (principal) manifests consent to have another person (agent) to act on her behalf with respect to some task. Though most agency relationship is created by a contract between the principal and the agent, and though the principal has the right to control the goal of the relationship, the agency relationship itself is not a contractual relationship. Indeed, at the core of any agency relationship is a zone of acceptable acts the agent is authorized to perform without asking any consent from the principal, and any act the agent has chosen within this authorized zone binds the principal to third parties and third parties to the principal. It is therefore a tautology that the principal is unable to form contract with the agent with respect to acts within this zone, for the whole purpose of setting up an agency relationship is to delineate a zone of acts that are free from any *prior* contractual

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[27] § 8.01 (6) of *Revised Model of Business Corporation Act*, for instance, states: "All corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed, under the direction of its board of directors . . .." See also §3.01 of *Principles of Corporate Governance*.

[28] I will come back to the problems of corporate governance in Chap. 6. This subchapter is based on Iwai (1999, 2002).

specifications. ALI's *Restatement Second, Agency* explicitly characterizes "agency" as "the fiduciary relation."

(5. Partner/Partner): Each member of a partnership is subject to the virtual veto power of fellow partners in any contractual decision that binds the partnership, because all partners have "*equal* rights in the management and conduct of the partnership business." In fact, "every partner" is regarded as "an agent of the partnership for the purpose of its business."[29]

(6. Doctor/Patient, Lawyer/Client, Priest/Penitent, and Fund Manager/Investor): A patient treated by doctor may be totally unconscious, a client counseled by lawyer may be utterly unrealistic, a penitent guided by priest may be wholly devoted, and an investor having her assets managed by fund manager may be fully absorbed in her own business. And even when the patient is conscious or the client realistic or the penitent poised or the investor attentive, they are in general informationally dominated by their doctor or attorney or priest or fund manager in the sense that what they know about their *own* medical or legal or spiritual or financial matters is much less than what their doctor, lawyer, priest, and fund manager do.[30] Even if a patient, for instance, write a contract with a doctor that obliges him to choose the best possible treatment for her, there may be no way for her to tell whether a worsening of her condition is due to the doctor's self-seeking choice of treatment or caused by an unlucky

[29] *Uniform Partnership Act* (1914): *§18 (c)* and *§9 (1).*

[30] This should not be confused with the assumption of asymmetric information commonly made in contract theory where each of contracting parties knows his or her own actions or characteristics better than the other party does. Here, a doctor or a lawyer or a priest or a fund manager knows their beneficiary's medical/legal/spiritual/financial states much better than the beneficiary herself does.

circumstance in spite of the doctor's most conscientious effort. The doctor is often able to misrepresent his disloyal act as if it were made in the patient's best interests without any fear of being exposed to the light of the day.[31] Indeed, *Appendix 1* is devoted to a formal demonstration of how the doctor's informational dominance over patient can endow the doctor with an absolute power to hide the sub-optimality of his treatment even if the patient can monitor his treatment and identify its result on her with certainty.

In each of the above six cases, it is not the relative imbalance of bargaining power but the absolute lack of contractual capacity of one of the parties in relation to the other that inevitably turns an apparently contractual relationship between them, at least in part, into a self-contract by the other party. In any of these relationships, even if the latter party is willing to serve the needs of the former party, he cannot owe a legally enforceable duty to her, as long as they are confined to the realm of contract law. All that the latter party can do is to "vow" to act on behalf of the former party, that is, to unilaterally impose a duty on oneself for the benefit of the former party.

To impose a duty on oneself for the benefit of the other is, of course, one of the Kantian

[31] Darby and Kami (1973) have defined "credence goods" as goods whose qualities are "expensive to judge even after purchase." See Dulleck and Kerschbamer (2006) for a set of the conditions under which the market mechanism is able to deter the suppliers of credence goods from exploiting the consumers' informational disadvantage. They find, however, that in the case of medical services it is difficult to set up the market environment that satisfies these conditions, especially the verifiability of the treatment's adequacy and even the identifiability of its quality. I believe legal, religious and some of financial services share the same difficulties for the market "solution." In fact, the main purpose of *Appendex 1* is to construct a model of doctor/patient relationship in which there is no way for patient ( and for that matter even courts) to verify the adequacy of the doctor's treatment both during and after the treatment.

formulae for an “ethical duty.”[32] But, we all know an unfortunate fact of human nature that ethical feelings cannot be counted as its richest endowment.[33] Some of the traditional “professions” have thus had recourse to group-imposed professional ethics (and group reputation) to supplement individual ethics. In medicine, the Hippocratic Oath has codified at least part of the ethical duties doctors owe to their patients, and in law and ministry (and in military as well) some forms of professional codes, while less explicitly stated, have also played important roles. But, it is awfully difficult to organize trustees, guardians, directors, agents, copartners into even the semblance of professional groups, and even in those traditional “professions” group-imposed codes have often proven to be insufficient to regulate their members’ misconducts.

If, either for promoting the good of the general public or for upholding basic rights of individuals, a society wishes to secure the integrity of the above relationships each of which would inevitably turn into a self-contract by one of the parties, there is no other way but to leave behind the realm of contract law. It has to set up a separate system of legal rules that is able to impose on anyone, once he or she has agreed to enter into such relationship, the duty to act solely for the benefit of the other *as a legally enforceable duty*.

[32] Kant (1797) identifies “*ethics*” with “the *doctrine of virtue*” (6:378) and defines “a duty of virtue” as “an *end that is in itself a duty*” (6:383). He then asked: “What are the ends that are also duties?” and answered himself that: “they are *one’s own perfection* and *the happiness of others*.” (6:385).

[33] True that recent game-theoretic experiments have demonstrated that a majority of people have preferences that care the welfares of others (see. e.g. Rabin (1993) and Camerer (2003)). But what is crucial for us is the fact that a non-negligible fraction (e.g., 30 % among undergraduate students playing trust games in Berg, Dickhaut and McCabe (1995)) is also shown to act self-interestedly.

That is the Fiduciary Law. Let us now see how it works as a legal system.

## 3. A BASIC MODEL OF FIDUCIARY RELATIONSHIP.

Let me introduce a basic model of fiduciary relationship in which a person (*Mr. F*) undertakes to act solely for the benefit of another (*Ms. B*). *F* is called the "fiduciary" and *B* the "beneficiary" of this relationship.[34] In *Appendix 1* I will formalize a model of doctor/patient relationship and show how it can be transformed into the one to be developed below, but the model itself has a much more generic structure that can encompass all the other forms of fiduciary relationship.

Let us denote by $U_B$ and $U_F$ the net benefit accruing to *B* and *F*, respectively. In the main text I will suppose that individual benefits (and losses) can be measured in terms of monetary unit and can be added to each other and subtracted from each other. This is, however, only for expositional simplicity. In fact, *Appendix 2* will show that it is not hard to rewrite the whole article without assuming the comparability, to say nothing of the additivity or subtractivity, of individual benefits. I will also normalize the net benefits of both *B* and *F* by setting their values equal to zero when they remain strangers to each other.

The fiduciary law imposes on whoever has accepted to be a fiduciary "the duty of loyalty" -- the duty to act "solely in the interests of the beneficiary."[35] In our formal model it may be

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[34] In what follows I will use a convention to call a fiduciary "he" and a beneficiary "she."

[35] See *n.2* above.

formulated as an open-ended rule that obliges $F$ to take whatever action a man of reasonable skill and judgment would be expected to take in maximizing $B$'s net benefit, at least within the confines of the terms stipulated at the inception of the relationship. Of course, no one is ever forced to undertake to act as fiduciary. In order for $F$ to take the position of fiduciary, he has to be fully remunerated for the costs and efforts he incurs in serving $B$'s interests, as long as they are "appropriate and reasonable" for his undertaking.[36] By subtracting all these costs and efforts from $F$'s benefit, an incentive constraint on $F$ becomes simply that his net benefit must be at least non-negative or that $U_F \geq 0$. The duty of loyalty can thus be formulated as

(1) *Max* $U_B$ *s.t.* $U_F \geq 0$ *and other constraints stipulated by the terms of fiduciary arrangement.*

The fiduciary law also imposes on fiduciary the duty of care -- a duty to exercise "reasonable care, skill and caution" in serving his beneficiary.[37] Though important and indispensable among many duties owed by fiduciary, this duty is secondary in relation to the duty of loyalty, for it makes no sense to ask whether the fiduciary exercises reasonable care, skill and caution when he is relentlessly pursuing his own interests. Moreover, the duty of care is not the

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[36] According to *Restatement Third, Trusts*, "investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee."(§90). This applies also to other types of fiduciary, except compensations to corporate managers. In §9, I will briefly give reasons to why managerial conducts are often given a special treatment in fiduciary law.

[37] *Restatement Third, Trusts* states: "A trustee will invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee will exercise reasonable care, skill, and caution" in §90 that has incorporated *Prudential Investor Act* of 1992 with no substantial changes.

distinguishing mark of fiduciary law -- it is in common, for instance, with the tort law of negligence. The rest of the present article will mostly ignore the issues concerning the duty of care and simply assume that it is duly observed whenever *F* acts loyally to *B*.

Let $(U_B^*, U_F^*)$ denote the benefits *B* and *F* obtain respectively when *F* observes the duty of loyalty to *B*. Our fiduciary, however, faces a possibility of conflict of interests with his beneficiary. Let $(U_B^0, U_F^0)$ denote the benefits *B* and *F* obtain respectively when *F* is disloyal to *B*, exploiting the relationship with *B* solely to maximize his own benefit without having secured any authorization by *B* or by courts or by the terms of fiduciary arrangement. That both $U_B^*$ and $U_F^0$ are defined to be the maxima immediately lead us to obtain the following inequalities between $U_B^*$ and $U_B^0$ and between $U_F^0$ and $U_F^*$:

$$(2) \qquad U_B^* \equiv Max_{U_F \geq 0} U_B \geq U_B^0 \text{ and } U_F^0 \equiv Max\ U_F \geq U_F^* (\geq 0).$$

Suppose that *F* has acted disloyally to *B*. Let us then denote by $L_B$ the monetary value of the transfer to *B* that would put her in as good a position as she would have been in had *F* acted loyally to her. It will be called *B*'s "lost expectation." Let us also denote by $G_F$ the monetary equivalent to the net gain *F* has obtained over and above what he would have obtained had he acted loyally to *B*. It will be called *F*'s "unauthorized gain."[38] When the net benefits are measurable in monetary unit, $L_B$ and $G_F$ can be calculated as the difference between $U_B^*$ and $U_B^0$ and between $U_F^0$ and $U_F^*$ respectively, or as

[38] This definition of unauthorized "gain" includes not only the gross benefits *F* has earned but also the costs saved as a result of acting disloyally. This is the reason why we have called it the unauthorized gain, not the unauthorized profit.

(3) $L_B \equiv U_B^{*} – U_B^{0}$ $(\geq 0)$ and $G_F \equiv U_F^{0} – U_F^{*}$ $(\geq 0)$,

though these two notions can easily be defined without assuming the measurability of benefits, as will be shown in *Appendix 2*.

If both $L_B$ and $G_F$ are strictly positive, *F* actually faces a conflict-of-interests situation with *B* – once having entered into a fiduciary relationship with *B*, *F* is able to enhance his benefit over and above "appropriate and reasonable" level only at the expense of *B*'s benefit.

Note that I will not suppose that $U_B^0 < 0$ or that *F*'s disloyal act renders *B* into the worst off situation. In fact, if the worst-off scenario for *B* is to be betrayed by *F* after having entered into relationship with him, that is, if $U_B^0 < 0 < U_B^*$, our model would be identical with that of "trust game" -- a one-sided version of "prisoner's dilemma game"-- that has been extensively employed in economics and related fields.[39] As has been pointed out in § 1, one of the conspicuous features of fiduciary law is the disgorgement rule for the remedy for breach, which entitles *B* to recover every pence of *F*'s unauthorized gain, even when *F*'s disloyal act has not injured *B* (i.e., $U_B^0 \geq 0$).[40] Any attempt to justify or criticize this gain-based remedy thus ought to be based on a theoretical framework that does not presuppose at the outset that the *F*'s

[39] Even before it was named the trust game, this type of one-sided prisoner's dilemma game has been extensively explored as a model of "hold-up" problems in the theory of firm. See, e.g., Klein, Crawford and Alchian (1978), Williamson (1985), and Hart (1995). Note that the trust game is one of the most frequently used game forms in experimental economics. See, e.g., Berg, Dickhaut and McCabe (1995) and Camerer (2003).

[40] *Restatement Third, Trust* referred in note 10 quotes the following remark by Borgert (1987): "Whether the trustee acted in good faith and with honest intentions is not relevant, nor is it important that the transaction attacked was fair and for an adequate consideration so that the beneficiary has suffered no loss as a result of the disloyal act. It is not material that the trustee himself made no profit from the disloyal act, although in most cases he has benefited." (§95).

disloyalty is necessarily injurious to his beneficiary.

Some readers may have immediately objected to the above unabashedly deontological formulation of the duty of loyalty *(1)* on the ground that its reduction of *F*'s net benefit $U_F$ to a mere side constraint ($U_F \geq 0$) allows the relationship not to maximize the joint benefit $U_B+U_F$. For instance, Easterbrook and Fischel (1993) in the article already quoted claim that "[c]ontract and fiduciary duties lie on a continuum best understood as using a single, although singularly complex, algorithm," for " [w]hen actual contracts are reached, courts enforce them; when actual contracts are feasible, courts induce parties to bargain; when transactions costs are too high, courts establish the presumptive rules that *maximize the parties' joint welfare*." (446; *italics* are mine.) The economic approach to law often presents itself as a theory that the law, especially the common law, is best explained as a system of rules for maximizing "the parties' joint welfare" or the relationship's Kaldor efficiency.[41] An change in allocation is said to be "Kaldor efficient" if it would make at least one person better off without leaving any other person worse off if better-off persons could compensate worse-off persons in a lump-sum manner.[42] Needless to say, if individual benefits and losses are measurable in monetary units, as we have so assumed in the main text of the present article, a Kaldor efficient change can be identified simply as a change that increases the relationship's joint benefit $U_B+U_F$.

[41] See, e.g., Posner (1998): 26-29, 271-75; Polinsky (2003): 7-11, 158-162, and Cooter and Ulen (2008): 9-11,472-73.

[42] A change in allocation is said to be "Hicks efficient," if it would make at least one person better off without leaving any other person worse-off if worse-off persons could bribe better-off persons. The present article, however, need not introduce the notion of Hicks efficiency, though Kaldor efficiency and Hicks efficiency are equivalent so long as individual benefits are measurable in monetary units.

Suppose that *F* happens to be endowed with a special apparatus or skill or knowledge that could be used as a complementary factor of the property or power or information or other resources *B* possesses. In such a situation, even if *F* exploited his relationship with *B* as a means of seeking his own interests, the synergy effect could improve their relationship's Kaldor efficiency, or that $U_B^0+U_F^0>U_B^*+U_F^*$. If this is indeed the case, breaching the duty of loyalty is a thing to be much recommended from the standpoint of Kaldor efficiency! Adherents of the economic approach to law might then say: "What's wrong with the fiduciary's breaching the duty of loyalty, if it enhances the relationship's Kaldor efficiency?"

One possible answer is that a fiduciary breach is wrong in the sense that it may set in motion a breakdown process of fiduciary relationships as a social institution. Suppose that *F*'s disloyalty to *B* would leave *B* worse off than not having entered a relationship with *F*, or that $U_B^0 < 0$. Then, fearing such possibility, many beneficiaries would hesitate to enter into fiduciary relationship in the first place, thereby aborting potentially productive relationships from forming. Even if the breach of fiduciary duty is efficiency-enhancing *ex post*, it is likely to result in inefficiency *ex ante* and lead to the demise of fiduciary relationships in the long-run. This is called a "hold-up problem" in the theory of trust game, and we now have a huge literature proposing a variety of formal and informal devices that may overcome such difficulty at least in part, such as reputation mechanism, monitoring design, collateral requirement, liquidation rule, etc.[43]

Suppose that some of these devices have succeeded in mitigating the above *ex ante* inefficiency problem and keeping some of the potential beneficiaries from deserting from fiduciary relationships. Or suppose that some of the dishonest fiduciaries are, even without these devices, shrewd enough to refrain from exploiting their beneficiaries to the limit, leaving them barely better off than not entering into a relationship with them. In either event, *B*'s benefit is set equal to or slightly above *0*. It is this value that would now define *B*'s net benefit $U_B^0$ in the case of *F*'s disloyalty (as long as its value remains smaller than $U_B^*$). "What's wrong with the fiduciary's breaching the duty of loyalty," adherents of the economic approach to law might again say, "if it not only enhances the relationship's Kaldor efficiency but also stops short of worsening the beneficiary's position than before?"

Yet, the fiduciary law is still adamant in condemning fiduciary's breach of the duty of loyalty, even if his action has not made beneficiary worse off than before, nay, even if beneficiary herself has gained as a result of fiduciary's disloyalty. Indeed, it is to account for this fact that our model has not supposed, as in the trust game has, that $U_B^0$ is strictly negative. How can I, an economist, defend the duty of loyalty *(1)* that may fail to reap as much joint benefit as possible from the relationship? I will, however, take up such task only in the penultimate chapter, after I have elucidated the basic principles that underlie the disgorgement remedy and the strictness

[43] See, e.g., Hart (1995) and Laffont and Martimort (2002) for some of these devices..

liability of fiduciary breach.

## 4. DISGORGEMENT DAMAGES AS DETERRENCE POLICY

It is "a principle of the law of contracts that damages for breach should be based on the injured party's lost expectation."[44] When a party to a contract breaches his obligation, the breached party is entitled to recover an amount that will put her in as good a position as she would have been in had the contract been performed.[45] Within the framework of our formal model, damages $D$ according to this loss-based "compensatory rule" (or "expectation rule") may be identified with what we have called $B$'s "lost expectation":

$$(4) \qquad D = L_B.$$

In contradistinction to this loss-based compensatory rule in contract law, one of the defining characteristics of fiduciary law is said to be the "disgorgement principle" in remedy of its breach.[46] When a person in a fiduciary position breaches the duty of loyalty, the beneficiary is entitled to recover any gain the fiduciary has obtained through his position without any authorization by beneficiary or by courts or by the terms of fiduciary arrangement. Within the framework of our formal model, damages $D$ according to this gain-based "disgorgement rule"

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[44] Alan Farnsworth (1985): 1341.

[45] *Uniform Commercial Code*, e.g., says that "the aggrieved party may be put in as good a position as if the other party had fully performed." (§1-106). This is what §344 (a) of *Restatement Second, Contracts* calls the "expectation interest." To simplify the analysis, I will ignore what is called the "reliance interest" in the following discussion on the remedial rule for contractual breach.

[46] "[T] he disgorgement principle applies to breach of a fiduciary obligation." (Farnsworth (1985):1356.) In addition to the articles quoted in *n.1*, see Laycock (2002): 585-603; Virgo (2006): 514-525.

can be identified with what we have called *F*'s "unauthorized gain":

$$(5) \qquad D = G_F.$$

In fact, in the fiduciary law, even if *F*'s action has not actually injured *B* (i.e., $U_B^0 = 0$), nay, even if *B* herself has made a gain as a result of *F*'s disloyalty (i.e., $U_B^0 > 0$), *F* has to disgorge all the unauthorized gains and convey them to *B*.

The availability of disgorgement damages for fiduciary breach has been so well established that one 19th century English judge even went so far as to make the disgorgement damages the defining characteristic of fiduciary relationship.[47] Though this begs the whole question, it serves as a testament to the indisputability of disgorgement damages for fiduciary breach.

Nevertheless, once we start to look for rationales given in the past for this form of remedial consequence of fiduciary breach, we immediately find ourselves on a disputable terrain. Although there have been many attempts to justify disgorgement damages either as an instrument of deterrence policy (to prevent future breaches) or on the principle of corrective justice (to undo a past injustice), neither attempt has so far been completely successful.[48]

I will examine the deterrence policy rationale first.[49] It is indeed almost tautological to say

[47] "What is a fiduciary relationship? It is one in respect of which if a wrong arise, the same remedy exists against the wrong-doer on behalf of the principal as would exist against a trustee on behalf of the *cestui que trust* (the beneficiary)." *Ex parte Dale & Co.*, 11 Ch. D. 772, 778 (1879) *per* Fry, j.

[48] See references cited in *n. 49* and *n 55*, respectively.

[49] "In enforcing the duty of loyalty the court is primarily interested in improving trust administration by deterring trustees from getting into positions of conflict of interests." (Bogert (1987): 341). Since there are many works on the role of disgorgement damages as an effective deterrent to fiduciary breach, I cite only few others: Scott and Fratcher (1987): 323; Friedman (1980), 551-558; Cooter and Freedman (1991); Easterbrooks and Fischel (1993); Edelman (2002);

that the gain-based disgorgement rule could strip the disloyal fiduciary of all his unauthorized gain $G_F$, for its sole purpose is to disgorge all his unauthorized gain from the mouth of disloyal fiduciary. In contrast, the loss-based compensatory rule would fail to do so, even if *F* were caught in the act and paid the damages $L_B$, whenever his unauthorized gain falls short of *B*'s lost expectation.[50] This can be confirmed by calculating the net benefit of disloyal *F* when he pays the compensatory damages *(4)* and the disgorgement damages *(5)* respectively and comparing each value with the net benefit of loyal *F*. We have:

$$(6) \qquad U_F^0 - L_B \equiv U_F^* + G_F - L_B \ \substack{\geq \\ <} \ U_F^* \ \Leftrightarrow \ G_F \ \substack{\geq \\ <} \ L_B.$$

$$(7) \qquad U_F^0 - G_F = U_F^* \ \Leftrightarrow \ G_F \ \substack{\geq \\ <} \ L_B.$$

While the loss-based compensatory rule *(4)* would even encourage any self-seeking fiduciary to breach the duty of loyalty, whenever *F*'s unauthorized gain $G_F$ exceeds *B*'s lost expectation $L_B$, the gain-based disgorgement rule *(5)* would purge out of *F* any economic incentive to be disloyal to *B*, whether the unauthorized gain is larger than the lost expectation or not.[51] If one adheres to the policy of deterrence, this is the end of the story -- one cannot gain from one's breach.

The deterrence policy justification of the disgorgement rule for fiduciary breach, however,

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83-86, 212-216.

[50] Farnsworth, p. 1341.

[51] Note, however, that if we take into account of the difficulty of detecting all the incidences of fiduciary breach and of winning all the cases of litigation, the remedy based on the policy of deterrence should be set equal to $R^D/p$ where $0 < p \leq 1$ denotes the probability of detecting a breach and winning a case. See Cooter and Freedman (1991), 1051. In so far as this probability is less than one, the policy of deterrence has failed to justify the disgorgement rule fully.

contains serious conceptual difficulties at least as a positive theory of law, especially with respect to its treatment of the breached beneficiary. To see this, let us note that the loss-based compensatory damages will by definition always make *B* full, or that

$$(8) \qquad U_B^{0} + L_B \equiv U_B^{*} \Leftrightarrow G_F \gtrless L_B.$$

In contrast, the payment of the gain-based disgorgement damages will make *B* more or less than full, depending upon whether *F*'s unauthorized gain exceeds or falls short of *B*'s lost expectation, or

$$(9) \qquad U_B^{0} + G_F \gtrless U_B^{*} (\equiv U_B^{0} + L_F) \Leftrightarrow G_F \gtrless L_B.$$

On the one hand, whenever *F*'s unauthorized gain does not exceed *B*'s lost expectation, I believe few would disagree that the gain-based disgorgement rule *(5)* should be taken over by the loss-based compensation rule *(6)* as a remedial system. Although the amount of damages would be excessive as a deterrent, it would force *F* to internalize the efficiency loss his breach will inflict on the society. The remedial rule for fiduciary breach has thus to be revised in such a way that the damages payment is the greater of *B*'s lost expectation and *F*'s unauthorized gain, or

$$(10) \quad D = Max\ [L_B, G_F].$$

This hybrid of compensation rule and disgorgement rule is precisely what *the Uniform Trust Code* has adopted in its remedial formula, when it says that "a trustee who commits a breach of trust is liable to the beneficiaries affected for the greater of: (1) the amount required to restore the value of the trust property and trust distributions to what they would have been had the breach not occurred; or (2) the profit the trustee made by reason of the breach." (Section 1002). The first part of this characterization of fiduciary liability is no more than *B*'s lost expectation $L_B$, whereas the second part can be identified with *F*'s unauthorized gain $G_F$.

On the other hand, whenever *F*'s unauthorized gain exceeds *B*'s lost expectation, *F*'s payment to *B* of the disgorgement damages inevitably raises her net benefit over and above what she would have had but for the breach. That *F* should surrender all the ill-gotten gains may cause little uneasiness among us. But, that *B* would receive all the gains *F* has surrendered is a different matter. It is especially so because the disgorgement rule would reward *B* all the disgorged gain from *F*, even if *B* did not suffer from *F*'s breach (*i.e.*, $U_B^0=0$), nay even if *B* did gain as a result of *F*'s breach (*i.e.*, $U_B^0>0$). The disgorgement damages in excess of the lost expectation, $G_F - L_B$, thus appears a mere "windfall," of which the beneficiary is no more than an accidental recipient.[52] Why shouldn't the court channel the amount of excess remedy $G_F - L_B$ to people or organizations it believes more instrumental for the policy of deterrence or more worthy for the good of the society?

From the standpoint of deterrence policy, is there any rationale for the beneficiary being rewarded more than she has lost? None, for the deterring effects on potential wrongdoers would not be generally dependent on whom the damages were rewarded. Of course, a keen

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[52] See, e.g., Jones (1968), 478. Shepherd (1981) went so far as to call the amount of remedy that exceeds the expectation loss a beneficiary's "unjust enrichment." (75-76).

practitioner of the economic approach would evaluate the legal rule not only for its effects on the wrongdoers' incentives but also for its effects on their victims' incentives. But, this is totally a pointless exercise in the case of fiduciary relationships whose beneficiaries are beneficiaries simply because they absolutely lack capacities to form contractual relationships with fiduciaries. How can, for instance, a trust beneficiary who has not yet been born take precautions against possible breach of its trustee? More than that, such a calculation would only make the case worse. For what it would demonstrate is that, if potential victims were not totally passive agents, any compensation would deteriorate their incentives to take precautions against possible injuries, so that there should be no damage payment to the victims.[53] Indeed, when the amount of compensation gets larger, people may take too many cases to courts to bet on lucky success in litigation and may even choose to act vulnerably so as to induce wrongful conducts. If the deterrence policy is unable to justify even the traditional principle of compensating victims for their losses, it is totally at a loss to justify the disgorgement damages in excess of the lost expectation that appears a mere windfall to the breached beneficiaries.

This leads us to look at the second rationalization of the disgorgement rule – the principle of corrective justice, for it postulates that the injurer's duty to pay damages and the injured's right

[53] See Polinsky and Che (1991) and Cooter and Porat (2002). Posner (1998), on the other hand, argues that it is only when the monetary amount of damages $D$ would match the expected loss $L_B$ from their injuries (including litigation costs, risk premium, time preference, etc.) that potential victims would exercise an optimal level of precautions against injurious activities. (209). But his argument fails to take account of the possibility that, the higher the level of potential victims' safety precautions, the lower the potential wrongdoers' incentives to be lawful.

to receive damages constitute “a single whole.”[54]

## 5. DISGORGEMENT DAMAGES AS CORRECTIVE JUSTICE

“The traditional argument for restoring plaintiff to his rightful position is based on corrective justice. Plaintiff should not be made to suffer because of wrongdoing, and if we restore plaintiff to this rightful position, he will not suffer. To do less would leave part of the harm unremedied; to do more would confer a windfall gain.”[55] The basic idea of corrective justice can be traced back to Aristotle’s *Nichomachean Ethics* but has seen a strong revival in recent years in the area of private law, especially in tort law, as the deontological alternative to the economic (or more generally the utilitarian) approach to law. Corrective justice is literally “justice as rectification.” Its whole purpose is to rectify a particular injustice that has occurred between two parties, i.e., between the injurer and the injured. In its modern theorization it is formulated as a simple deontological principle that, whenever a person breaches one of his primary duties to another, he should be imposed a secondary duty (also called a remedial or sanctioning duty) to restore that person to the position she would have been in but for the breach.[56] The injurer, in other words, has to pay the injured what we have called the lost expectation, and this is precisely

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[54] Ernest Weinrib (1995): 143.

[55] Douglas Laycock (2002):17. The modern representatives of corrective justice approach are Jules Coleman (1995) and Weinrib (1995, 2000).

[56] According to Weinrib (1995): “When the defendant . . . breaches a duty correlative to the plaintiff’s right, the plaintiff is entitled to reparation.”(135), and according to Coleman (1995): “Corrective justice claims that when someone has wronged another to whom he owes a duty ..., he thereby incurs a duty of repair.” (32).

what the compensatory remedy means.[57]

Then, how can I use the notion of corrective justice as a rationalization of the disgorgement rule, if the remedial principle generic to it is none other than the compensatory rule, its rival? In fact, the only justification the corrective justice approach has so far been able to come up with is the supposed "property-like" nature of beneficiary's interests entrusted to fiduciary.[58] Needless to say, property rights give the owner not only the exclusive right to use and the exclusive right to alienate her property (that is, to transfer or to destruct her property) but also the exclusive right to enjoy the whole fruits from the use and from the alienation of her property. (These rights correspond to the *ius utendi*, the *ius abutendi* and the *ius fruendi* in Roman law.) Any gain a piece of property generates is as much within the entitlement of the owner as the property itself is. Hence, when a person has interfered with another's property, any profit he has earned from the interference is as much a loss to the owner as the loss of the property itself.[59]

If beneficiary's interests from her relationship with fiduciary could really be treated as a piece of property or the like, we would be able to employ this logic of property right to justify disgorging unauthorized gain from fiduciary in breach. And yet, to treat many things as "property" or "property-like" that are not in the truest sense a piece of property as a rationalization of the legal practice of disgorgement damages for fiduciary breach is merely

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[57] Weinrib (1995): "Under corrective justice damages are compensatory . . ." (135, n. 25); and Coleman (1995) : "The principle of corrective justice" imposes on the injurer "the duty . . . to make good the victim's loss. . ." (56).
[58] See Shepherd (1981), 93-123, Frankel (1983), 827, and Weinrib (2000), 141-142.
[59] See, e.g., Friedmann (1980), 504; Virgo (2006), 475-6.

stating a conclusion, not a rationale.[60] In fact, in trust law jurisprudence there is a longstanding and often intense controversy over the nature of the beneficiary's right between those who argue that the right of a trust beneficiary (*cestui que trust*) is a property right (or a right *in rem*) in the trust property and those who maintain that the beneficiary of a trust relationship has merely a personal right (a right *in personam*) against the trustee.[61] This controversy has long lost its heat, but has not completely died out. If it is controversial to treat the beneficiary's right as proprietary even in the case of trust relationship that deals directly with a piece of property (trust property), it is all the more controversial to base the justification for the disgorgement remedy on the supposed "property-like" nature of the beneficiary's right in other (trust-like) fiduciary relationships that have no hard "property" involved. It is for this reason that many judges and legal scholars who are otherwise unsympathetic to economic approach to law have endorsed the deterrence rationale when they come to explain the disgorgement rule in fiduciary law.[62]

Is there a way to rationalize the disgorgement damages for fiduciary breach without having

[60] Weinrib (1975): 10-11; Friedman (1980): 552-553; Easterbrook and Fischel (1993): 435; and Edelman (2002): 192-193. Shepherd (1981) himself has pointed out two cases where the property theory breaks down completely, at 53-56 and 278. The first is the case where a civil servant has to account to the state not only for the original amount of the bribe he took but also for the increased value of the property representing the bribe. It is virtually impossible to create a property concept in which the state as a principal is the beneficiary owner of a bribe to its agent. The second is the case of corporate opportunities. It has always been accepted that the taker of corporate opportunities cannot use in his defense the argument that the corporation could not have acquired the opportunity itself.

[61] See Waters, (1967) for this controversy.

[62] Daniel Friedman (1980) thus claims that: "Breach of fiduciary duty constitutes perhaps the most conspicuous area of application of deterrent principles to restitution [i.e., disgorgement damages]. It generally entails liability in restitution even if the fiduciary did not appropriate any "property" belonging to the beneficiary" (553).

recourse to the property or property-like nature of beneficiary's interests? I believe there is, and it is by going back to the very characterization of the fiduciary's duty of loyalty.

Let us first keep in mind that the beneficiary's right in a fiduciary relationship is, at least at its core, not a property right (a right *in rem*) over her interests, but a personal right (a right *in personam*) against the fiduciary. In this respect, it is no different from the promisee's right against the promisor in contractual relationship.[63] What fundamentally distinguishes the former from the latter is the content of the correlative duty. While the promisor's duty in contract is confined to the performance of the promised act, the fiduciary's duty of loyalty is essentially "open-ended." What it dictates the fiduciary is only to act solely with the beneficiary's interests in mind, with reasonable care, skill and caution, at least within the confines of the terms set at the inception of the relationship. In fact, even in the case of bare trust where the trustee holds the trust property to the order of the beneficiary, the trustee has discretion not to follow the order, if it would jeopardize the very interests of the beneficiary. In our formal model of fiduciary relationship, the duty of loyalty has been formulated as an open-ended rule *(1)* that

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[63] Even in a contract for supplying a piece of property, what the promisee acquires by the contract in exchange for consideration is not a property right to that piece of property but a personal right against the promisee to his promise to supply that piece. (In other words, a *jus in personam ad rem* is a *jus in personam* not a *jus rem*.) To be sure, the contract right itself can be treated as a kind of property, to the extent that its content can be separated from particular personal relationship between promisor and promisee. In particular, the so-called choses in action, such as bank-accounts, debts, corporate shares, etc., can indeed be bought and sold or even borrowed and lent just like other ordinary choses (things). But the fact still remains that to have, for instance, a bank account is not to own a certain sum of money in the bank's vault but merely to own a personal right against the bank to demand that sum. That a property right can be set up on a contract right does not transform the contract right into a property right; a contract right itself continues to be a personal right – a right against a particular person.

dictates *F* to take whatever action a man of reasonable skill and judgment would do to maximize *B*'s net benefit subject to his participatory constraint, or as $Max\ U_B,\ s.t.\ U_F \geq 0$. This means that whenever *F*'s pursuit of his own interests results in a failure of the beneficiary to reap as much benefit as she would have were the fiduciary to act solely in her interests, he should be regarded as breaching the duty of loyalty to her and subject to the process of corrective justice. (When the fiduciary fails to maximize the beneficiary's benefit even if he is not pursuing his own interests, he should be regarded as breaching the duty of care.) I will argue now that this open-endedness of the duty of loyalty necessarily keeps the value of *F*'s unauthorized gain from exceeding that of *B*'s lost expectation.

To show this, suppose that *F*'s unauthorized gain indeed exceeds *B*'s lost expectation or that $G_F > L_B$. It is then trivial to see that in such a situation *F*'s disloyalty to *B* would rather improve their relationship's Kaldor efficiency, for *F* could still make himself better off without making *B* worse off (in fact, *F* could make both *B* and himself better off) even if he were to transfer a part of his ill-gotten gain to *B*. Formally, let *P* be a monetary value *F* transfers to *B* after his disloyal act. We then obtain:

$$(11) \quad G_F > L_B \Rightarrow \text{There is a } P>0 \text{ such that } G_F > P > L_B \text{ or } U_B^0 + P > U_B^* \text{ and } U_F^0 - P > U_F^*.$$[64]

Note that this also implies that the joint benefit under *F*'s disloyalty is necessarily greater than the joint benefit under *F*'s loyalty, or that:

[64] *Appendix 1* shows this when no interpersonal comparison of individual benefits is allowed.

$(11')\quad G_F>L_B \Rightarrow U_B^0+U_F^0 > U_B^*+U_F^*.$

We can go further. In that situation, even if $F$ were to transfer *all* of his unauthorized gain $G_F$ to $B$, he would still be fully remunerated for the costs and efforts he has incurred as a fiduciary in the sense that $U_F^0-G_F=U_F^*\geq 0$. This, of course, implies a contradiction! For $F$'s duty of loyalty is to promote $B$'s benefit to the maximum, and, as long as there is a way for $F$ as a man of reasonable skill and knowledge to improve $B$'s benefit further without destroying his own incentive to serve $B$, what has been supposed to be his loyal act proves not to be truly loyal at all. What $F$ should do to fulfill his duty of loyalty is to earn the gain $G_F$ (temporarily at $B$'s expense) but transfer it fully to $B$, thereby promoting $B$'s benefit to the level higher than the supposed maximum $U_B^*$. If we keep the notational convention to place an asterisk (*) on the variables in the case of loyalty, we now have to redefine $U_B^*(\equiv Max_{U_F\geq 0}U_B)$ and $U_F^*$ as $U_B^0+G_F$ and $U_F^0-G_F$ respectively, though the latter being by definition equal to the original $U_F^*$.

It follows that, whenever $F$'s unauthorized gain exceeds $B$'s lost expectation, the gain $F$ earns from the relationship without authorization is what $B$ would have had had $F$ acted loyally. In other words, $F$'s unauthorized gain now becomes equal to $B$'s lost expectation, or

$(12)\quad L_B = U_B^* - U_B^0 = (U_B^0+G_F) - U_B^0 = G_F.$

The situation is somewhat similar to Zeno's story of Achilles and the tortoise. The moment $F$'s unauthorized gain exceeds $B$'s lost expectation, we have to redefine what constitutes $F$'s loyal act and adjust the value of $B$'s lost expectation by adding to it the excess of $F$'s unauthorized gain, thereby making them equal with each other. Under the fiduciary principle *(1)* *F*'s unauthorized gain can never exceed *B*'s lost expectation, that is,

*(13)* $G_F \leq L_B$.

It should be noted that the above argument by no means implies that *F* should increase *B*'s net benefit over and above the level a man of reasonable skill and judgment is able to do. There is nothing in the fiduciary principle that obliges or even encourages *F* to do so, even if *F* happens to be endowed with special capability that has a synergy effect with *B*'s resources. Any above-normal benefit *F* bestows on *B* should be regarded as *F*'s purely voluntary act of donation to *B*. In any case, if *F* has actually earned an unauthorized gain above and over the reasonable and appropriate level by having served *B* as her fiduciary, that gain should be treated as belonging to *B*.

We have already revised in *(10)* the remedial rule for fiduciary breach in such a way that when *F*'s unauthorized gain fails to exceed *B*'s lost expectation, *F* has to compensate *B* fully for her lost expectation above and over his unauthorized gain. We have now seen that *F*'s unauthorized gain can never exceed *B*'s lost expectation by the very open-ended nature of the duty *F* owes to *B*, because the moment *F*'s unauthorized gain has exceeded *B*'s lost expectation, *F*'s duty of loyalty entitles *B* to receive this excess gain so that the value of *B*'s lost expectation will be automatically raised to that of *F*'s unauthorized gain. To be sure, *F* has to disgorge every penny of his ill-gotten gains in such situation, but what *F* has to disgorge is no more than the compensation of what $B$ has lost as a result of $F$'s breach. In sum, we have:

(14) $D = Max[G_F, L_B] = L_B$.

We have thus succeeded in eliminating any windfall element from the damages awarded to the beneficiary in the law of fiduciary. This resolution, however, has come at substantial price. For we have at the same time lost as an independent remedial rule the very disgorgement rule we have been trying to rationalize. Indeed, all that we need is the most venerable of all the remedial rules – the compensatory rule that obliges the injuring party to compensate the injured party for the amount of her lost expectation. The gain-based appearance of the disgorgement remedy *(5)* is a mere appearance – the fiduciary's unauthorized gain $G_F$ has to be disgorged only because it constitutes a part, or at most the whole, of the beneficiary's lost expectation $L_B$. Even in the case of fiduciary's breach of the duty of loyalty, the basic remedial principle remains to be compensatory, as in the case of contractual breach.[65] The fiduciary law is certainly anti-contractual, but its remedial rule is far from being anti-compensatory.

While this conclusion brings the old-fashioned idea of corrective justice back to life as a justificatory principle for the fiduciary law's remedial rule, its resurrection of the deterrence policy justification is only partial. To be sure, the compensatory rule *(4)* can now function also as a deterrent to future disloyalty of potential fiduciaries, because it has absorbed the disgorgement rule *(5)* as its part. But, the deterrence policy *per se* is still incapable of justifying

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[65] This remark may cast a serious doubt on the necessity of the concept of "restitution" in the area of private law.

why the beneficiary has to be the recipient of even a part of the fiduciary's damages payment for his breach of fiduciary duty.

More important is the fact that our explanation of the seemingly gain-based feature of the remedial rule for fiduciary law is based solely on the open-ended nature of the duty of loyalty without having presupposed the "property" or "property-like" nature of the interests the relationship with *F* provides *B* with. *B* is entitled to any unauthorized gain *F* has earned from his relationship with her, not because *B* has a "property" or "property-like" right to her interests, but because *B*'s right correlative to *F*'s duty of loyalty is an open-ended right to any benefit *F* generates from the relationship. Indeed, if *B*'s opportunities to benefit from the relationship appear to be "property-like," it is the result, not the reason, of the necessity to disgorge *F* of his unauthorized gain for compensatory purpose.[66]

Gareth Jones once remarked that: "to compel a fiduciary, who has proved his honesty beyond doubt and has acted *in his principal's best interests*, to account for profit made at the expense of a third party is less easily justifiable particularly if the principal has also benefited through the

[66] This is in perfect conformity with the following observation by Edelman (2002): "It was once thought that liability for breach of fiduciary duty was based in notions of property. However, any doubts were resolved in *Attorney General for Hong Kong v. Reid*, where the Privy Council made it clear that fiduciary liability was independent of any question of interference with property held by the fiduciary. ... The breach of fiduciary duty in that case – receiving bribes – clearly did not involve property of the claimant (principal)." (192-193). This, however, leaves us one loose end to tie up. It is the fact that, in spite of the longstanding controversy as to the personal/proprietary nature of the beneficiary's right in trust relationship, the modern tendency is to make it essentially "proprietary" or "proprietary-like." (See, for instance, Borgart (1987), sec. 37, or Penner (2002), sec. 2-34.) How can we reconcile this fact with our premise that the beneficiary's right in the fiduciary relationship, which of course includes the trust relationship, is at least in its core a personal right against the fiduciary? I need another paper to answer this question.

fiduciary's actions" than to make "a foolish but honest fiduciary" liable for a real loss suffered by the beneficiary through his act or omission, even though he has made no gain.[67] But what we have seen is that, whenever a fiduciary has pocketed an unauthorized gain, he has, by the very characteristics of the fiduciary duty, not acted in his beneficiary's best interests, even though the beneficiary benefited from his conduct.

## 6. STRICTNESS OF FIDUCIARY LIABILITY.

Fiduciary law imposes on anyone who has accepted the position of fiduciary the primary duty of loyalty towards beneficiary. Fiduciary law also imposes on any fiduciary who has breached that duty the secondary duty of compensation to the beneficiary. To make our analysis of the fiduciary law self-contained, I now have to describe an evidentiary procedure that determines whether a fiduciary has indeed breached the duty of loyalty or not.

In order to bring an action, the plaintiff must have a "cause" that will entitle her to obtain a remedy in court from the defendant. In the case of a contractual breach, it is the plaintiff who must allege and prove the fact of breach.[68] Unless she can show with "reasonable certainty" that she has been harmed by the defendant's breach, the plaintiff may not be rewarded, at least in full, the damages for her loss.[69] That the burden of proof is on the plaintiff is justifiable

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[67] Jones, 484. (Italics are mine.)

[68] See, e.g., Corbin (1952): § 1228.

[69] See *Restatement Second, Contracts* §360 comment b: "If the injured party has suffered loss but cannot sustain the burden of proving it, only nominal damages will be awarded."

either on the basis of economic analysis or on the basis of corrective justice. From the economic standpoint, the promisee who has suffered the loss is the most efficient source of evidence with regard to the breach and has a full incentive to seek damages against the promisor in court. From the corrective justice standpoint, the promisee whose primary right is breached should be awarded a secondary right to damages as rectification of an injustice inflicted by the promisor and should be responsible to produce evidence in order to affirm that right in courts.

Yet, once we have entered into the realm of fiduciary relationships, we see immediately that there is no chance for such evidentiary procedure to work. Since the very *raison d'être* of setting up a fiduciary relationship lies in the beneficiary's absolute lack in capacity to form contract with the fiduciary, it is often impossible, usually impractical, and almost always ineffectual to have the beneficiary to allege and prove the fact of breach.[70] A ward needs a guardian just because she is a minor or mentally incompetent. A trust beneficiary may not be informed or may not be intelligent or may yet be born; and even when she were alive, intelligent, and informed, the fact that the legal owner of the trust property is not the beneficiary but the trustee would give the trustee ample means to disguise his transactions with regard to the trust property as if it were for the beneficiary's best interests. A corporation under the

[70] See, e.g., Flannigan (2006). Flannigan (1990) at 46 quotes the following remark by Lord Eldon on *Ex parte Lacey*: "It is founded upon this: that though you may see in a particular case, that he has not made advantage, it is utterly impossible to examine upon satisfactory evidence in the power of the Court, by which I mean, in the power of the parties, in ninety-nine cases out of an hundred, whether he has made an advantage, or not."

management of directors and officers has only a legal personality that has no natural capacity to do anything, let alone to allege and prove the fact of managerial breach. A principal is incapable of monitoring her agent who is representing her in a deal with third parties in her absence, and even if she hires the second agent to monitor the first agent she is then unable to monitor that monitoring agent. Members of a partnership are also incapable of monitoring every detail of her fellow partners' conducts because they have to divide their work through specialization. A patient, a client, a devotee, and an investor may be unconscious or unrealistic or infatuated or occupied; and even if the patient were conscious, the client were realistic, the devotee were poised, and the investor were attentive, the doctor, the lawyer, the priest, and the fund manager could easily exploit their informational dominance over their beneficiary to structure their self-seeking actions as if they were for the sake of the beneficiary. (See again *Appendix 1* for the formal proof of this claim.)

Fiduciary law has, through a long historical process, "solved" this problem of evidentiary procedure, albeit imperfectly, by making the fiduciary liability strictly "strict." It starts from a formalization of the duty of loyalty as a set of rules that fiduciary has to observe externally – "a fiduciary (a) cannot use his position to his own or to a third party's advantage; or (b) cannot, in any manner within the scope of his service, have a personal interest or an inconsistent engagement with a third party – unless this is freely and informedly consented to by the beneficiary or is authorized by law." (Finn (1989a) at 27). The former rule that disentitles a fiduciary to earn unauthorized gain or secret profit from his position is called “the profit rule” and the latter that disallows a fiduciary to place himself in a position where his own interest conflicts his duty to the beneficiary “the conflict rule”. What these rules implicitly tell the fiduciary is that the courts do not delve into his internal state of mind in determining a breach. All that is required of the fiduciary is the external “appearance” of conforming to the duty of loyalty. But that requirement also implies that any act of the fiduciary that “appears” to have compromised the undivided loyalty to the beneficiary is presumed to have breached the duty itself, unless it is freely and informedly consented by the fiduciary or is approved by courts or authorized by the terms of fiduciary arrangement. It is immaterial whether the action in question was taken in good faith, or the terms of transactions were fair, or no harm resulted to the beneficiary.[71] Indeed, once a fiduciary is alleged to have violated one of the rules, either he is held to be liable without any defense allowed in courts, or, more often the case, he has the burden of proving his loyalty against the contrary appearance. The whole purpose of subjecting the fiduciary to such “strict” liability is to surmount the intrinsic difficulty of determining the fact of breach in the fiduciary relationship.

It is true that in the United States and several other countries the strictness of the fiduciary liability has been relaxed at least for corporate managers. Managers may now be able to justify his self-interested transaction, as long as it is proved to be fair to the corporation, even without

[71] See again *Restatement Third, Trusts,* §78, Comment on (1) and (2), quoted in *n. 10*.

any authorization by courts, nay, even in the absence of any approval by disinterested managers.[72] This, however, should not be taken as a denial of the evidentiary procedure's basic presumption, because in the case of corporate managers the so-called corporate governance system regulates the behavior of managers not only by imposing fiduciary duties on them but also by encouraging a variety of stakeholders to monitor their activities and hold them accountable. The derivative action permits individual shareholders to sue on behalf of their corporation when managers are believed to have violated fiduciary duties; the board of directors in a publicly held corporation must have a certain number of directors (a majority in the case of a large publicly held corporation) who are free of any significant relationship with its senior managers in order to restrain the latter's potential self-dealing or conflict of interest transactions; there are "voices" of core employees, main banks, long-term suppliers, regular customers, local communities, etc. that may be able to check the managers' performances from inside and outside of the corporate organization; and the stock market is also expected to function as a "market for corporate control" especially for dispersedly owned public corporations.[73] It is to the extent that these supplementary devices are available, and only to that extent, that a certain relaxation of the strict liability has been permitted for fiduciary breach of corporate managers. The fiduciary liability should be kept strict in other fiduciary

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[72] See Marsh (1966) for the evolution of the manner in which American courts have interpreted the duty of loyalty, especially for that of corporate managers. See generally *Principle of Corporate Governance*, especially Part V.

[73] See again *Principle of Corporate Governance*. See Iwai (1999, 2002) for more detailed discussion on these supplementary corporate governance mechanisms on the basis of corporate theory.

relationships unless there is a room for non-beneficiaries to assist the beneficiary to prove the fact of breach. In any case, even in the relationship between corporation and its managers it is still the managers who have to bear the burden of proving the fairness of their transactions.

There has been a debate as to whether the profit rule and the conflict rule are the same thing or two separate rules.[74] Leaving aside its historical origin as the ancient prohibition against compensations to fiduciary, the profit rule is evidently a corollary of the conflict rule. Whenever a fiduciary makes a gain from his position without any consent or authorization, he certainly has "a personal interest or an inconsistent engagement with a third party." A violation of the profit rule is necessarily a violation of the conflict rule. Yet, I believe, there is a reason to have the profit rule presented separately from the conflict rule. It is that the fiduciary's unauthorized gain $G_F$ may serve as a surrogate measure of the beneficiary's damages suffered from the breach.

It is one thing to prove the fact of fiduciary's breach but quite another to measure the amount of beneficiary's lost expectation. Even when a breach is successfully proved, the beneficiary as well as courts would still be left with equally daunting problem of measuring "with reasonable certainty" the amount of damages $L_B$ the beneficiary has suffered from the breach. This is especially difficult in the case of professional relationships, such as doctor and patient, lawyer and client, priest and devotee, and fund manager and investor, where the effects of

[74] Shepherd (1981b): 147-151.

professional's actions are beset with so large an uncertainty that the most conscientious effort may end up with the worst situation and the totally self-interested performance may give rise to the best possible outcome. An aggravation of symptoms, for instance, is not always a sign of doctor's choice of suboptimal treatment, nor an improvement an indication of his loyalty to the patient's interests. The patient's lost expectation is positive only in the sense of statistical average, and there may be a non-negligible probability that the realized medical benefit from a suboptimal treatment turns out to be better than the medical benefit expected from the optimal treatment.[75]

If it were in the realm of contract law, this would mark the end of the story -- no damages will be awarded to the beneficiary unless she herself cannot show the evidence of her lost expectation. But, since the law of fiduciary relationships has turned the table around and placed the burden of proof on the fiduciary's shoulders, there remains an important piece of information that can still be exploited effectively. It is the fiduciary's unauthorized gain $G_F$. In so far as it is not of psychic nature, it is often observable by the beneficiary, or, if she is incapable, by well-informed third parties including courts. Especially if the gain is in the form of excessive compensation or abnormal price or kickback, it is not easy for fiduciary to hide it from the eyes of others. Since we have already shown in *(13)* that by the open-ended nature of the duty of loyalty the fiduciary's unauthorized gain can never exceed the beneficiary's lost

[75] *Appendix 1* demonstrates this fact in a formal model of doctor/patient relationship.

expectation, or $G_F \leq L_B$, not only its presence can serve as the sure evidence of the fiduciary's breach but also its amount as the lower bound measure of the beneficiary's lost expectation. Whenever a fiduciary is found to have earned an unauthorized gain $G_F$, his beneficiary is automatically entitled to receive at least that amount from the fiduciary as a compensation for her lost expectation $L_B$. Although the gain-based disgorgement remedy has been subsumed under the loss-based compensatory remedy, the fiduciary's unauthorized gain has thus been shown to have still an important role to play in the evidentiary procedure in fiduciary law.

Let us now go back to Judge Caldozo's famous dictum quoted in Chap.1: "a [fiduciary] is held to something stricter than the morals of the market place." Most commentators have interpreted this as a command of ethicality or altruism on fiduciary. But they then miss the fundamental fact about fiduciary law. In spite of its highly exalting tone, what Judge Caldozo exalted is not the virtuousness of fiduciary's internality but the "strictness" of his external adherence to the rules of conduct. To be sure, "not honesty alone, but the punctilio of an honor the most sensitive" is demanded of fiduciary, but it was not as to his state of mind but as to his "standard of behavior." Indeed, the very essence of the fiduciary law is to impose on any person in the position of fiduciary the duty to act loyally to another *as legally enforceable duties*. The duty of loyalty is therefore not an ethical duty at all but a legal duty *per excellence*.[76] For what distinguishes an ethical duty from a legal one is that while the latter is subject to external

[76] I thus agree with deMott (1992): "the duty to act loyally is one imposed by the law in particular relationships ... In contrast, in its conventional sense, altruistic [or ethical] action is self-willed, not compelled by law." (478)

constraint by courts, the former is subject only to individual's free self-constraint. An ethical duty ceases to be "ethical" the moment it becomes a duty coerced from outside.

Of course, fiduciaries are free to internalize the duty of loyalty as an ethical duty, and Judge Caldozo's dictum and the like have certainly helped many fiduciaries to fulfill their duty out of their self-imposed motivation. But, this does not change the fact that the duty of loyalty in itself is a legal duty enforced externally by courts. In fact, the intrinsic difficulty of proving the fact of fiduciary breach has driven the fiduciary law to the very limit of the legality by requiring the fiduciary only of external conformity with the profit and conflict rules and at the same time presuming any "appearance" of disloyalty as evidence of a breach of the duty of loyalty. The fiduciary liability is "strict" not because the fiduciary law is "ethical" but because it is "legal" through and through.

## 7. "ECONOMIC"JUSTIFICATION OF FIDUCIARY PRINCIPLES

I left Chap.3 without having answered the economic approach's possible criticism of our deontological formulation of the duty of loyalty *(1)* that its reduction of fiduciary's net benefit to a mere side constraint may fail to maximize the joint benefit between *B* and *F*. What's wrong with the fiduciary's breaching the duty of loyalty, if it enhances the relationship's Kaldor efficiency?

It is true that we have demonstrated in Chap.5 that, whenever *F*'s unauthorized gain $G_F$

exceeds $B$'s lost expectation $L_B$, the open-ended nature of the duty of loyalty *(1)* automatically equates the value of $B$'s lost expectation to that of $F$'s unauthorized gain. But, this is no answer to the economic approach that criticizes the very duty of loyalty as possibly causing economic inefficiency. In order to take up such criticism we now have to introduce the possibility that $F$'s unauthorized gain $G_F$ exceeds $B$'s lost expectation $L_B$ once again.

The starting point of our "economic" justification of the fiduciary duty of loyalty is an observation that, as long as $F$'s unauthorized gain is larger than $B$'s lost expectation or $G_F > L_B$, there always exists an alternative allocation that is equal in terms of Kaldor efficiency but is superior in terms of Pareto optimality. Needless to say, a change in allocation is said to be "Pareto optimal" if it actually makes at least one person better off without making any other person worse off. Indeed, *F had an option of not having placed himself as B's fiduciary but purchased a "right" to serve B as a third party in the market.* Of course, in such a situation somebody else, say *f*, would have had to take care of $B$ as her fiduciary. (I will keep designating $F$ as $F$, though he is no longer a fiduciary to $B$.) If we denote by $P$ a price $F$ would offer for such right, $B$'s net benefit and $F$'s net benefit would respectively become equal to $U_B^0+P$ and $U_F^0$-$P$. Then, the set of inequalities *(11)* given in Chap. 5 can now be read as saying that, as long as $F$'s unauthorized gain is larger than $B$'s lost expectation, there always exists a price $P$ that would give $F$ an incentive to propose such a transaction, even if he were a self-seeking monster, and that would at the same time put *f* an obligation to accept $F$'s proposed transaction, in so far as he or she is a loyal fiduciary acting solely on *B*'s behalf. (Where the price *P* is actually set between $G_F$ and $L_B$ is determined by the relative bargaining strengths between *F* and *f*.) It goes without saying that, as any open transaction would do, such an open transaction between *F* and *B* through the intermediary of the latter's loyal fiduciary *f* would automatically ensure the Pareto optimality and of course the Kaldor efficiency of the resulting allocation among all the parties involved including *F* as a third party, though it may fail to maximize the Kaldor efficiency of the fiduciary relationship. (For $U_B=U_B^0+P>U_B^*$, $U_F=U_F^0-P>U_F^*\geq 0$, and $U_f\geq 0$.) By contrast, although *F*'s disloyalty to *B* would certainly be superior to *F*'s loyalty in terms of Kaldor efficiency even within the fiduciary relationship, it would fail to be so in terms of Pareto optimality. (For $U_B^0<U_B^*$, even if $U_B^0+U_F^0>U_B^*+U_F^*$.)

Note that, even if *F* tries to purchase from *f* the right to serve *B* as a third party, he may be outbid by another in the market. But, so much the better for the society, for then *B*'s property or power or information or other resources would be served by the more productive user, thereby promoting the society's Pareto optimality further.

I suppose that few trained in economics would object to our use of the notion of Pareto optimality as a standard of welfare comparison. I also believe that even the die-hard adherent of the economic approach to law would not reject the basic axiom I now propose – that if two alternative courses of action are equivalent in terms of Kaldor efficiency it is "wrong" to choose the one that is not Pareto optimal over the one that is.[77] As a matter of fact, the argument given above is a mere restatement of the first lesson in welfare economics that Kaldor efficiency is another name for “potential” Pareto optimality and that any Kaldor efficient allocation could be turned into a Pareto optimal one by actual transfer of monetary values from better-off persons to worse-off persons.

Some may, however, still oppose to our argument on the ground analogous to “the the theory of efficiency breach” in contract law.[78] In the case of contractual relationships, Richard Posner (1998), for instance, wrote that “[if ] the profit from breach exceed his profits from completion of the contract,” and “[i]f it would also exceed the expected profit to the other party from completion of the contract, and if the damages are limited to the loss of that profit, there will be an incentive to commit a breach.” “But,” he then added, “there should be.”

In the case of fiduciary relationships as well, if *B* could always bring a suit against *F* in breach and give in evidence the amount of her lost expectation $L_B$, and if courts could always verify *F*’s breach and set the damages *D* equal to *B*’s lost expectation, *F*’s self-seeking activity would bring about a Pareto optimal allocation (in a weak sense, though). *F* then has an incentive to breach his duty to *B* only when his unauthorized gain $G_F$ exceeds the damages $L_B$ he has to pay *B*. The resulting allocation would then be superior to the allocation under his

[77] I recognize that even Paretian criterion is not without criticisms – that it allows a wide disparity of incomes, that it is too weak to determine the unique optimal, that it may conflict with the minimum requirement of liberty, etc. All these criticisms are, I believe, legitimate, but not relevant to its use in this article.

[78] The concept of efficient breach was first introduced by Birmingham (1970). Its textbook account can be found in Posner (1998):133, Polinsky (2003): 29-41,63-69 and Cooter and Ulen (2008): 262-69.

loyalty in terms of Pareto optimality, for that will leave *F* better off and make *B* not worse off than under *F*'s loyalty, or $U_F = U_F^0 - L_B > U_F^*$ and $U_B = U_B^0 + L_B = U_B^*$. One may call this the efficiency breach, or better, the Pareto optimal breach of fiduciary duty.

It thus appears necessary for us, as practitioners of the economic approach to law would always do, to start comparing the associated transactions costs of the two principles that are equally capable of bringing about Pareto optimal allocations – the one that obliges fiduciaries to observe the duty of loyalty, purging all the self-seeking activities from inside of their relationship with beneficiaries, and the other that allows fiduciaries to exploit their relationship with beneficiaries to seek their own interests, so long as they can compensate the beneficiaries for their lost expectation.[79] But such comparison is totally one-sided in the case of fiduciary relationships. As we have argued in Chap.6, it is often impossible, usually impractical, and almost always ineffectual to count on beneficiaries to bring a suit against disloyal fiduciaries, let alone prove the amount of her lost expectation, and it is again often impossible, usually impractical, and almost always ineffectual to rely on courts to verify the fact of fiduciary breach, let alone measure the correct amount of damages fiduciaries owe to beneficiaries. Those evidentiary problems and the associated transactions costs would multiply

[79] This comparison is analogous to the one between property rules and liability rules for the law of torts, especially, of intentional torts. See Calabresi and Melamed (1972) for the original formulation and Kaplow and Shavel (1996) for its critique. A property rule is a rule that allows no one to take things from another, unless she/he buys them at the price its possessor voluntarily agrees. A liability rule is a rule that allows anyone to take things from another, as long as she/he compensates the possessor for the court's estimate of their value. In the case of fiduciary relationships, we have in Chap.5 deduced the property rule itself from the open-ended nature of the duty of loyalty, and we will show below the total ineffectualness of the liability rule.

astronomically, once fiduciaries are allowed to breach the duty whenever they find it profitable to do so even after they pay compensatory damages. It would inevitably end up with nullifying the very remedial process of compensatory damages that is supposed to ensure the Pareto optimality of the Pareto optimal breach of fiduciary duty. Surely, even the disgorgement remedy *(5)* (that has now been subsumed by the compensatory remedy *(4)* under the duty of loyalty) may not be able to deter all the fiduciary breaches. But the fiduciary law has at least devised a way to minimize their occurrence by making the fiduciary liability strictly "strict," thereby maximizing the likelihood of Pareto optimal outcomes. After a long detour we again find ourselves from where the present article started. For such one-sided comparison of transactions costs is after all a mere rehash of the *raison d'être* of the duty of loyalty. It is the absolute lack of capacity of one of the parties in relation to the other that inevitably turns their supposedly free contractual relationship into the latter's self-contract that is not enforceable within the realm of contract law. The fiduciary law imposes on anyone who accepts the position of fiduciary the duty to act solely for the benefit of the other and makes that duty legally enforceable by inferring fiduciary's breach solely from its external appearance.

Note that in the opposite case where *F*'s unauthorized gain fails to exceed *B*'s lost expectation, or where $G_F \leq L_B$, *F*'s disloyalty towards *B* would never improve Kaldor efficiency, or $U_B^0 + U_F^0 \leq U_B^* + U_F^*$. It is thus "wrong" even from the standpoint of economic approach without invoking the notion of Pareto optimality.

I think I am now able to claim even on the basis of “economic” analysis that no fiduciary should be allowed to seek his own interests at the expense of his beneficiary, no matter how beneficial that would be to the total efficiency of the relationship. If someone wishes to gain from a relationship with another person who lacks a capacity to form contract with him, he should not chose a fiduciary position as a means for his own enrichment but seek an opportunity to transact openly with her loyal fiduciary as a third party transactor outside of the relationship. (Or he should arrange a *prior* authorization in the form of trust instrument or articles of corporation or agency contract or partnership deed, or he should at least obtain either an informed consent of all the beneficiaries or, if that is impossible, an approval by the court.[80]) The fiduciary’s unauthorized gain should thus be purged from the objective function of any fiduciary relationship, except in a side constraint that gives a minimum incentive for serving a fiduciary, and we obtain the duty of loyalty formalized in *(1)*.[81]

## 8. PARETO PRINCIPLE AS BRIDGE BETWEEN ECONOMIC APPROACH AND DEONTOLOGICAL APPROACH

Our analysis of the fiduciary law, especially of its disgorgement remedy, has resulted in reviving the old-fashioned idea of corrective justice as a straightforward application of the

[80] Bishop and Prentice (1983) provide an excellent discussion on these possibilities in their theoretical justification of the non-remuneration rule for trustees.

[81] Our theoretical objection to the Pareto optimal breach of fiduciary duty can be translated with suitable translation to the so-called “efficient theft” (See, e.g., Posner (1998): 225-269.) The present article, however, has no space to pursue this point further.

“deontological” approach to law. We have, however, also been able to provide an “economic” justification for the fiduciary duty of loyalty as a rule that would necessarily promote Pareto optimality of the society as a whole. There is, however, nothing surprising about this, for the notion of Pareto optimality can be regarded as a common meeting ground between the two rival ethical principles -- utilitarianism and deontologism. While the notion of Pareto optimality is first and foremost a utilitarian standard that insists that the collective welfare of the society as a whole does not increase unless at least one person’s welfare increases and no one else’s decreases, it can also serve as a manifestation of deontological view of individual autonomy that “every person has an equal right not to have her or his welfare be sacrificed as the mere means of increasing the welfare of someone else” or of promoting some collective objective of the society.[82] As long as the evaluative standard is Kaldor efficiency, there is no reason for the injurer to pay damages to the injured, for a loss of Kaldor efficiency is not a loss to any particular individual but a loss to the society at large. The notion of Pareto optimality, in contrast, takes the separateness of individuals seriously, so that whenever a loss occurs it is exclusively a loss to a particular individual or a particular set of individuals. Under the Pareto principle, therefore, if the injurer is obliged to pay damages for a loss he has caused it is the injured who has all the reason, indeed all the “right,” to be its sole recipient. This is what the corrective justice is all about.

[82] Kronman (1980): “This constraint expresses,” continues Kronman, “respect for the integrity of individuals, and distinguishes paretianism from every ethical theory – including utilitarianism – that treats the maximization of some impersonal good as an end in itself.” (488). I, however, do to subscribe to his distributive conception of contract law.

If there has been anything that can be agreed upon between advocates and opponents of economic approach to law, it is the utter uselessness of the notion of Pareto optimality as a guide to legal analysis, in comparison with the practically powerful notion of Kaldor efficiency.[83] Yet we have now seen that it has served a key role in our "economic" justification of the duty of loyalty in fiduciary law. I hope that the present article would serve as a juncture between the economic approach and the corrective justice approach or, more generally, between the utilitarianism and the delontologism that have long been opposed with each other in economics, law, and other moral sciences.

## *APPENDIX 1:* A SIMPLE MATHEMATICAL MODEL OF DOCTOR'S INFORMATIONAL DOMINANCE OVER PATIENT

Let $x \in X$ be a medical condition of a patient (i.e., a beneficiary), $a \in A$ a treatment by a doctor (i.e., a fiduciary), and $y \in Y$ a medical result of such treatment. To simplify the exposition, $X$, $A$ and $Y$ are assumed to be discrete and finite. Medical science is not an exact science, and a causal relationship between a medical result $y$ and a medical treatment $a$ performed on the patient with a medical condition $x$ can only be represented by a conditional probability $Pr(y|a,x)$. Let $u_B(y)$ measure the net benefit the patient receives from a medical result $y$, and $u_F(a)$ the net benefit the doctor gains from performing a treatment $a$. Then, the "optimal"

[83] On the side of economic approach, see, e.g., Calabresi (1991):1216-17; Posner (1998):15-17; Cooter and Ulen (2008): 378-380; and on the side of its opponents, see, e.g., Dworkin (1985): 238-240, and Coleman (1984): 651.

treatment $a^*(x)$ for the patient with $x$ can be defined as the treatment that maximizes her expected net benefit: $U_B(a,x) \equiv \Sigma_{y \in Y}\, u_B(y)Pr(y|a,x)$, subject to the doctor's participation constraint: $u_F(a) \geq 0$, or $a^*(x) \equiv \arg\max_{\{a \in A,\, u_F(a) \geq 0\}} U_B(a,x)$. (In order not to make our model trivial, $a^*(x)$ is assumed to be sensitive to a change in $x$, in the sense that $a^*(x_i) \neq a^*(x_j)$ for any pair of $x_i$ and $x_j$ $(\neq x_i)$ in $X$.) The set of all the optimal treatments $\{a \in A|\ a = a^*(x)$ for some $x \in X\}$ will be denoted by $A^*$.

Our basic premise is that the doctor dominates the patient informationally or that the doctor has finer information about $a$, $x$ and $y$ than the patient has. To simplify the analysis, I will suppose that, while both doctor and patient can observe $a$ and $y$ with certainty, only the doctor can observe $x$ and understand its medical implications. This supposition differs from the standard assumption of asymmetric information in contract theory. True that doctor is better informed than patient is, but what he is better informed is not of his own action (as in the model of moral hazard) or of his own state (as in the model of adverse selection) but of the state of the patient he is dealing with. The most important fact is that such informational dominance endows the doctor with a power to choose a sub-optimal treatment $a^0$ without any fear of being detected by patient (as well as by courts) *ex post*, as long as he faithfully follows the following steps. First, make sure that $a^0$ is optimal for one of the feasible medical conditions $x^0$, or $a^0 = a^*(x^0)$ for some $x^0 \in X$. Next, make sure that every possible $y$ of a treatment $a^0$ applied to a condition $x$ can never be an impossible result of $a^0$ applied to a fictional $x^0$ for which $a^0$ is optimal; in other words, make sure that $Pr(y|a^*(x^0),x^0)>0$ for every $y \in Y$ such that $Pr(y|a^*(x^0),x)>0$ for a true medical condition $x$. (Note that $y$ is a "possible" result of $a$ and $x$ if $Pr(y|a,x)> 0$ and an "impossible" result if $Pr(y|a,x)= 0$.) Then, there remains no possibility that the doctor's disloyalty will be exposed to the light of the day by any actual result $y$. The doctor never fails to justify himself by claiming to the patient that her medical condition was $x^0$ and his treatment $a^0$ is its optimal treatment $a^*(x^0)$. Let us denote a set of all such treatments by $A^0(x)$, or $A^0(x) \equiv \{a^0= a^*(x^0)$ for all $x^0 \in X|\ Pr(y|a^*(x^0),x^0)>0$ for every $y \in Y$ such that $Pr(y|a^*(x^0),x)>0\}$. (Note that $a^*(x)$ is also contained in $A^0(x)$.) It might be called "a set of exposure-proof pseudo-optimal treatments" for a medical condition $x$. A sufficient condition that $A^0(x)$ contains at least one sub-optimal treatment $a^0 \neq a^*(x)$ is that anything can happen in medical treatment, or that $Pr(y|a,x)>0$ for any $a \in A$, $x \in X$ and $y \in Y$. In this case, $A^0(x)$ extends to the whole $A^*$. A necessary and sufficient condition for $A^0(x)= A^*$ independently of $x$ is that $Pr(y|a^*,x)>0$ for any $a^* \in A^*$, $x \in X$ and $y \in Y$. As a rule of thumb, the larger the number of $y$s possible from $a^*(x)$ and the smaller the number of $y$s possible from each $a^0 \neq a^*(x)$, the larger $A^0(x)$, hence the larger the doctor's power to exploit his informational dominance over patient.

A self-seeking doctor would then choose a treatment that would maximize his net benefit $u_F(a)$ within $A^0(x)$. Let $a^0(x)$ be such treatment, or $a^0(x) \equiv \arg\max_{\{a \in A^0(x)\}} u_F(a)$. It follows trivially that $U_B^* \equiv U_B(a^*(x),x) \geq U_B^0 \equiv U_B(a^0(x),x)$ and $U_F^0 \equiv u_F(a^0(x)) \geq U_F^* \equiv u_F(a^*(x))$. Hence, the model in this *Appendix* is formally identical with the model set up in Chap. 3 of the main text.

It should be emphasized here that, since $U_B^*$ and $U_B^0$ are expected values, $U_B^* \geq U_B^0$ does not necessarily imply that a realized value of $u_B(y)$ under $a^*(x) \geq$ a realized value of $u_B(y)$ under $a^0(x)$. Hence, an aggravation of symptoms is not always a sign of doctor's disloyalty nor an improvement a proof of loyalty, as we have argued in Chap. 6.

Note that the analysis given in this appendix can be applied with little modification to other professional relationships such as those between lawyer and client, priest and devotee, and fund manager and investor.

## ***APPENDIX 2*: THE CASE WHERE INDIVIDUAL BENEFITS ARE NOT INTERPERSONALLY COMPARABLE**

Suppose that individual benefits $U_B$ and $U_F$ are not comparable between *B* and *F*. Let $U_F^0(-P)$ and $U_B^0(+P)$ denote their values when *F* first acts disloyally to *B* but later subsidizes a monetary amount *P* to *B*. For simplicity I assume that both $U_B^0(+P)$ and $U_F^0(-P)$ are continuous and increasing in $+P$ and $-P$, respectively or that income effects are continuous and strictly positive for both parties. Evidently, $U_F^0(-0)= U_F^0$ and $U_B^0(+0)= U_B^0$. Then, define a set $\Omega^0$ of all the pairs of benefits that can be made equal in terms of Kaldor efficiency to the pairs of benefits under *F*'s disloyalty by means of *F*'s side-payment to *B*, or $\Omega^0 \equiv \{(U_B, U_F) : U_B= U_B^0(+P)$ *and* $U_F=U_F^0(-P)$, *where* $P \geq 0\}$. If the benefits were measurable in money, we would have $U_F^0(-P)= U_F^0 -P$, $U_B^0(+P)= U_B^0+P$ , and $\Omega^0=\{(U_B,U_F): U_B+U_F = U_B^0+U_F^0, U_F \geq U_F^0\}$, bringing us back to the model of the main text.

I am now able to define *B*'s lost expectation $L_B$ (the amount of money that would put the injured party in as good a position as she would have been in but for the breach) and *F*'s unauthorized gain $G_F$ (the monetary equivalent to the gain he has obtained from his position as fiduciary without authorization by beneficiary or courts or the terms of arrangement) as

$(A2\text{-}1)\quad U_B^0(+L_B) \equiv U_B^*$ and $U_F^0(-G_F) \equiv U_F^*$.

Then, it is easy to prove the following statements by the assumptions of continuity and the increasingness of $U_B^0(+P)$ and $U_F^0(-P)$ that:

$(A2\text{-}2)\quad G_F \leq L_B \;\Leftrightarrow\;$ *There is no* $(U_B,U_F)\ \varepsilon\ \Omega^0$ *such that* $(U_B,U_F) > (U_B^*,U_F^*)$*; in other words,* $(U_B^0,U_F^0)$ *is not superior to* $(U_B^*,U_F^*)$ *in terms of Kaldor efficiency.*

$(A2\text{-}3)\quad G_F > L_B \;\Leftrightarrow\;$ *There is a* $(U_B,U_F)\ \varepsilon\ \Omega^0$ *such that* $(U_B,U_F) > (U_B^*,U_F^*)$*; in other words,* $(U_B^0,U_F^0)$ *is superior to* $(U_B^*,U_F^*)$ *in terms of Kaldor efficiency.*

All the results in the main text hold true even without interpersonal comparability of benefits.

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