Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered

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This Article offers a novel account of the doctrines of good faith and fiduciary duties under a functional perspective that reconciles the theoretical contributions of law-and-economics scholarship with the actual application of the law. The traditional doctrinal statements on this matter assert that fiduciary duties impose high standards of behavior on the parties named fiduciaries, while the duty of good faith is highly context-specific and constantly escapes definition. Law-and-economics scholars argue that although good faith and fiduciary duties differ in the strength of the obligations imposed, a continuum exists between these different doctrines. In this view, both share the same nature as contract gap fillers that help promote efficiency by providing the parties with the terms they would have contracted for in a world of zero transaction costs and unlimited foresight. This Article adds to the conventional wisdom and demonstrates that good faith and fiduciary duties embody distinct gap-filling methods. While fiduciary duties are untailored defaults that supply the term that most parties in a certain fiduciary category would have wanted, the doctrine of good faith mandates the application of a tailored gap-filling method that fills in contractual gaps with the terms that the parties before the court would have contracted for. I show how the hidden tension between a tailored and an untailored gap-filling method sheds light on the outcome and the dissenting opinions of prominent fiduciary law cases. Finally, I argue that there is reason to believe that the existence of these different gap-filling methods represented by the doctrines of good faith and fiduciary duties is not only descriptively accurate, but also normatively desirable.

I. INTRODUCTION

This Article aims to analyze the relationship between contractual good faith and fiduciary duties, which are plastic legal concepts with a common etymological origin: the Latin word *fides*, which means

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trust, confidence, reliance, faith.[1] Although good faith and fiduciary duties are famously hard to conceptualize—and their meanings differ in various legal systems—they each embody different versions of the notion of honesty and fidelity.[2] While these words suggest a close connection to morality, it is in the economic sphere that the concepts of good faith and fiduciary duties are most often utilized to define the proper behavior of different actors.[3]

Fiduciary duties and good faith have received substantial attention from scholars as separate matters.[4] However, the precise relationship between good faith and fiduciary duties remains largely unexplored. This Article aims to shed light on the differences and similarities between these doctrines by exploring nuances to the traditional contractarian approach, according to which both good faith and fiduciary duties are doctrinal tools to deal with the problem of incomplete contracts.[5] I intend to go beyond the doctrinal labels and analyze good faith and fiduciary duties under a functional perspective.

My contribution to the understanding of the interplay between good faith and fiduciary duties is to present a more accurate descriptive view of the law than the contractarian approach has thus far provided. Adding to the conventional wisdom crystallized in the seminal work of Easterbrook and Fischel, which states that a

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1. *See* THE CLASSIC LATIN DICTIONARY 223-24 (1928).

2. *See, e.g.*, Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 879 ("Fiduciary obligation is one of the most elusive concepts in Anglo-American law.").

3. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

4. *See* Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. U. L. REV. 955, 993 (1995) ("[T]he current view [is] that fiduciary duty and good faith are wholly separate concepts."). For a discussion on fiduciary duties, see GERARD M.D. BEAN, FIDUCIARY OBLIGATIONS AND JOINT VENTURES: THE COLLABORATIVE FIDUCIARY RELATIONSHIP (1995). For general works on good faith, see, for example, STEVEN J. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT (1995); E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963) (examining the possible implication of the U.C.C. provisions of good faith and commercial reasonableness); Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968) [hereinafter Summers, *"Good Faith" in General Contract Law*] (discussing the application of good faith in the law of sales); Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982) (detailing the historical perspectives of good faith and the evolution of the current view of the general duty of good faith).

5. *See, e.g.*, DeMott, *supra* note 2, at 885-86 (describing the contractarian approach to fiduciary obligations and good faith).

continuum exists between good faith and fiduciary duties,[6] I argue that these doctrines correspond to different methods of gap filling. I distinguish good faith and fiduciary duties by showing that good faith provides a framework for tailored gap filling by enabling courts to provide the term most suitable to the agreement in question, while fiduciary duties are untailored defaults that provide the regime that most parties in a fiduciary category would have wanted. This claim has not yet been advanced in the literature on good faith and fiduciary duties.

The Article proceeds as follows: In Part II, I describe how the theme of incomplete contracts serves both as an objection to the neoclassical economic model and as the economic underpinning of the contractarian approach to good faith and fiduciary duties. I explain how good faith and fiduciary duties can help promote efficient outcomes in the face of the incomplete contracts problem by providing the terms that the parties would have contracted for in a world of zero transaction costs and unlimited foresight. I also refute the objections raised by anticontractarians, who claim that notions of contract are insufficient to explain the domain of fiduciary law. In Part III, I elaborate on the argument that good faith is a tailored gap-filling method, whereas fiduciary duties are untailored defaults. While fiduciary duties provide the regime that most parties in the fiduciary category would want to govern their relationships, good faith is a doctrinal rubric that allows courts to fill gaps with the terms that the parties before them would have bargained for had they foreseen the contingency in question. I carefully scrutinize the doctrinal statements of good faith and fiduciary duties to demonstrate how they fit into the tailored and untailored gap-filling classification proposed in this Article. In Part IV, I explain how the hidden tension between a tailored and an untailored method of gap filling explains the majority and the minority opinions in two prominent fiduciary law cases.

II. GOOD FAITH AND FIDUCIARY DUTIES AS GAP-FILLING DEVICES

The legal rhetoric associated with the doctrines of contractual good faith and fiduciary duties famously appeals to high moral principles.[7] However, despite strong arguments to the contrary,[8] the

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6. *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 446 (1993).

7. *See, e.g.*, Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("Many forms of conduct permissible in a work a day world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the

increasingly prevalent view about the nature of these institutions is the contractarian approach espoused by law-and-economics scholars.[9] The contractarian view posits that fiduciary duties and good faith are essentially frameworks to help solve contracting problems, rather than means to impose inflexible moral standards on business parties or to accommodate other public policy considerations.[10]

Under the contractarian perspective, not only good faith but also fiduciary duties function as gap fillers in incomplete contracts.[11] The underlying premise is that, in our world of positive transaction costs and bounded rationality, parties cannot write complete contracts specifying a suitable provision for every possible state of the world.[12] From a Coasean perspective, the law can help promote efficient outcomes by providing as default rules the terms the parties would have contracted for in a world of zero transaction costs and unlimited foresight.[13] In this context, the notion of a *hypothetical bargain* (also known as the "what the parties would have wanted" approach) emerges as the main framework for efficient gap filling.

By definition, the notion of a hypothetical bargain should come into play only in cases where there are no express terms on a given

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market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.").

8. *See, e.g.*, DeMott, *supra* note 2, at 879-80 (arguing that descriptions of fiduciary duties drawn on contract law are mistaken); Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303, 353 (1999) (arguing that contractarians would impoverish justice, virtue, and freedom); Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1210 (1995) (discussing the negative implications for fiduciaries and entrustors under the contractarian approach).

9. Easterbrook and Fischel wrote the seminal article applying the hypothetical bargain framework to ascertain the gap-filling nature of fiduciary duties. Easterbrook & Fischel, *supra* note 6; *see also* Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. TORONTO L.J. 299, 301 (1993) ("[I]t is only possible to make sense of fiduciary duty in a world where the initial contract is incomplete for some reason."); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 26-31 (1991) (arguing that shareholders, as the residual claimants of corporate value, should be the sole beneficiaries of fiduciary duties because other constituents are better positioned to protect themselves through either contract or political pressure).

10. *See* Easterbrook & Fischel, *supra* note 6, at 427.

11. *See id.* at 430.

12. It is worth stressing, however, that providing the parties with the terms that would have been contracted for is not the only way by which fiduciary law helps solve the problem of incomplete contracts. The law also promotes adequate deterrence by making up for the difficulties in monitoring associated with fiduciary relationships by making disgorgement of profits the standard remedy for breaches and treating the mere appearance of breach as a wrong. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1051-52 (1991).

13. *See* Easterbrook & Fischel, *supra* note 6, at 426.

contingency. Because the parties are in a better position than courts to assess what terms promote their own welfare, an actual bargain is certainly superior to a hypothetical bargain. Still, in many cases, courts are better equipped to find the appropriate terms ex post than the parties can draft ex ante. Accordingly, if a gap exists in the agreement, courts should provide the parties with the terms for which they would have bargained, which are presumably those that increase the size of the contractual pie.

The conventional economic view in the seminal work of Easterbrook and Fischel is that good faith and fiduciary duties share the same function as contract gap fillers, but they lie at different points upon a continuum.[14] Their assertion about the underlying unity between fiduciary duties and good faith is categorical:

> When transactions costs reach a particularly high level, some persons start calling some contractual relations "fiduciary," but this should 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.[15]

In this context, incomplete contract situations characterized by unusually high costs of specification and monitoring may give rise to fiduciary duties. On the contrary, good faith is the canon of interpretation for ordinary contracts.[16] I believe this view is in essence correct, but rather incomplete; it does not specify what distinguishes good faith and fiduciary duties as gap-filling methods. The conventional understanding implies that fiduciary duties are stronger than contractual good faith and impose more demanding standards of behavior,[17] but does not provide a more meticulous characterization of how the doctrines of fiduciary duties and good faith differ in their practical application. Such a characterization is the aim of this Article.

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14. *See* Easterbrook & Fischel, *supra* note 6, at 438.

15. *Id.* (footnote omitted). For a more recent work thoroughly embracing Easterbrook and Fischel's characterization of the continuum between fiduciary duties as a "blur and not a line," see Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 134 (2006).

16. *See* Easterbrook & Fischel, *supra* note 6, at 427.

17. *See* Mkt. St. Assocs. LP v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) ("[The duty of good faith is] halfway between a fiduciary duty (the duty of *utmost* good faith) and the duty merely to refrain from active fraud. . . . The concept of the duty of good faith like the concept of fiduciary duty is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute.").

If fiduciary duties are indeed no more than contract gap fillers, one could wonder whether the fiduciary label is of any functional significance at all. Answering in the affirmative, I will demonstrate that both good faith and fiduciary duties operate as gap fillers, but in somewhat different ways. The hypothetical bargain framework is not the only possible method for efficient gap filling,[18] although it is the technique that possesses the greatest explanatory power with respect to both good faith and fiduciary duties. Nevertheless, the hypothetical bargain framework is too broad a concept, because it does not adequately specify the level of generality at which the decision about what terms the parties would want is made.

I contend that the doctrines of good faith and fiduciary duties both embody the notion of a hypothetical bargain, but at different levels of generality. I employ Ian Ayres and Robert Gertner's distinction between "tailored" and "untailored" gap-filling provisions to shed light on the differences between good faith and fiduciary duties.[19] As Ayres and Gertner first pointed out, the hypothetical-bargain paradigm gives margin to very distinctive possible applications.[20] As one possibility, courts could endeavor to discover the terms for which the specific parties before them would have contracted.[21] Alternatively, courts could seek an untailored default that corresponds to the "majoritarian" term that most parties would have wanted.[22] While a tailored provision aims to supply precisely the terms for which the parties would have contracted, an untailored provision supplies the parties with a "single, off-the-rack standard that in some

18. *See* Ayres & Gertner, *supra* note 3, at 91 (arguing that in addition to the hypothetical bargain model, penalty defaults that encourage parties to reveal information may also be efficient). Since the seminal work of Ian Ayres and Robert Gertner, the hypothetical bargain is no longer considered the only possible method for efficient gap filling. In some circumstances the most efficient rule would provide precisely the terms that parties do *not* want in order to give them incentives to reveal information and contract around the default. *See id.* at 95-97. In these cases, efficiency would favor "penalty defaults" instead of the "what the parties would have wanted" paradigm of gap filling. *See id.*; *see also* Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1, 7 (1993) [hereinafter Ayres, *Preliminary Thoughts*] (explaining Kaplan's analysis of the use of rules rather than standards); Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591, 1606-10 (1999) (explaining Adler's analysis of penalty default rules); Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1391-1403 (1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991)) (discussing the incomplete nature of default rules).

19. *See* Ayres & Gertner, *supra* note 3, at 91-92.

20. *See id.*

21. *Id.*

22. *Id.*

sense represents what the majority of contracting parties would want."[23] Here I argue that good faith and fiduciary duties are tailored and untailored standards, respectively.[24]

However, in arguing that fiduciary duties are untailored defaults, I do not mean that fiduciary duties are in any way rigid concepts. To the contrary, it is precisely the protean nature of fiduciary duties that does the work of filling the blanks and supplying a suitable regime to circumstances not originally provided. For instance, the fiduciary duty of care generally provides that a fiduciary must act as a reasonably prudent person under similar circumstances in the same position.[25]

Unquestionably, the fiduciary duty of care is highly context-dependent, but this does not make it untailored as I have defined the term. All that this means is that fiduciary duties are by and large untailored *standards*, rather than *rules*.[26] According to a prominent definition, while a standard may leave both the specification of what conduct is permissible (or prohibited) and the determination of factual issues to the adjudicator, a rule usually entails a determination of what conduct is permissible in advance, so that the adjudicator is left solely with factual questions.[27]

Therefore, even the eminently situational fiduciary duty of care cannot be interpreted as a tailored default. Although such a standard is

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23. *Id.* at 91. The article refers to "tailored" and "untailored" defaults. I loosely employ the term *default* in this Article although good faith is not technically a default rule, because it cannot be freely abrogated by agreement. *See, e.g.*, U.C.C. § 1-302(b) (2004) ("The obligations of good faith, diligence, reasonableness, and care prescribed by [the Uniform Commercial Code] may not be disclaimed by agreement. The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable. Whenever [the Uniform Commercial Code] requires an action to be taken within a reasonable time, a time that is not manifestly unreasonable may be fixed by agreement." (alterations in original)).

24. To be sure, tailoring is a matter of degree. There are no tailored or untailored provisions in absolute terms. Even a very general provision can be considered tailored with respect to a given set of fact patterns to which it applies. Therefore, the very existence of fiduciary categories with distinctive variations of the applicable fiduciary obligations indicates some degree of tailoring. Indeed, it is plausible that any majoritarian rule requires some amount of tailoring; if the universe is too broad, it would be increasingly harder to identify what rule could be genuinely identified as reflecting the preferences of most parties. Yet, this should not obfuscate the fact that even if an untailored rule purports to be satisfactory to the majority of parties, it may not be the most adequate to the deal in question. Good faith, to the contrary, represents a tailored gap-filling method in the sense that it has very little content ex ante and aims to fill the gaps of the specific contract in question.

25. Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984).

26. For a discussion of how rules and standards can be both tailored and untailored, see Ayres, *Preliminary Thoughts*, *supra* note 18, at 5.

27. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560-62 (1992).

presumably desirable by most parties, it does not necessarily represent the regime that the parties before the court would want.[28] In sum, the tailored-untailored dichotomy refers to the degree to which the gap fillers approximate the bargain that the contracting parties would have reached.[29] A tailored provision aims to provide precisely the term that those specific parties would have wanted for the deal in question, whereas an untailored provision supplies the term that a majority of parties in a certain category would generally prefer.[30]

Before I proceed to describe the doctrines of good faith and fiduciary duties and their application by courts as methods of tailored and untailored gap-filling, one caveat is necessary. The opponents of the contractarian view challenge its soundness on the ground that parties are not always allowed to contract out of the general regime of good faith and fiduciary duties.[31] Quite to the contrary, good faith is stated as mandatory by the Uniform Commercial Code (U.C.C.), in the sense that it cannot be subject to wholesale abrogation, even though the parties may define in their agreement what constitutes good faith as long as it is not manifestly unreasonable.[32]

Unlike good faith, an overview of the private law areas where fiduciary duties apply reveals their mainly default character. Almost all rules of trust law are default law,[33] although an indiscriminate elimination of fiduciary duties in the instrument would not be permitted because it would make the trust form illusory.[34] Likewise, in agency relationships, virtually all fiduciary duties do not apply if the

28. Indeed, Delaware's ample experience with the limitation of the fiduciary duty of care through the adoption of section 102(b)(7) illustrates that the fiduciary duty of care does not seem desirable to many corporations. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

29. *See* Ayres & Gertner, *supra* note 3, at 90-93.

30. *Id.* at 91.

31. *See id.* at 87-89 (arguing that immutable rules displace parties' abilities to contract and are only justified when society wants to protect either parties within or outside of the contract).

32. U.C.C. § 1-302(b) (2004). In Ayres and Gertner's terminology, good faith is an immutable rule. *See* Ayres & Gertner, *supra* note 3, at 87-88.

33. *See* UNIF. TRUST CODE § 105 (amended 2005), 7C U.L.A. 428-29 (2006).

34. *See, e.g.*, John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105, 1122 (2004) ("[E]ven the duty of loyalty, the 'most fundamental' rule of trust fiduciary law, yields to contrary terms of the settlor. Trust law allows the settlor to conclude that particular fiduciary rules would overprotect or otherwise complicate the particular trust and its purposes; hence, the beneficiaries would be better served by abridging them. Oddly, however, although the various fiduciary rules are default rules, the settlor may not abrogate them in their entirety, because eliminating all fiduciary duties would make the trust illusory.").

parties expressly agree otherwise.[35] Also in the partnership context, limitations on fiduciary duties of loyalty and care are permissible, though subject in some circumstances to a minimal requirement of reasonableness.[36] Even in the law of corporations, business forms once viewed as derived from a privilege granted by the state and therefore subject to more stringent limitations on freedom of contract in its organizational structure, the degree to which fiduciary duties may be varied by agreement is increasing.[37] Moreover, recent statutes relating to other business entities (limited partnership and limited liability companies) make clear that parties may opt out of fiduciary duties altogether.[38]

Hence, it is hardly questionable that fiduciary duties in these contexts are by and large default law whose effects are trumped if the parties agree otherwise. Furthermore, the existing limitations on wholesale or unreasonable elimination of fiduciary duties do not compel a conclusion about the anticontractarian or public policy character of fiduciary law as a means to deter immoral behavior in the marketplace.[39] Instead, the rules seeking to preserve a minimal core of fiduciary duties can be best understood as intent-implementing or contract-forcing.[40] Rather than impose upon parties a regime that they disdain, the main purpose of these rules is to ensure that parties understand the effects of the abrogation of fiduciary duties. It is precisely because the parties' ability to specify the best regime for

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35. RESTATEMENT (SECOND) OF AGENCY §§ 379-398 (1958). All of the provisions relating to fiduciary duties start with "unless otherwise agreed" or some other linguistic formulation serving the same purpose. *See, e.g.*, *id.* § 387 ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.").

36. UNIF. P'SHIP ACT § 103(b)(3)-(4), 6 U.L.A. 73 (2001) (stating that abrogation of the duty of loyalty and duty of care is allowed if not manifestly unreasonable). Delaware does not impose any restriction on the elimination of any and all liabilities for breach of fiduciary duties in the partnership agreement. DEL. CODE. ANN. tit. 6, § 15-103(f) (2005).

37. *See* discussion *infra* Part III.

38. *See* DEL. CODE ANN. tit. 6, §§ 17-1101(f), 18-1101(e).

39. In the words of Judge Posner, "[i]t would be quixotic as well as presumptuous for judges to undertake through contract law to raise the ethical standards of the nation's business people." Mkt. St. Assocs. v. Frey, 941 F.2d 588, 595 (7th Cir. 1991).

40. The insistence in some fields that the opting out of fiduciary duties be made by specifying the contrary arrangements (as opposed to wholesale abrogation) can be interpreted as creating incentives for parties to spell out the intricacies of their deal. *See, e.g.*, Langbein, *supra* note 34, at 1120-26 (discussing this argument in the context of mandatory trust law). Moreover, the underlying purpose of requiring parties to specifically opt out of fiduciary duties seems to be intent-serving rather than intent-defeating. *See id.* The objective is to have parties understand the consequences of abrogating fiduciary duties rather than prevent them from opting out when that is clearly against their interest. *See id.*

every contingency is at best limited (not only by transaction costs, but also by their limited foresight) that the law requires opting out of gap fillers to be done in a careful and informed manner. This does not imply, however, that the law is going to stand in the way of parties who expressly contract for a provision that is inconsistent with the default regime.

To be sure, fiduciary duties can be imposed on a mandatory basis to serve regulatory or protective purposes in noncontractual scenarios, as is the case in the traditional guardian-ward relationship[41] or, more recently, in the Employee Retirement Income Security Act of 1974 (ERISA).[42] Nonetheless, this should not mask the fact that fiduciary duties operate in private law areas as contract-enhancing mechanisms rather than public policy interventions. Most fiduciary law areas leave a significant degree of discretion to the parties in altering the default regime. The general mandatory character of good faith could imply that this doctrine is interventionist in character, but such a conclusion would also be illusory.[43] Although good faith functions as a mandatory tailored gap-filling method, it does not serve to inflict on parties substantive contract terms they would prefer to reject. The courts' persistent moderation in interpreting the duty of good faith within the terms of the deal, in conjunction with the policy of avoiding judicial rewriting of bad bargains, signifies that good faith is also well-contained by contractarian ideals.

In sum, the doctrines of good faith and fiduciary duties aim to solve real contracting problems that the parties face, rather than inexorably impose on them the regime that policymakers consider to be more just, moral, or otherwise appropriate. The gist of the contractarian argument is that the legal doctrines of good faith and fiduciary duties operate to fix the limitations of the contracting processes for an optimal allocation of resources. Because transaction costs and limited foresight hinder the drafting of complete contracts, the law helps promote efficient outcomes by providing the terms that the parties would have wanted. Consequently, whenever parties know exactly what they want and spell it out accordingly, their determinations will almost certainly prevail.

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41. *See* UNIF. PROBATE CODE § 5-314, 8 U.L.A. 125-26 (Supp. 2007).
42. Employee Retirement Income Security Act of 1974 § 404, 29 U.S.C.A. § 1104 (West Supp. 2007).
43. *See* discussion *infra* Part II.

III. A DOCTRINAL OVERVIEW OF GOOD FAITH AND FIDUCIARY DUTIES

As mentioned above, the doctrines of good faith and fiduciary duties embody different schemes for the realization of the hypothetical bargain. This distinction between tailored and untailored defaults helps distinguish fiduciary duties from good faith. Fiduciary duties are usually thought to impose very high standards of behavior on the parties named fiduciaries.[44] These demanding standards contained in the notion of fiduciary duties, I argue, are "untailored" defaults. Fiduciary duties provide the rules and standards that, presumably, most parties in the various fiduciary *categories*—e.g., trust, agency, or partnership—would want. That is to say, policymakers conceive the hypothetical bargain as a gap-filling method at a high level of generality—at the category level. For example, because policymakers believe that settlors would like to have trustees administer the trust solely in the interests of beneficiaries, they establish a stringent duty of loyalty as the default standard.[45] Also based on the supposition that a typical partner would not want to have his or her partners competing with the partnership, such a rule is provided under the partnership duty of loyalty.[46] In considering that creditors of corporations can adequately protect themselves through contractual covenants and other legal doctrines, courts have refused to impose fiduciary duties on directors of corporations in the "zone of insolvency."[47]

The instances of enunciations of general fiduciary standards at the category level are numerous. Indeed, fiduciary duties are not limited to a general duty to comply with "loyalty"; very often, the specific repercussions of a duty of loyalty are also stated in advance, making some branches of fiduciary duties considerably rule-like.[48] The Uniform Trust Code provides that "[i]f a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the

44. BEAN, *supra* note 4, at 23 ("Fiduciary law is about special relationships that impose high standards of conduct on the person considered to be a fiduciary.").

45. *See* UNIF. TRUST CODE § 802 (amended 2004), 7C U.L.A. 588-90 (2006).

46. UNIF. P'SHIP ACT § 404(b)(3), 6 U.L.A. 143 (2001).

47. N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007).

48. *See, e.g.*, UNIF. TRUST CODE § 802(b) (amended 2004), 7C U.L.A. 588-89 (stating a transaction entered into by a trustee that is in conflict with her fiduciary duty is voidable). Although fiduciary duties are in most instances standard, in some cases the ramifications of this principle may amount to a rule. For a definition of rules and standards, see Kaplow, *supra* note 27, at 560.

beneficiaries' respective interests."[49] The Restatement (Second) of the Law of Agency states that "[u]nless otherwise agreed, an agent is subject to a duty not to deal with his principal as an adverse party in a transaction connected with his agency without the principal's knowledge."[50] The Uniform Partnership Act establishes that a partner must "refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership."[51]

Hence, for certain relations characterized by enhanced discretion as a result of information asymmetry and monitoring problems, the law imposes fiduciary duties as default rules. Because the law assumes that most partners would prefer to have their relationships governed by a duty of care and loyalty, partners owe each other such duties, unless trumped by the terms of the agreement.[52] Courts, therefore, do not inquire whether the specific partners before them would have agreed to a duty of loyalty.[53] Instead, the law imposes fiduciary duties at the category level and applies them to every partnership unless otherwise agreed.[54] While these presumptions are probably accurate for the vast majority of cases, it is also imaginable that some parties would prefer to adopt a different regime, which is something they can generally do by expressly contracting for such different terms.[55]

As one of the main critics of the contractarian approach to fiduciary duties has noted, courts do not generally frame fiduciary duties in terms of a judicial guess about the terms that the parties would have wanted to govern their relationship.[56] This is accurate: In cases where there is no clear evidence of opting out of the default fiduciary standards, courts do not at all discuss whether the parties would have bargained for the application of fiduciary duties.[57] The

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49. UNIF. TRUST CODE § 803, 7C U.L.A. 600.

50. RESTATEMENT (SECOND) OF AGENCY § 389 (1958).

51. UNIF. P'SHIP ACT § 404(b)(3), 6 U.L.A. 143 (2001).

52. *Id.*

53. *See* Miller v. Am. Real Estate Partners, No. CIV.A.16788, 2001 WL 1045643, at *8-9 (Del. Ch. Sept. 6, 2001).

54. *See* UNIF. P'SHIP ACT § 404, 6 U.L.A. 143.

55. For a greater elaboration on the default character of fiduciary duties, see *supra* discussion Part I.

56. *See* DeMott, *supra* note 2, at 885 ("The definition of fiduciary obligation articulated in the *Jordan* opinions appears to be literally unprecedented in prior Anglo-American caselaw. The opinions define fiduciary obligation as the court's guess about what the parties would have agreed to, had they bargained over the matter.").

57. In *Arnott v. American Oil Co.*, 609 F.2d 873, 882-84 (8th Cir. 1979), for example, in finding that a fiduciary relationship existed between the parties, the court did not discuss whether the parties would have bargained for the application of a fiduciary obligation.

absence of language about the hypothetical bargain, however, does not erode the claim that fiduciary duties are untailored gap-filling provisions. Just like other untailored default rules or standards in the law that are widely recognized as gap fillers, the question of what the parties before the court would have bargained for does not come into question. An untailored rule or standard applies if not expressly trumped by the terms of the parties' contract.

The recent developments involving the so-called alternative business entities, such as the limited partnership and the limited liability company, provide a fertile territory to test the proposition that good faith and fiduciary duties embody different methods of gap filling. Although fiduciary duties are largely default law across the different fiduciary categories, nowhere in the law is the default character of fiduciary duties as explicit as in the statutes that regulate these new business entities. The statutes unambiguously permit the agreement to provide for "the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties)."[58]

This outright assertion of the contractarian character of fiduciary duties presented the question of whether they would maintain their character as untailored defaults. In the fiduciary realm, as well as in other contract law scenarios, with respect to untailored or off-the-rack defaults, the rule is that unless the contract expressly provides otherwise, a default rule or standard will be read into the agreement to the same effect as an express provision.[59] The question then was whether after the increasing contractualization, fiduciary duties would

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58. DEL. CODE ANN. tit. 6, § 17-1101(f) (2008) ("A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."). For almost identical statutory language in the context of limited liability companies, see *id.* § 18-1101(c) to (e). In the context of limited partnerships, see *id.* § 17-1101(d) ("To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing."). For a more complete overview of the state of the law in Delaware, see generally Paul M. Altman & Srinivas M. Raju, *Fiduciary Duties in Delaware Alternative Entities*, *in* WHAT ALL BUSINESS LAWYERS & LITIGATORS MUST KNOW ABOUT DELAWARE LAW DEVELOPMENTS 383 (2005).

59. *See* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 29 (1990).

still be employed as default standards that apply independently of the terms of the deal unless clearly trumped by express terms of the agreement; or if, instead, there would be a pressure to treat fiduciary duties as indeed closer to the concept of good faith, which requires the additional regime to be in some way implicated by the express terms of the deal.[60]

An early decision of the Delaware Court of Chancery seemed to lean towards the latter. In *R.S.M. Inc. v. Alliance Capital Management Holdings*, the court stated:

> [W]here the use of default fiduciary duties would intrude upon the contractual rights or expectations of the general partner or be insensible in view of the contractual mechanisms governing the transaction under consideration, the court will eschew fiduciary concepts and focus on a purely contractual analysis of the dispute. Put somewhat differently, the irreconcilability of fiduciary duty principles with the operation of the partnership agreement can itself be evidence of the clear intention of the parties to preempt fiduciary principles.[61]

However, in a more recent decision, the Court of Chancery has signaled that even in the face of their express contractualization, fiduciary duties remain indeed untailored defaults that will only be trumped by clear drafting efforts. *Miller v. American Real Estate Partners* elucidates that the court will make every effort to reconcile the application of fiduciary duties with the terms of the agreement in the absence of express and unambiguous limitation of traditional fiduciary duties.[62] While the court made clear that it "will not [be] tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties,"[63] the opinion also emphasizes that the great freedom of contract afforded to limited partnerships requires that the restrictions on fiduciary duties be set forth "clearly and unambiguously."[64] *Miller* signals that in the law of alternative business entities, fiduciary duties do not require a finding of a "gap" in the

60. For an argument in favor of the contractualization of fiduciary duties in the realm of limited partnerships and limited liability companies, see Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 4 (2007).

61. 790 A.2d 478, 497-98 (Del. Ch. 2001) (footnote omitted).

62. *See* Miller v. Am. Real Estate Partners, No. CIV.A.16788, 2001 WL 1045643, at *8-9 (Del. Ch. Sept. 6, 2001).

63. *Id.* at *8.

64. *Id.*

agreement; instead, they remain default standards that apply in conjunction with the terms of the deal, unless clearly abrogated by contract.[65]

In sum, when dealing with cases involving fiduciary relationships, courts do not entertain the issue of what the parties before them would have wanted. The hypothetical bargain is envisaged at the category level. Hence, absent evidence of abrogation of the default standard, a categorical fiduciary relationship leads to the imposition of fiduciary duties. The fact that the main purpose of fiduciary duties is to fill inherent gaps does not imply that courts have to first find a gap in the contract. Just as in the context of other default rules, the presumption is that fiduciary duties apply if the parties did not expressly agree to the contrary.[66]

In contrast, the doctrine of good faith does not provide a precise command to act "solely in the interests of the beneficiaries"[67] or to "refrain from competing."[68] As protean as fiduciary duties certainly are, scholars do not usually claim that they are positively indefinable.[69] Yet this is precisely the position embraced by Professor Summers in the most influential scholarly debate on the meaning of contractual good faith.[70] Defending an exclusionary approach to good faith, a view that was later adopted in the Restatement (Second) of Contracts, Professor Summers argued that it was impossible to define good faith.[71] In response to Professor Summers' view, Professor Burton presented the positive description that bad faith performance occurs when a party uses its discretion to recapture opportunities forgone when entering a contract.[72] The idea here is that the party should not

65. *See id.* at *8-9.

66. The English case of *Boardman v. Phipps* provides an illustration of a situation where the harsh treatment provided by the majoritarian fiduciary default most likely did not reflect the terms that the parties before the court would have provided had they foreseen the contingency. Boardman v. Phipps, (1967) 2 A.C. 46 (H.L.) (appeal taken from Eng.) (U.K.), *aff'g* Phipps v. Boardman, [1965] Ch. 992 (C.A.) (U.K.). For a discussion of *Boardman v. Phipps*, see John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 666 (1995).

67. UNIF. TRUST CODE § 802(a), 7C U.L.A. 588 (2006).

68. UNIF. P'SHIP ACT § 404(b)(3), 6 U.L.A. 143 (2001).

69. *See* Emily M.S. Houh, *The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?*, 2005 UTAH L. REV. 1, 1 (citing the U.C.C. to define good faith)

70. *See* Summers, *"Good Faith" in General Contract Law*, *supra* note 4, at 199-207.

71. *See id.*

72. *See* Steven J. Burton, *Breach of Contract and the Common Law Duty To Perform in Good Faith*, 94 HARV. L. REV. 369, 378-94 (1980).

take advantage of gaps inherent in the contract to get out of a losing deal.[73]

In the U.C.C., good faith is defined as "honesty in fact in the conduct or transaction concerned."[74] Restatement (Second) of Contracts section 205 provides that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[75] Slightly more illuminating is the definition in the comments to section 205 on good faith in performance of a contract as emphasizing "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party."[76] The comments to section 205 further state that "[t]he phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context."[77]

Several years after the well-known debate between Summers and Burton, scholars still endeavor to find meaning in the doctrine,[78] but the results are generally not comforting. To be sure, mainstream works in law-and-economics literature have recognized the gap-filling nature of the doctrine of good faith, but they have not yet provided a more detailed positive account of the application of the duty. Moreover, the most sophisticated works on gap filling focus on a theory of default rules; because these scholars immediately label good faith as an immutable rather than as a default rule, the manner in which good faith operates to fill contractual gaps has been largely neglected.[79]

As a result, a puzzle remains. As a prominent author synthesizes the prevailing sense of agnosticism in the literature, "notwithstanding the extensive literature on the subject, no consensus exists on precisely what the duty of good faith means."[80] Indeed, a cursory examination can easily lead to the conclusion that grounds for such an assertion

73. *See id.*

74. U.C.C. § 1-201(19) (2004).

75. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

76. *Id.* § 205 cmt. a.

77. *Id.*

78. *See, e.g.*, Houh, *supra* note 69, at 54-56 (contemplating the question of whether the duty of good faith serves any meaningful function in contract law).

79. *See, e.g.*, Ayres & Gertner, *supra* note 3, at 87 (finding good faith to be an immutable rule rather than a gap-filling default rule).

80. Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 140 (1989) (footnote omitted); *see also* Marietta Auer, The Structure of Good Faith: A Comparative Study of Good Faith Arguments 5 (Nov. 17, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=945594 ("It has almost become a trademark of writings in this genre to begin by emphasizing the unsatisfactory state of the debate, which mostly seems to be concerned with the insurmountable difficulty of defining a concept such as 'good faith.'").

abound. The application of good faith is relentlessly fact-specific. In some cases, courts use good faith to apply a subjective standard of behavior; in others, they use the very same doctrine and declare that the appropriate standard should instead be objective.[81] Sometimes good faith gives rise to a duty to inform, but in other circumstances it does not.[82]

The perceived lack of any pattern in the application of good faith is, however, misleading. The mutability of the duties imposed through good faith does not inexorably imply that the doctrine lacks meaning. Instead, I argue that the context-specific character of good faith is its central and distinguishing feature. Differing from fiduciary duties, which provide more specific guidance for behavior at the category level, good faith, I argue, performs two fundamental functions.

First, and perhaps most importantly, good faith serves as a doctrinal rubric for a tailored gap-filling provision.[83] The most universal formulation of the doctrine of good faith states that a party cannot act to prevent the other from obtaining the fruits of the contract.[84] The lack of a more precise definition for the duty of good faith provides the ideal framework for courts to fill the gaps with a *case-specific hypothetical bargain method*.[85] Some restrictions

81. *See* Summers, *"Good Faith" in General Contract Law*, *supra* note 4, at 204-06 (discussing different ways to conceptualize good faith).

82. *See infra* text accompanying notes 104-127.

83. In U.S. law, the doctrine of good faith is a genuine gap-filling method; it is not usually used to police bargains that courts deem unfair or to rewrite the parties' agreement. *See* Summers, *"Good Faith" in General Contract Law*, *supra* note 4. This is not the case in European law, where one of the functions of the doctrine of good faith is to provide courts with a statutory basis for reallocating contractual risks, an action that U.S. courts have consistently refused to make. For an overview of the doctrine of good faith in Europe, see generally GOOD FAITH IN EUROPEAN CONTRACT LAW (Reinhard Zimmermann & Simon Whittaker eds., 2000); Martijn W. Hesselink, *The Concept of Good Faith*, *in* TOWARDS A EUROPEAN CIVIL CODE 471 (Arthur Hartkamp et al. eds., 3d ed. 2004).

84. *See, e.g.*, Conoco Inc. v. Inman Oil Co., 774 F.2d 895, 908 (8th Cir. 1985) (finding good faith imposed a duty to do nothing destructive of another party's right to the fruits of the contract); Lloyd Noland Found., Inc. v. City of Fairfield Healthcare Auth., 837 So. 2d 253, 267 (Ala. 2002) (same); Anthony's Pier Four, Inc. v. HBC Assocs., 583 N.E.2d 806, 820-21 (Mass. 1991) (same); Ass'n Group Life, Inc. v. Catholic War Vets. of U.S., 293 A.2d 382, 384 (N.J. 1972) (same). Perhaps the most recurrent example of behavior disallowed by the doctrine of good faith is the one of an employer who in order to avoid paying a bonus to an employee fires him just before the date payment is due. In this scenario, courts find a violation of the duty of good faith on the basis that the employer's opportunistic conduct prevented the employee from enjoying the fruits of the contract and award payment of the bonus. *See* Fortune v. Nat'l Cash Register Co., 364 N.E.2d 1251, 1257-59 (Mass. 1977).

85. *See, e.g.*, Seidenberg v. Summit Bank, 791 A.2d 1068, 1077 (N.J. 2002) ("The guiding principle in the application of the implied covenant of good faith and fair dealing emanates from the fundamental notion that a party to a contract may not unreasonably

imposed on the doctrine of good faith, such as the notion that the doctrine does not create an independent duty divorced from the specific clauses of the contract,[86] reinforce the claim that good faith operates to provide the most appropriate gap-filling provisions taking into account the precise characteristics of the deal in question.

A second and related prong of the doctrine of contractual good faith prohibits bad faith or malicious advantage taking in contract performance (i.e., it requires, in the wording of the U.C.C., that the parties behave with "honesty in fact," also known as the rule of "pure heart and empty head").[87] The requirement of honesty in fact can be understood as a corollary of the gap-filling character of good faith; however, its more universal application is due to the plausible assumption that no one would agree to being taken advantage of maliciously.[88]

Unlike other contractual duties derived from good faith, which vary according to the express terms and characteristics of the deal in question, the requirement of honesty in fact applies to every contract as a floor to the parties' bargained for duties.[89] If the deal so requires, courts will imply different and more demanding standards through tailored gap filling. Therefore, although good faith is generally a tailored gap-filling method, the ban on ill-motivated behavior embodies the sole *untailored* aspect of the doctrine.

Not surprisingly, when Delaware courts innovated in the legal rhetoric and introduced the so-called "fiduciary duty of good faith," in addition to the traditional fiduciary duties of care and loyalty, they referred precisely to the untailored aspect of the doctrine providing a

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frustrate its purpose.... '[Thus,] the defendant [may] not exercise ... discretion ... under the literal terms of the contract to thwart plaintiff's expectation or purpose.'" (quoting Emerson Radio Corp. v. Orion Sales Inc., 80 F. Supp. 2d 307, 314 (D.N.J. 2000), *rev'd in part on other grounds*, 253 F.3d 159 (3d Cir. 2001))); Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990) ("'Good faith' is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.").

86. *See* Sarah Howard Jenkins, *Contracting Out of Article 2: Minimizing the Obligation of Performance & Liability for Breach*, 40 LOY. L.A. L. REV. 401, 438-39 (2006).

87. U.C.C. § 1-201(20) (2007).

88. The finding of bad faith conduct in some contract scenarios may give rise to tort damages. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. c (1981). In this case, the prophylactic element of the doctrine of good faith may be comparable to the damages and presumption structure of fiduciary law.

89. *See* Lachenmaier v. First Bank Sys., Inc., 803 P.2d 614, 617 (Mont. 1990) (stating that honesty in fact applies to all contracts).

generalized ban on malicious misconduct.[90] Notwithstanding the lively debates about the nature of the fiduciary duty of good faith,[91] a close scrutiny of Delaware judicial opinions reveals that it means little more than the well-known untailored requirement of honesty in fact.[92]

In the important case of *In re Walt Disney Co. Derivative Litigation*, the Delaware Supreme Court upheld the Court of Chancery's articulation of the duty of good faith.[93] According to the court:

> A failure to act in good faith may be shown, for instance, where the fiduciary *intentionally* acts with a purpose other than that of advancing

90. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) ("To rebut [the presumption of the business judgment rule], a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care." (emphasis omitted)).

91. *See, e.g.*, Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 74 (2006) (exploring the fiduciary duty of good faith of managers in statutes and case law that extend duties of care and loyalty); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 482-94 (2004) (exploring the enforcement of the duty of good faith standards by state courts in Delaware); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 497-515 (2004) (exploring the divergence between the Delaware Supreme Court and the Delaware Court of Chancery regarding the duty of good faith).

92. *See, e.g.*, E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 443 (Del. 1996) (citing the U.C.C. to support its definition of honesty in fact).

93. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35-36 (Del. 2006). Chancellor Chandler wrote in the lower court decision that

> a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation. . . . A failure to act in good faith may be shown, for instance, where the fiduciary *intentionally* acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts *with the intent* to violate applicable positive law, or where the fiduciary *intentionally* fails to act in the face of a known duty to act, demonstrating a *conscious disregard* for his duties.

In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005) (internal citations omitted) (emphasis added). Perhaps most significantly, Chancellor Chandler took the subjective element of good faith to an extreme in assessing Eisner's liability:

> Despite all of the legitimate criticisms that may be leveled at Eisner, especially at having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom, I nonetheless conclude, after carefully considering and weighing all the evidence, that Eisner's actions were taken in good faith. That is, Eisner's actions were taken with the *subjective belief* that those actions were in the best interests of the Company—*he believed* that his taking charge and acting swiftly and decisively to hire Ovitz would serve the best interests of the Company notwithstanding the high cost of Ovitz's hiring and notwithstanding that two experienced executives who had arguably been passed over for the position (Litvack and Bollenbach) were not completely supportive. Those actions do not represent a *knowing violation* of law or evidence a *conscious and intentional disregard* of duty. In conclusion, Eisner acted in good faith . . . .

Id. at 763 (emphasis added).

> the best interests of the corporation, where the fiduciary acts with the *intent* to violate applicable positive law, or where the fiduciary *intentionally* fails to act in the face of a known duty to act, demonstrating a *conscious disregard* for his duties.[94]

Disney made clear that a violation of the duty of good faith under Delaware corporate law refers to no more than "'subjective bad faith,' that is, fiduciary conduct motivated by an actual *intent* to do harm'"[95] or an "*intentional* dereliction of duty, a *conscious* disregard for one's responsibilities."[96] The *Disney* standard was later reaffirmed in *Stone v. Ritter*, in which the Delaware Supreme Court disaffirmed the so-called "triad" of fiduciary duties as a colloquial classification and emphasized the subjective nature of the duty of good faith.[97]

Delaware courts have thus applied what I describe as the sole untailored content of good faith—the ban on ill-motivated behavior—to condemn misconduct that is intentional or malicious and thus more culpable than the gross negligence standard that more often than not exculpates pursuant to Delaware General Corporation Law section 102(b)(7). Such recent developments in corporate law are thus consistent with general contract theory, which holds that parties cannot contract out of the duty of good faith.[98]

Therefore, at the core of the gap-filling nature of the doctrine of good faith is the idea of preventing a party from taking advantage of gaps—which, as previously described, are immanent in complex contracting processes—to defeat the purposes of the contract.[99] In determining whether there is a gap, courts pay special attention to the

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94. *In re Walt Disney*, 906 A.2d at 67.

95. *Id.* at 64 (emphasis added).

96. *Id.* at 62 (emphasis added).

97. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[A]lthough good faith may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly." (footnote omitted)).

98. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

99. *See, e.g.*, Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 280 (7th Cir. 1992) ("Contract law does not require parties to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother's keeper. That philosophy may animate the law of fiduciary obligations but parties to a contract are not each other's fiduciaries—even if the contract is a franchise. Contract law imposes a duty, not to 'be reasonable,' but to avoid taking advantage of gaps in a contract in order to exploit the vulnerabilities that arise when contractual performance is sequential rather than simultaneous.... [A] provision [cannot be] invoked dishonestly to achieve a purpose contrary to that for which the contract [has] been made." (internal citations omitted)).

characteristics of the deal in question and fill them accordingly.[100] This is precisely the reason why the specific duties derived from the implied covenant of good faith are hard to specify ex ante; unlike fiduciary duties, good faith serves to fill the gaps with the terms most appropriate to the deal before the court.[101] As the case law demonstrates, the duty of good faith implicates a duty to disclose or a requirement of reasonableness in some, but not all, contracts.[102] Courts have been very reluctant to fill gaps providing duties which are dissociated from the specific bargain struck by the parties.[103]

In *U & W Industrial Supply, Inc. v. Martin Marietta Alumina, Inc.*, the seller of an industrial piping requirements contract brought a breach of contract claim against the buyer.[104] U & W Industrial Supply, Inc. (U & W) was one of the suppliers who signed on after responding to the invitation of Martin Marietta Alumina, Inc. (MMA) to bid on some of the blanket-order contracts.[105] Under each of these contracts, U & W was obligated to maintain an inventory of each specific part adequate to supply MMA's needs at its current level of production.[106] U & W understood that it was bound to carry a ninety-day supply of each part for MMA until the term of the blanket contract expired or was otherwise terminated by one of the parties.[107] The district court implied a thirty-day notice provision into the blanket-order contracts because it determined that MMA had breached its duty of good faith when it failed to give U & W a thirty-day notice before cancelling individual purchase orders that it had the option of placing under its blanket order contracts.[108] All that the contract provided was a thirty-day notice of a change in production levels at MMA's St. Croix aluminum ore processing facility.[109]

The United States Court of Appeals for the Third Circuit held that the district court erred when it rewrote the parties' contract in favor of

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100. *See, e.g.*, U & W Indus. Supply, Inc. v. Martin Marietta Alumina, Inc., 34 F.3d 180, 186-88 (3d Cir. 1994) (refusing to imply a notice provision into the contract as part of Martin Marietta Alumina's duty of good faith since U & W Industrial Supply, Inc. had benefitted from a requirements contract and such was part of its business risk).

101. *See infra* text accompanying notes 104-127.

102. *See infra* text accompanying notes 104-127.

103. *See infra* text accompanying notes 104-127.

104. 34 F.3d at 182.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.* at 184.

109. *Id.* at 181.

U & W.[110] The court acknowledged that the duty of good faith recognized by U.C.C. section 1-203 and Restatement (Second) of Contracts section 205 was applicable to the deal in question.[111] Nonetheless, the court considered that, in this case, "U & W took a calculated business risk when it agreed to supply MMA with parts as needed. It accepted the risk that it would have to dispose of unused inventory if MMA canceled the contract or went out of business. This risk is inherent in requirements contracts."[112] Moreover, there was no evidence in the case permitting an inference that MMA acted in bad faith, unfairly, or dishonestly.[113]

The decision thus stated that while section 1-203 controls the manner in which the parties carry out the obligations undertaken in a contract, it does not give the court power to impose additional obligations on contracting parties merely because it regards the risk allocation specified by the contract as unfair.[114] Interestingly, the court stressed that in some circumstances, the duty of good faith may include a duty to notify.[115] The *U& W* court cited *KLT Industries, Inc. v. Eaton Corp.*, in which the court held that where the defendant permitted the plaintiff to continue a specialized contract and failed to object to a performance that did not strictly conform to the agreement, the defendant was required to give some notice of its intention to cancel the contract.[116] Yet the *U & W* court emphasized that the precedents, including *KLT*, do not stand for the proposition that

> a party invariably has a good faith obligation to notify a supplier before reducing, altering or canceling an agreement. Instead, they merely acknowledge certain circumstances in which a general implied obligation to act in good faith will command or prohibit acts not specifically delineated in the agreement.... [T]he language of the agreement and expressed intent of the parties always guide the application of the implied duty of good faith.[117]

U & W is, therefore, illustrative of the claim that good faith does not impose an off-the-rack duty to notify the contracting partner of changes. Instead, the operation of the doctrine of good faith is context-

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110. *See id.* at 181-82.

111. *Id.* at 185.

112. *Id.* at 188.

113. *See id.*

114. *See id.*

115. *Id.* at 186-87 (citing KLT Indus., Inc. v. Eaton Corp., 505 F. Supp. 1072, 1079-80 (E.D. Mich. 1981)).

116. *Id.*

117. *Id.*

dependent and deferential to the measure of risk distribution adopted in the deal.

The case *Market Street Associates v. Frey* exemplifies how the duty of good faith may lead to an obligation of disclosure, where nondisclosure would amount to opportunistic advantage-taking.[118] In 1968, J.C. Penney entered into a sale and leaseback arrangement with the General Electric Pension Fund.[119] Under the arrangement, J.C. Penney sold properties to the pension trust, which the trust then leased back to J.C. Penney for a term of twenty-five years.[120] The court described paragraph 34 of the lease as follows:

> [P]aragraph 34 of the lease entitles the lessee to "request Lessor [the pension trust] to finance the costs and expenses of construction of additional Improvements upon the Premises," provided the amount of the costs and expenses is at least $250,000. Upon receiving the request, the pension trust "agrees to give reasonable consideration to providing the financing of such additional Improvements and Lessor and Lessee shall negotiate in good faith concerning . . . the financing by Lessor of such costs and expenses." Paragraph 34 goes on to provide that, should the negotiations fail, the lessee shall be entitled to repurchase the property at a price roughly equal to the price at which Penney sold it to the pension trust in the first place, plus 6 percent a year for each year since the original purchase.[121]

In 1988, Market Street Associates wrote a letter to the pension trust requesting financing.[122] The pension trust rejected the request on the grounds that it did not meet their investment criteria and was not interested in making loans for less than seven million dollars.[123] Thereafter, Market Street sent a letter stating that it was exercising the option to purchase the property upon the terms specified in paragraph 34, which allowed the lessee to repurchase the property in the event that negotiations over financing broke down.[124] The contract formula led to an exercise price of only one million dollars.[125] Judge Posner maintained:

> [I]t is one thing to say that you can exploit your superior knowledge of the market—for if you cannot, you will not be able to recoup the

118. 941 F.2d 588, 595 (7th Cir. 1991).
119. *Id.* at 591.
120. *Id.*
121. *Id.* (first alteration in original) (quoting from contract).
122. *Id.*
123. *Id.*
124. *Id.* at 592.
125. *Id.*

> investment you made in obtaining that knowledge—or that you are not required to spend money bailing out a contract partner who has gotten into trouble. It is another thing to say that you can take deliberate advantage of an oversight by your contract partner concerning his rights under the contract. Such taking advantage is not the exploitation of superior knowledge or the avoidance of unbargained-for expense; it is sharp dealing. Like theft, it has no social product, and also like theft it induces costly defensive expenditures, in the form of overelaborate disclaimers or investigations into the trustworthiness of a prospective contract partner, just as the prospect of theft induces expenditures on locks.[126]

Judge Posner identified the crucial issue in this case as being "whether Market Street Associates tried to trick the pension trust and succeeded in doing so. If it did, this would be the type of opportunistic behavior in an ongoing contractual relationship that would violate the duty of good faith performance . . . ."[127]

The moderate duty to refrain from malicious nondisclosure imposed by *Market Street* illustrates how good faith operates to fill apparent gaps based on the terms of the deal. Had the parties thought about the possibility that J.C. Penney would not have had the content of paragraph 34 in mind when Market Street requested financing approximately twenty years after the contract was signed, they would most probably have agreed that Market Street could not intentionally fail to mention the term. It is unlikely that the risk of J.C. Penney failing to recall the consequences of a failure of negotiations under paragraph 34 when responding to financing requests was in any way assumed by the parties or priced under the initial contract. Good faith thus operated to provide a supplementary provision that, while necessary to best achieve the regime set out by the express terms of the agreement, was not specifically included due to transaction costs and the parties' limited foresight.

Another instance of the case-specific application of the doctrine of good faith concerns contracts where payments are conditioned upon parties' approval. Most cases hold that the duty of good faith in these circumstances requires the disapproval to be motivated by dissatisfaction with the object of performance, as opposed to a rejection motivated solely by the desire to back out from the deal. In these cases the standard is interpreted as requiring subjective good

126. *Id.* at 594 (citing Burton, *supra* note 72, at 393).
127. *Id.* at 596.

faith.[128] Nevertheless, when the circumstances of the contract are such that a subjective standard would seem to defeat the purpose of the deal, a court may read the clause as requiring the exercise of reasonableness.[129] Also, the apparent indefiniteness does not render the doctrine meaningless; on the contrary, the lack of ex ante guidance is a tool for courts to provide the term that the parties before it would have wanted.

The exposition so far demonstrates that, unlike fiduciary relations, which impose high standards of behavior as default rules unless expressly trumped, the duties required by the doctrine of good faith are highly case-specific. In some circumstances, good faith may entail a duty to disclose, while in others it may not. Sometimes good faith will interpolate a requirement of reasonableness in approvals, while in other situations good faith will let the subjective standard prevail. The cases show that the implication of terms in the agreement through the doctrine of good faith depends on the attributes of the deal in question.

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128. *See, e.g.*, Brant Constr. Co. v. Metro. Water Reclamation Dist. of Greater Chi., 967 F.2d 244, 247 (7th Cir. 1992) ("The only limit on contracts which provide for subjective satisfaction is bad faith.") (citing Beasly v. St. Mary's Hosp. of Centralia, 558 N.E.2d 677, 682 (Ill. App. Ct. 1990)); Doubleday & Co. v. Curtis, 763 F.2d 495, 501 (2d Cir. 1985) (considering specific facts to determine the good faith needed for a publisher); Daniels v. Army Nat'l Bank, 822 P.2d 39, 43 (Kan. 1991) (finding a good faith test is subjective with respect to arguments by borrowers against lenders).

129. In *Morin Building Products Co. v. Baystone Construction, Inc.*, 717 F.2d 413, 414 (7th Cir. 1983), General Motors hired Morin Building Products Company to supply and erect aluminum walls for its Chevrolet plants. The contract provided that

> should any dispute arise as to the quality or fitness of materials or workmanship, the decision as to acceptability shall rest strictly with the Owner, based on the requirement that all work done or materials furnished shall be first class in every respect. What is usual or customary in erecting other buildings shall in no wise enter into any consideration or decision.

Id. The only issue on appeal was the correctness of a jury instruction which said that the satisfaction clause must be determined by objective criteria. *Id.* Judge Posner upheld the instruction, applying a tailored hypothetical bargain framework. *Id.* at 415-16. The court reasoned:

> The requirement of reasonableness is read into a contract not to protect the weaker party but to approximate what the parties would have expressly provided with respect to a contingency that they did not foresee, if they had foreseen it. Therefore the requirement is not read into every contract, because it is not always a reliable guide to the parties' intentions. In particular, the presumption that the performing party would not have wanted to put himself at the mercy of the paying party's whim is overcome when the nature of the performance contracted for is such that there are no objective standards to guide the court.

Id. at 415.

The reasons why good faith works as a tailored gap-filling method, providing very little content ex ante, are not mysterious. First, contract law has its own set of untailored defaults.[130] Good faith is thus no more than a *residual* method of gap filling, one that fills gaps based on hints provided by the contract's express terms. Second, as articulated above, *every* contract contains a covenant of good faith and fair dealing.[131] Hence, good faith applies to the entire spectrum of contractual relationships, whose heterogeneity makes the finding of any untailored majoritarian regime less likely.

Alan Schwartz has suggested that default rules in the contract arena should be rare because the combination of the generalist ambitions of contract law, which aim to apply to each and every contractual relationship, coupled with the variety of contracting problems in a diverse economy, render broadly acceptable solutions through majoritarian default rules unlikely.[132] Conversely, whenever policymakers can identify certain categories where there is a relatively high degree of homogeneity, it becomes feasible to design suitable majoritarian or untailored defaults.[133] This is the case with respect to fiduciary relations, especially because the exact contours of fiduciary duties vary across the different categories of fiduciary relationships. Hence, the literature seems to support the view that the tailored and untailored characters of good faith and fiduciary duties are not only descriptively accurate, but also normatively desirable.

Moreover, good faith is a tailored gap-filling method of moderate application. By moderate I mean that courts tend not to fill gaps in the absence of clear indications of intent and agreement. As Deborah DeMott observed, "good faith has suppletory and protective functions whose scope is defined by the express terms of the parties' contract."[134] Indeed, judges tend to be unwilling to apply good faith to imply new

130. The following provisions of the U.C.C. illustrate a few of the many default rules in force in the contract law arena. *See, e.g.*, U.C.C. § 2-314(1) (2004) (describing the implied warranty of merchantability); *id.* § 2-314(3) (describing other warranties); *id.* § 2-308 (describing delivery terms); *id.* § 2-513(1) (describing the right to inspect goods).

131. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

132. *See* Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 396 (1993).

133. *See id.* at 397 ("[M]ost of the state-supplied problem-solving defaults that regulate contracting behavior are not contract law rules at all; rather, they are corporate law rules, partnership law rules, property law rules and so forth."). Schwartz also suggests that the creation of good defaults perhaps "should be assigned to legal fields other than contracts." *Id.* at 419.

134. Deborah A. DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context*, 25 WAKE FOREST L. REV. 15, 24 (1990).

obligations unless it is "clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to . . . had they thought to negotiate with respect to that matter."[135] As put by another court:

> A promise will not be read into a contract unless it arises by necessary implication from the provisions thereof. Terms are to be implied in a contract not because they are reasonable but because they are necessarily involved in the contractual relationship so that the parties must have intended them and have only failed to express them because they are too obvious to need expression.[136]

Courts therefore employ good faith to fill gaps more visibly implicated in the agreement, but refuse to supply terms where the contract does not provide hints as to what regime the parties would have adopted.

The reasons why courts stick with a "no independent duty" rule, thereby refusing to imply provisions that are not supported by express terms, are twofold. The first reason relates to the comparative advantages of parties and courts to fill certain kinds of gaps. The courts' moderation in crafting duties without benchmarks in the parties' agreements creates incentives for parties to spell out their arrangements when it is cheaper for them to do so ex ante than it is for courts to do so ex post. The second reason has to do with judicial competence. While judges are generally able to accurately fill clear gaps in order to implement express terms, envisioning and articulating the independent duties that the parties would have agreed to is a substantially trickier task. By applying good faith as a gap-filling method in a moderate manner, and thereby refraining from implying duties not clearly required to fulfill the express terms of the agreement, courts minimize the risk of judicial error in the task of gap filling and avert costly uncertainties in contract adjudication that could result otherwise.

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135. Katz v. Oak Indus. Inc., 508 A.2d 873, 880 (Del. Ch. 1986).

136. Danby v. Osteopathic Hosp. Ass'n of Del., 101 A.2d 308, 313-14 (Del. Ch. 1953). In *English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983), the Supreme Court of Texas abolished the duty of good faith in Texas common law and effectively prevented courts from implying even obvious terms. *See* Mark Gergen, *A Cautionary Tale About Contractual Good Faith in Texas*, 72 TEX. L. REV. 1235, 1259-60 (1994) ("Later cases read *English* to hold that the good faith doctrine may never be used to supplement or vary express terms of a contract."). As described by Gergen, the *English* court disregarded the fact that parties contract to make insurance payable to a noteholder in order to protect the security, and, based on a poorly drafted contract, allowed the noteholder to take advantage of a repairable loss to get out of a term note at an unfavorable interest rate. *Id.* at 1259.

Judicial moderation in applying the concept of good faith to supply independent contract terms stems from a fundamental trade-off involved in the optimal character of gap filling. Because good faith often covers contractual situations where hurdles to express contracting are not as extreme (i.e., where the enhanced information asymmetry problems typical of fiduciary relationships are absent), the law does not want to undercut the parties' incentives to memorialize the deal for themselves. The law aims to further efficient outcomes by providing as default rules outcomes that would be too costly for parties to contract for themselves, but it does not want to undermine the parties' incentives to craft their own terms when that is possible.

Were tailored gap filling applied in an expansive manner, the parties' incentives to spell out their deal would be significantly undermined. In many circumstances, it is not self-evident whether or not a gap in fact exists. Most terms could be more complete and could be improved by adding nuances that make them more suitable to a resulting state of the world. If any terms that the parties craft could then be subject to judicial scrutiny and alteration, they would probably not be worth the additional drafting and negotiation costs. But when the departure of express terms from the optimal possibility is minimal, the case for courts' intervention is weakened; presumably courts are not as well equipped as parties to write suitable contract terms. If courts were to intervene even in the face of express terms, parties would then be discouraged from spelling out their preferred arrangements even when the parties themselves are better situated than courts to assess their needs.

Therefore, where information asymmetry and monitoring problems are not substantial, the law creates incentives for parties to reveal information and specify their own arrangements. As a result, the doctrine of good faith solves the trade-off by equipping courts to fill apparent gaps to avoid opportunistic advantage taking, while insisting that more specific duties arising from good faith track the contract terms. In contractual situations that fall short of the fiduciary paradigm, both the underlying heterogeneity and the reduced monitoring and specification problems suggest that giving incentives to parties to specify their deals will lead to superior results.

Gap filling in fiduciary settings reflects a different balance. Given the information asymmetry and the monitoring problems embedded in fiduciary relationships, any efforts to create incentives for parties to specify their arrangements for themselves would likely be futile. In the words of Easterbrook and Fischel, "[w]hen one party hires the other's knowledge and expertise, there is not much they can write down."[137] Fiduciary duties are therefore provided as default rules independently from the terms of the deals; that is, the law does not require terms of the arrangement to serve as benchmarks.[138]

An important practical consequence stemming from the fact that fiduciary duties are default standards with some significant a priori content is that the criterion for what counts as abrogation is set at a higher level. Although opting out is of the essence of legal defaults, scholars have observed that courts are consistently biased against departure from the standard regime.[139] Therefore, the fact that fiduciary duties are untailored default standards explains why courts generally permit the parties to opt out but require the abrogation to be done in an express and specific manner.

The discussion also sheds light on the apparent inconsistency generated by the concurrent mandatory character of good faith and the unwillingness by the courts to employ the implied covenant to override the express terms of the deal. A prominent contract scholar has noted that "[i]t is sometimes no simple matter to reconcile the mandatory character of the duty of good faith with the principle, often repeated by courts, that there is no such duty if it would conflict with an express provision of the contract."[140] Nonetheless, the view of good faith as a mandatory tailored gap-filling method that I advance here helps unravel this apparent paradox.

In this sense, good faith does not impose substantive terms on the parties' agreement. All it mandates is the application of a tailored gap-filling method that equips courts to complete contracts with the terms for which those parties would have contracted. As explained above, the only universal ex ante content of the doctrine is the ban on

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137. Easterbrook & Fischel, *supra* note 6, at 426.

138. *See id.* at 426-27.

139. Scholars suggested that the reluctance in recognizing opting out of statutory standards is due to the courts' view that default rules embody some notion of intrinsic fairness, thus making default rules "stickier" than originally intended. *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 284-86 (1985) (discussing the difficulty in opting out of default contextual norms); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 596 (2003) (discussing how courts create barriers to contracting out of default rules).

140. 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 7.17, at 341 (2d ed. 1998); *see, e.g.*, Riggs Nat'l Bank of Wash. D.C. v. Linch, 36 F.3d 370, 373 (4th Cir. 1994) ("An implied duty of good faith cannot be used to override or modify explicit contractual terms."); Chamison v. Healthtrust, Inc.—The Hosp. Co., 735 A.2d 912, 921 (Del. Ch. 1999) ("The implied covenant cannot contravene the parties' express agreement and cannot be used to forge a new agreement beyond the scope of the written contract.").

opportunistic or ill-motivated advantage-taking in the contractual relationship. Thus, the mandatory character of the doctrine of good faith is far less interventionist than it may first appear.[141]

Mandating the application of the first prong of the doctrine of good faith—that is, the tailored gap-filling method—provides only minimal hurdles for parties to achieve exactly the deal they want. Because good faith as a tailored gap-filling method has very little content ex ante that is independent from the terms of the deal, there is no substantive content being imposed on the contracting parties. As to the second prong of good faith, the sensible presumption that no informed party would consent to being opportunistically taken advantage of makes the mandatory character of good faith rather innocuous.

IV. DISTINCT TAILORING IN PRACTICE

The main purpose of this Article is to unveil the fact that fiduciary duties are untailored default rules that apply to categorical situations characterized by enhanced specification and monitoring costs, while good faith is a tailored gap-filling method that applies to the entire spectrum of contractual relations. In this Part, I will examine two prominent fiduciary law cases in which the hidden tension between tailored and untailored gap-filling methods explains the dispute between the majority and the dissenting opinions. In both cases, the opinion conceiving fiduciary duties at a higher level of generality—i.e., in an untailored manner—prevailed.

The importance of the *category* in triggering the application of fiduciary default rules is well-illustrated in the celebrated case of *Meinhard v. Salmon*.[142] In this case, Meinhard and Salmon entered into a joint venture agreement with the purpose of leasing real estate in New York for a term of twenty years.[143] Meinhard was to pay to Salmon half of the money necessary to manage and operate the property, and Salmon was to pay Meinhard forty percent of net profits for the first five years of the lease and fifty percent thereafter.[144] Each party would bear losses equally, but Salmon was the sole manager of

141. For the argument that good faith as a gap-filling method does not promote efficiency in all circumstances and should therefore be a default, rather than a mandatory, regime, see SIMONE MARIA SEPE, GOOD FAITH AND CONTRACT INTERPRETATION: A LAW AND ECONOMICS PERSPECTIVE 51-52 (2006), http://www.unisi.it/lawandeconomics/simple/042_Sepe.pdf.

142. 164 N.E. 545 (N.Y. 1928).

143. *Id.* at 545-46.

144. *Id.* at 546.

the enterprise.[145] Four months before the end of the lease, Salmon received an offer for a new lease covering the whole tract of land and involving a huge outlay.[146] Salmon completed the lease without communicating with Meinhard about this opportunity.[147] The issue before the New York Court of Appeals was whether this conduct was permissible.[148]

In his memorable language, Justice Cardozo announced:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[149]

Quite notably, Cardozo began his analysis by analogizing joint venturers to partners.[150] Thus, the first step in Cardozo's opinion was the recognition of a fiduciary category.[151] The decision turned on the rule that joint ventures are deemed equivalent to partnerships for the purposes of the incidence of fiduciary duties.[152] That is to say, Cardozo announced that joint ventures are a fiduciary category. Once a fiduciary category is recognized, high standards of behavior are automatically imposed on the party named fiduciary.

Cardozo's analysis did not at any moment inquire what Meinhard and Salmon would have agreed to had this issue come into question at the time they were drafting their agreement. The emphasis lies instead on the category level. Meinhard and Salmon formed a joint venture, which is subject, like a partnership, to fiduciary duties.[153] The fact that a joint venture is subject to the standards of partnership fiduciary law puts an end to investigation: partners owe each other the duty of utmost loyalty, which requires the disclosure of upcoming opportunities.

Cardozo then praised the rigid imposition of high standards of behavior once a fiduciary category is identified, leaving no room for

145. *Id.*
146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. *Id.*
153. *Id.*

context-specific considerations. Cardozo stated: "Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."[154]

The dissenting opinion written by Judge Andrews opposed the majority precisely with respect to the categorical classification.[155] For Andrews as well, the first level of analysis did not pertain to what Meinhard and Salmon would have agreed had they considered this issue, but rather to what *category* their relationship belongs.

Andrews did not dispute either the obligation of a fiduciary to share the opportunity of renewal of a lease or the rigid application of such stringent standards of conduct when a traditional fiduciary relationship exists:

> Less tangible than "good will," [a tenant's expectancy of the renewal of a lease] is never included in the tenant's assets, yet equity will not permit one standing in a relation of trust and confidence toward the tenant unfairly to take the benefit to himself. At times the principle is rigidly enforced. Given the relation between the parties, a certain result follows. *No question as to good faith, or injury, or as to other circumstances is material.* Such is the rule as between trustee and cestui; as between executor and estate; as between guardian and ward.[156]

Nevertheless, Andrews also acknowledged that the imposition of a duty to share the opportunity to renew a lease is not inexorable when it comes to relationships falling outside the traditional fiduciary categories, but rather contingent upon the facts and circumstances of the deal in question.[157] He argued, "At other times some inquiry is allowed as to the facts involved. *Fair dealing and a scrupulous regard for honesty is required. But nothing more.*"[158]

The main source of Andrews' disagreement with the majority opinion thus lies in his refusal to treat the joint venture between

154. *Id.* (internal citation omitted).

155. *Id.* at 550 (Andrews, J., dissenting).

156. *Id.* (internal citations omitted) (emphasis added).

157. *See id.* (focusing on the facts of the initial venture).

158. *Id.* (emphasis added). Although Andrews did not expressly state in this passage that "good faith" governs those contractual situations outside the scope of fiduciary categories, his use of traditional rhetoric associated with good faith is noteworthy in the choice of the expression "[f]air dealing and a scrupulous regard for honesty is required." *Id.*

Meinhard and Salmon as a fiduciary category.[159] Andrews refuted the analogy drawn by Cardozo between partnerships and joint ventures with respect to fiduciary obligations.[160] "Were this a general partnership between Mr. Salmon and Mr. Meinhard," he declared, "I should have little doubt as to the correctness of this result, assuming the new lease to be an offshoot of the old."[161] A key element in Andrews' argument is the assumption that a joint venture does not qualify as a fiduciary relationship; consequently, the stringent standards of behavior do not apply without a further inquiry about the structure of the deal in question.

Consistent with my argument throughout this Article, once the fiduciary category is rejected, only the duty of good faith applies; but good faith is highly contextual. Andrews stated: "We have here a different situation governed by less drastic principles. I assume that where parties engage in a joint enterprise each owes to the other *the duty of the utmost good faith* in all that relates to their common venture."[162] He added:

> [E]ven as between joint adventurers one may not secretly obtain a renewal of the lease of property actually used in the joint adventure where the possibility of renewal is expressly or impliedly involved in the enterprise. I assume also that Mr. Meinhard had an equitable interest in the Bristol Hotel lease. Further, that an expectancy of renewal inhered in that lease. Two questions then arise. Under *his* contract did he share in that expectancy? And if so, did that expectancy mature into a graft of the original lease? To both questions my answer is "No."[163]

Andrews' dissenting opinion is thus especially instructive about the different gap-filling methods. Once the objective and abstract fiduciary standards were rejected, he turned to the question of what the specific deal at issue between Mr. Meinhard and Mr. Salmon

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159. Andrews' opinion that Salmon's conduct was permissible was based on two independent reasons. First, he argued that "[t]here was no general partnership, merely a joint venture for a limited object, to end at a fixed time." *Id.* Second, he claimed, "[t]he new lease, covering additional property, containing many new and unusual terms and conditions, with a possible duration of 80 years, was more nearly the purchase of the reversion than the ordinary renewal with which the authorities [compelling a fiduciary to disclose the opportunity to its counterparty] are concerned." *Id.* This Article focuses only on the first rationale, which is the one that the opinion developed more fully; Andrews expanded on the second argument solely in the last substantive paragraph of the opinion. *See id.* at 552.

160. *Id.* at 550.

161. *Id.* at 551.

162. *Id.* (emphasis added).

163. *Id.* (emphasis added).

provided.[164] He concluded that, in light of the surrounding circumstances of this case, the deal generated no expectancy of renewal.[165] Therefore, good faith by itself did not require a duty to disclose in order to attain the purposes of the agreement.[166]

The contrast between the application of a tailored and an untailored method of gap filling is exemplified in the case of *Jordan v. Duff & Phelps, Inc.*[167] In 1977, Jordan started working as a securities analyst at Duff & Phelps, Inc., a closely held corporation that evaluates firms and securities risk.[168] In 1981, Duff & Phelps offered Jordan the opportunity to buy its stock subject to an agreement providing that upon termination of employment, Jordan would have to sell his shares to the corporation at a price of adjusted book value.[169] In 1983, Jordan told the chairman of the board that he was planning to resign.[170] Jordan did not make any inquiries at that time about potential transactions likely to affect the value of the shares.[171] The chairman of the board did not volunteer to tell Jordan that the company was negotiating a merger that would substantially increase its book value.[172] Jordan filed suit arguing that because the company did not volunteer information about the proposed transaction, he timed his departure in order to receive the

164. *Id.* at 550.

165. Judge Andrews observed that the venture was for "a limited object, to end at a fixed time." *Id.*

166. Interestingly, in a different context, but in an a no less famous case, Justice Cardozo and Judge Andrews espoused positions that mirror the dispute in *Meinhard v. Salmon* with respect to the level of generality in which a decision is made. In the celebrated torts case of *Palsgraf v. Long Island Railroad Co.*, 162 N.E. 99, 99 (N.Y. 1928), a package carried by a train passenger was dislodged while guards were helping him board the train. The package fell and exploded, injuring Mrs. Palsgraf, a passenger standing on the platform many feet away. *Id.* Cardozo, writing for the majority, decided the case at a higher level of generality, declaring that there was no duty to a plaintiff outside the orbit of danger. *Id.* at 100. Andrews, in contrast, argued that that a defendant who is negligent shall be liable even if the person injured is outside the zone of danger. *Id.* at 102 (Andrews, J., dissenting). The practical result of Andrews' position is to add the question of the foreseeability of a plaintiff to the series of case-specific factors to be considered under the rubric of proximate cause. Cardozo's view, in contrast, favors the more untailored rule that a negligent defendant does not owe a duty to an unforeseeable plaintiff. In considering a joint venture as a fiduciary category in *Meinhard* and in determining that there is no duty to plaintiffs outside the zone of danger in *Palsgraf*, Cardozo favored standards that are determined at a higher level of generality compared to Andrews' tailored gap filling in *Meinhard* and his preferred fact-intense determination of proximate cause in *Palsgraf*.

167. 815 F.2d 429 (7th Cir. 1987).

168. *Id.* at 432.

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.*

book value of his shares as of December 31, 1983 ($23,225).[173] Had he known of the merger and remained in the company until January 10, he would have been entitled to receive $425,000.[174]

The main issue in the case was whether the company was under a duty to inform Jordan about the potential merger.[175] Yet, in a fascinating judicial dispute involving the authors of important academic contributions to the field, Judge Easterbrook and Judge Posner applied the hypothetical bargain framework to the facts of the case and reached opposite results.[176]

Easterbrook, writing for the majority, found a violation of a fiduciary obligation.[177] He started his opinion by citing precedents for the proposition that closely held firms buying their own stock are under a duty to disclose material information to the investors from whom it purchases such shares, including information about a potential acquisition before an agreement in principle has been reached on the price and structure of the transaction.[178] The first step of Easterbrook's analysis in repudiating the argument that Duff & Phelps was entitled to be silent was the unequivocal identification of a fiduciary category:

> This argument [that Duff & Phelps was entitled to remain silent] is unavailing on the facts as we know them. The "duty" in question is the fiduciary duty of corporate law. Close corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts.[179]

Given the abstract formulation of a fiduciary duty of closely held corporations to inform investors when buying back stock, Easterbrook did not have any problem in finding a violation of fiduciary duties on the facts of this case.[180] In consonance with the view of fiduciary duties as untailored defaults, Easterbrook explained:

> Because the fiduciary duty is a standby or off-the-rack guess about what parties would agree to if they dickered about the subject explicitly, parties may contract with greater specificity for other arrangements. It

173. *Id.* at 433.
174. *Id.*
175. *Id.* at 435.
176. *See id.* at 436.
177. *Id.* at 443.
178. *Id.* at 435 (citing Strong v. Repide, 213 U.S. 419 (1909); Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965); Todd A. Bauman, Comment, *Insider Trading at Common Law*, 51 U. CHI. L. REV. 838 (1984)).
179. *Duff & Phelps*, 815 F.2d at 435.
180. *Id.*

> is a violation of duty to steal from the corporate treasury; it is not a violation to write oneself a check that the board has approved as a bonus.[181]

Consistently with the view of fiduciary duties as untailored defaults, the majority opinion embraced the view that opting out of such standards requires unequivocal express contracting:

> It is therefore unwarranted to say that the implicit understanding between Jordan and Duff & Phelps should be treated as if it had such a no-duty clause; we are not confident that this is the clause firms and their employees regularly would prefer. Duff & Phelps has not identified any firm that adopted such a clause explicitly, and the absence of explicit clauses counsels caution in creating implicit exceptions to the general fiduciary duty.[182]

Easterbrook's analysis is straightforward: closely held corporations have a default fiduciary duty to shareholders when buying back stock.[183] Jordan and Duff & Phelps did not expressly contract otherwise in order to trump the default standard; therefore, Duff & Phelps violated its duty to Jordan in failing to disclose material information about the value of the company.[184] Easterbrook recognized that both a term requiring disclosure and a term exempting disclosure could have been in the interest of the parties.[185] However, because the hypothetical bargain in the case of fiduciary duties is determined at the category level, only an actual bargain abrogating such standards could serve as a defense.[186] Because Jordan and Duff & Phelps did not enter into an agreement to opt out of the fiduciary standard, Jordan was entitled to the general protective treatment.[187]

Judge Posner wrote a harsh dissenting opinion which can be interpreted as diverging from the majority in that he wanted to apply fiduciary duties as a more tailored gap-filling method. Unlike the dissenting opinion of Judge Andrews in *Meinhard*, Judge Posner pursued a tailored solution in *Jordan* in spite of his acknowledgment that the facts before the court fell within a fiduciary category.[188] He noted that "[the majority] find[s] such a duty implicit in the fiduciary relationship between a closely held corporation and its shareholders.

181. *Id.* at 436.
182. *Id.*
183. *Id.* at 435.
184. *Id.* at 436.
185. *Id.*
186. *Id.*
187. *Id.*
188. *See id.* at 445-46 (Posner, J., dissenting).

By this approach, what should be the beginning of analysis becomes its end."[189]

Posner criticized the majority for applying the fiduciary duty on an abstract basis without further inquiry about the peculiarities of the deal. "[T]he mere existence of a fiduciary relationship between a corporation and its shareholders," he argued, "does not require disclosure of material information to the shareholders. A further inquiry is necessary, and here must focus on the particulars of Jordan's relationship with Duff and Phelps."[190]

Posner admitted that the parties did not enter into an employment agreement in this case.[191] However, he considered that the clause in the shareholders' agreement providing that the ownership of stock did not give rise to a right of employment entitled Duff & Phelps to terminate Jordan as a shareholder subject only to a duty to buy back his shares at book value.[192] The resulting arrangement that allowed the employer to dismiss the employee at will was, he argued, incompatible with an inference that Duff & Phelps undertook to keep Jordan informed of developments affecting the value of the firm.[193] Posner found that a duty to disclose material information to Jordan was inconsistent with

189. *Id.* at 445 (emphasis added). Posner initially justified his tailored approach based on the "price-and-structure" rule applicable in the context of publicly traded corporations, which states that unless and until an agreement in principle is reached with respect to the price and structure of a given transaction, a public corporation does not need to disclose the existence of ongoing negotiations when buying stock from its shareholders. *Id.* at 449. For Posner, the conclusion then followed that the existence of a fiduciary relationship does not necessarily trigger a duty to disclose. *Id.* at 445. Such a duty, he argued, was contingent upon the analysis of the facts and circumstances surrounding the case. *Id.* As explained in Judge Easterbrook's decision, however, the price and structure rule is not an exception, but rather an application of fiduciary duties to the shareholders. *Id.* at 451. Because most shareholders of public companies will benefit if information about acquisitions is kept private until an agreement on price and structure is made, the price and structure rule enables the corporation some flexibility in the *timing* of its disclosure obligations in order to promote the best interests of the shareholders. *Id.* at 447. The price and structure rule, therefore, reflects an application of the *standard* character of fiduciary duties by allowing the exact conduct required to discharge such duties to change according to the circumstances in order to best promote the interests of the beneficiaries of such protective treatment. The view differs substantially from that of the dissenting opinion. Judge Posner did not state that the absence of a duty to disclose represents the best way to protect the interests of the beneficiaries of fiduciary duties in this case. *See id.* at 444-52. To the contrary, the dissenting opinion is based on the notion that the circumstances of the case suggest that fiduciary duties are inconsistent with the general arrangements between the parties, thus switching the focus from a category type of analysis typical of fiduciary duties to deal-specific considerations typical of the tailored gap-filling method embodied in the doctrine of good faith. *See id.*

190. *Id.* at 445.

191. *Id.* at 446.

192. *Id.*

193. *Id.*

the facts of the case and "*with the even more fundamental proposition that duty is a function of circumstances*, and with the terms of the stockholder agreement in this case and of the employment relationship."[194]

Posner claimed that "[t]he majority's view that 'the silence of the parties' is an invitation to judges to 'imply other terms-those we [judges] are confident the parties would have bargained for if they had signed a written agreement' is doubly gratuitous."[195] Posner did not want the existence of fiduciary duties to be the end of the analysis; he was committed to providing the parties with the term he considered to be best suited to the transaction.[196] In other words, notwithstanding the recognition of a fiduciary category, Posner envisioned a tailored and moderate gap-filling method typical of the doctrine of good faith.

Here the result turned on the level of express contracting required to abrogate fiduciary duties as untailored default standards. The majority view was that, absent an express agreement to the contrary, the standard fiduciary duties apply.[197] Unlike good faith, a moderate and tailored gap-filling method which only fills gaps where the express terms and surroundings of the deal struck by the parties clearly suggest that the proposed term is necessary to promote the purpose of the transaction and that the parties would have so contracted had they foreseen the contingency in question, fiduciary duties apply unless the parties specifically contract out of the default fiduciary regime.[198] As argued in Part III, courts very often require clear abrogation of the fiduciary default standards.

In Judge Easterbrook's words, "the absence of explicit clauses counsels caution in creating implicit exceptions to the general fiduciary duty."[199] In contrast, Judge Posner was committed to providing the parties with the term he considered to be best suited to the transaction, given the particularities of the case, not with the terms generally provided to the parties in the same category.[200] While the theory concerning the optimal level of tailoring remains embryonic,[201] the courts' view that the hypothetical bargain ought to be determined at

194. *Id.* at 450 (emphasis added).
195. *Id.* at 449 (alteration in original).
196. *See id.* at 445-51.
197. *Id.* at 436 (majority opinion).
198. *See id.*
199. *Id.*
200. *Id.* at 445-51 (Posner, J., dissenting).
201. For an exploratory work on the subject, see Ayres, *Preliminary Thoughts*, *supra* note 18, at 7.

the category level in fiduciary law, not in a case-by-case basis, has until now prevailed.

V. CONCLUSION

Both good faith and fiduciary duties are doctrinal responses to contracting problems, but the idea that these doctrines serve the same function as contract gap fillers should not obscure their different content and operation. Fiduciary duties are untailored defaults that strike the hypothetical bargain to decide what most parties would have wanted at a higher level of generality—that of a fiduciary category. Good faith aims to fill the gaps based on what the parties would have wanted for the specific deal before the court.

The reasons why these doctrines further the same goal but operate in a different way are not enigmatic. The underlying rationale for gap filling is that an actual bargain is superior to a hypothetical one. In fiduciary relationships, however, hurdles created by monitoring, specification, and information asymmetry make detailed contracting impracticable and inefficient. Attempts by the law to create incentives for parties to specify their relationship would most likely be futile or at least inefficient. Therefore, fiduciary duties are provided upfront and apply unless the contours of the agreement clearly indicate otherwise.

The doctrine of good faith, however, applies to the entire range of contractual relationships. The resulting heterogeneity of the whole spectrum of contracts to which good faith applies would undoubtedly undermine efforts to identify any single majoritarian default content upfront. Moreover, where extreme noncontractibility conditions are absent, the law wants to create incentives for the parties to spell out their preferred arrangements because parties can often do so more cheaply and accurately than courts. As a result, the doctrine of good faith provides a method for tailored gap filling, one that prevents parties from taking advantage of contractual gaps to back out of the deal. Nevertheless, courts usually require express terms to be used as an anchor for the application of good faith. This is aimed to encourage parties to spell out terms when it is cheaper for them to do so ex ante than for courts to do so ex post, and to maintain their incentives in drafting more complete contracts by reading a gap where there is none.

In summary, this Article explores the functional distinction between the doctrines of good faith and fiduciary duties. The notion that fiduciary duties are untailored defaults, whereas good faith provides a rubric for tailored gap filling, provides an accurate description of the existing law and makes sense in economic terms. The tension between these different gap-filling methods possesses significant explanatory power about the dispute between the majority and the dissenting opinions in important fiduciary law cases. This Article demonstrates that there is more to the actual operation of good faith and fiduciary duties as gap-filling methods than the contractarian scholarship has so far described and opens up the discussion for additional normative implications to the descriptive account that is provided herein.