

# Why Fiduciary Law Is Equitable

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July 17, 2013

[in Andrew S. Gold & Paul B. Miller (eds.), *Philosophical Foundations of Fiduciary Law*, Oxford University Press, forthcoming, 2014]

## Introduction

The complaints about fiduciary law have a familiar ring. Or a cacophony of rings. Fiduciary law is celebrated as unbound by rules or deplored as unprincipled – and yet is seen as too technical and formal. Fiduciary duties are expressed in moral language of exacting honor, which is treasured by some as the essence of the area and as a flowery show by others. The moralists see in fiduciary law a fixed and mandatory system, even as legal economists and contractarians have cast fiduciary law as the ultimate set of defaults to fill in incomplete contracts. And the confusion over the nature of the fiduciary duty carries over into a vague sense that the remedies for breach of fiduciary duty should be stringent but an inability to say exactly why – is it the vulnerability of the victim, the proprietary status of the interest, or something else? The list could go on, but the fiduciary pudding has too many themes for any one of them to stand out.

This state of affairs is no accident. Fiduciary law is an outgrowth of equity – perhaps the most important and characteristic branch of the tree of equity – and it suffers from the hard times the theory of equity has fallen into, and for the same reasons. Like fiduciary law, equity too is celebrated as unboundedly contextual and abhorred as unprincipled and overexpansive, while at the same time exhibits pockets of seemingly strange formalism. Equity is sometimes vague and almost always morally inflected, which is alternatively welcomed, deplored, and downplayed. Is equity a direct infusion of morality? If so, is that good? Or is it all epiphenomenal, disguising what is “really” going on? And is there anything special about equitable remedies, or are they like fiduciary law – along with the rest of equity – better treated as standing on their own terms since the fusion of law and equity?

This paper will argue that a functional theory of equity – of equity as a safety valve aimed at countering opportunism – captures the character of fiduciary law. Indeed, fiduciary law is not only an historical outgrowth of equity but is at the functional core of the equitable decision making mode.

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Equity as anti-opportunism explains not only the general tenor, but the overall structure and particular features of fiduciary law. Fiduciary relationships carry more than the usual potential for opportunism. The situation of someone undertaking to act on another's behalf by using discretion carries with it a great potential for opportunism. Engaging in self-dealing and not avoiding conflicts of interest are more or less correlated with the danger of opportunism. In the equitable solutions to opportunism based on proxies and presumptions, fiduciary law gets its main features. Like equity but in a more sweeping way, fiduciary law sets the presumption against the fiduciary when certain proxies are triggered. In the case of fiduciary law, these proxies are very sweeping and robust. Thus, in situations of undisclosed conflict of interest the presumption of opportunism arises even without regard to the substance of the deal. For self-dealing likewise the presumption arises in an almost indefeasible way. Like equity generally, fiduciary law has a constrained residuum of open-endedness to deal with new and creative ways of being opportunistic. But as with equity as a safety valve, this open-endedness in fiduciary law is limited. It is in personam, here in the sense of only targeting those who have taken on certain duties known to have this quality as well as certain other actors in very special situations, like parents.

This paper begins in Part I with a sketch of the theory of equity as a safety valve targeting opportunists who might abuse the structures of the law. In its origins and functions, fiduciary law is at the core not just of equity jurisdiction. It also presents in especially stark terms the problem of hard-to-monitor and potentially creative misuse of the powers afforded by the law – that is, opportunism. Part II will then show how fiduciary law carries through equity as anti-opportunism with an especially broad and stable set of proxies and presumptions set against potential opportunists. Part III will show how this theory unifies the best aspects of traditional and modern theories of fiduciary law, and helps explain why fiduciary law has become so disparate and contested after the fusion of law and equity. Cut off from the special rationales of equity, fiduciary law itself threatens to become too expansive or too narrow and hidebound – like equity generally. Finally, the functional theory of equity as anti-opportunism helps explain the similarity of fiduciary law to another much misunderstood area of private law – unjust enrichment – and the relation between the two. Like unjust enrichment, fiduciary law is especially preoccupied with opportunism and so requires a heavier dose of equitable decision making in the form of more stringent proxies and presumptions. The paper concludes with some remarks about fiduciary law within the overall architecture of private law.

## **I. Equity as Anti-Opportunism**

Fiduciary law, like the rest of equity, tackles a serious problem of potential opportunism. The safety valve theory of equity is a functional one, and this paper will not claim that equity courts were exclusively concerned with opportunism. Nor were common law courts impervious to the way that their rules and doctrines could be misused. The equitable style of decision making could be found on both sides of the old law versus equity divide, but because of its unique role equity in the Anglo-American tradition

did often, and characteristically, reflect the equitable style of decision making. Nowhere is this more true, both historically and functionally, than in the case of fiduciary law.

## A. Origins and Function

Although our concern is not mainly historical, the development of equity and the trust help explain their preoccupation with opportunism and their characteristic morally infused ex post strategies of countering opportunism.

The equity courts emerged in the fourteenth century out of the dispute resolution activities of the chancellor on the king's behalf. Petitioners would come before the king and later the chancellor complaining of oppressive behavior and asking for an order directed at the alleged misdoer to put the matter right. In particular by the fifteenth century many of the complaints were against "foeffees," persons who held legal title for the benefit of another in a proto-trust (a "use," usually for the purpose of avoiding the tax-like feudal incidents that would be owed the lord on an intergenerational transfer). The arrangement was fraught with danger that the trusted party would take the property for himself – he had legal title after all – and the "faithless feoffee,"<sup>1</sup> was the central character in much of this early litigation. Thus, anti-opportunism was at the center of equity and its most important invention – the trust – right from the beginning. The early chancellors were clergymen, and equity drew heavily on civil and canon law in developing its substance and its procedure. The chancellor was the keeper of the king's conscience and equity courts were known as courts of conscience.<sup>2</sup> Equity bore a close relation to natural law and natural justice, and moral norms infused all of its work.<sup>3</sup>

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<sup>1</sup> 1 AUSTIN WAKEMAN SCOTT, WILLIAM FRANKLIN FRATCHER & MARK L. ASCHER, SCOTT AND ASCHER ON TRUSTS § 1.5, at 14 (5th ed. 2006) ("Petitioners complained frequently to the chancellor ... about faithless feoffees. Such breaches of faith naturally appealed strongly to the chancellor's sense of justice, and ... the chancellor began to compel recalcitrant feoffees to do what they had undertaken to do."); John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 615, 634 & n.42 (1995) (citing as an example a petition to the Chancellor from the 1390s, see *Select Cases in Chancery: 1364-1471*, at 48-49 (William P. Baildon ed., London, Selden Soc'y vol. 10, 1896).)

<sup>2</sup> See, e.g., J.H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 112-28 (3d ed. 1990); but cf. Mike Macnair, *Equity and Conscience*, 27 OXFORD J. LEGAL STUD. 659 (2007) (arguing that equity as a court of conscience originally meant that the judge knew and could draw on facts not in evidence).

<sup>3</sup> See, e.g., 2 HUGO GROTIUS, DE JURE BELLI AC PACIS LIBRI TRES [On the Law of War and Peace: Three Books] ii.6, at 193 (Francis W. Kelsey transl., Oxford at the Clarendon Press, 1925) (1646) ("We must, in fact, consider what the intention was of those who first introduced individual ownership; and we are forced to believe that it was their intention to depart as little as possible from natural equity."); GULIAN C. VERPLANCK, AN ESSAY ON THE DOCTRINE OF CONTRACTS: BEING AN INQUIRY HOW CONTRACTS ARE AFFECTED IN LAW AND MORALS, BY CONCEALMENT, ERROR, OR INADEQUATE PRICE 37 (New York, G. & C. Carvill 1825) ("[Lord Mansfield made] the judgments of the law correspond with the actual practice of intelligent merchants, and with those universal usages, founded partly in convenience, and partly in natural equity, which might be considered as the common commercial and maritime law of the civilized world."); see also *Bright v. Boyd*, 4 F. Cas. 127, 133 (C.C.D. Me. 1841) (No. 1875) ("I have ventured to suggest, that the claim of the *bonâ fide* purchase [in unjust enrichment for improvements made to real property] is founded in equity. I think it founded in the highest equity; and in this view of the matter, I am supported by the positive dictates of the Roman law. The passage already cited, shows it to be founded in the clearest natural equity. '*Jure naturae aequum est.*' ["By the law of nature it is equitable."] (Story, Circuit Justice);

The equity courts also drew on the tradition of equity stretching back to Aristotle, who defined equity (*epieikeia*) as an invocation of justice where law fails on account of its generality.<sup>4</sup> This tradition came in broader and narrower versions. On the broader one, equity fills any gap or corrects any flaw in the law in the interest of justice; it closes any gaps between the terms of the law and its purpose. I have argued for a narrower version in which one main reason law fails on account of its generality is that the resultant gap between the law and its purpose gives an opening to opportunists.<sup>5</sup> Such an interpretation, which I argue for on functional and (tentatively and partially) on historical grounds, is possibly the best interpretation of Aristotle's equity, as Dennis Klimchuk has shown.<sup>6</sup> On this more focused view, equity's domain is not over any and all gaps between the law and its purposes but is especially concerned with gaps that opportunists intentionally exploit (and even create) in hard-to-foresee ways.

On either the wide or narrow view of equity, not every situation can be anticipated by those framing the law, and so we need an individualized ex post approach. As we have seen, opportunism by its nature cannot be dealt with purely ex ante. And the strategic aspect of opportunism calls for individual tailoring. In a famous analogy, Aristotle likened equity to the leaden measuring rulers of the builders of the island of Lesbos. Unlike iron rulers, the lead rulers would take the shape of the measured stones, allowing the selection of another neighboring stone that would fit exactly. Opportunism requires this kind of tailoring, for two reasons. One is that if within its domain equity is too predictable the well-informed opportunists will anticipate it and evade it: ex post will collapse into ex ante. Further, as we will see it is in the nature of opportunists to be

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Moses v. Macferlan, [1760] 97 Eng. Rep. 676, 681 (K.B.) (Mansfield, J.) (“In one word, the gist of this kind of action is, that the defendant, upon the circumstances of the case, is obliged by the ties of natural justice and equity to refund the money.”). *But see* 1 FRED F. LAWRENCE, A TREATISE ON THE SUBSTANTIVE LAW OF EQUITY JURISPRUDENCE § 3 (1929) (arguing that it is fallacious to regard equity as based on natural justice).

<sup>4</sup> ARISTOTLE, NICOMACHEAN ETHICS 317 (G.P. Goold ed., H. Rackham trans., Harvard Univ. Press 1982); THOMAS AQUINAS, SUMMA THEOLOGICA I-II, q. 96, art. 6.; CHRISTOPHER ST. GERMAN, DOCTOR AND STUDENT 94-107 (T.F.T. Plucknett & J.L. Barton, eds. 1974); *see also, e.g.*, Riggs v. Palmer, 22 N.E. 188, 189 (N.Y. 1889) (quoting Aristotle on equity); Eric G. Zahnd, *The Application of Universal Laws to Particular Cases: A Defense of Equity in Aristotelianism and Anglo-American Law*, 59 LAW & CONTEMP. PROBS. 263, 270-75 (Winter 1996) (documenting influence of Aristotelian equity on Anglo-American law); *but cf.* Darien Shanske, *Four Theses: Preliminary to an Appeal to Equity*, 57 STAN. L. REV. 2053 (2005) (arguing that Aristotle's equity was not primarily legal).

<sup>5</sup> Henry E. Smith, *An Economic Analysis of Law Versus Equity*, October 22, 2010 (working paper), available at: [http://www.law.yale.edu/documents/pdf/LEO/HSmith\\_LawVersusEquity7.pdf](http://www.law.yale.edu/documents/pdf/LEO/HSmith_LawVersusEquity7.pdf).

<sup>6</sup> Dennis Klimchuk, *Is the Law of Equity Equitable in Aristotle's Sense?* 4 (June 2011) (unpublished manuscript), available at <http://www.law.ucla.edu/workshops-colloquia/Documents/Klimchuk.%20Is%20the%20Law%20of%20Equity%20Equitable%20in%20Aristotles%20Sense.pdf> (“Correction is sometimes necessary because all law is universal and, owing to its universality, can lead to error in particular cases.”).

inventive. Equity needs to be open-ended and individualized to capture new, hard-to-foresee ways of engaging in opportunism – the problem to which we now turn.

## B. The Problem of Opportunism

In other work I have argued that the theme of equity as a decision-making mode is the fight against opportunism.<sup>7</sup> Historically what has gone under the heading “equity” partakes greatly of this equitable mode. I start with the problem to be solved, but as we will see, in equity the main action occurs in defining the proxies for opportunism and the consequences of the triggering of these proxies and their associated presumptions.

In isolating opportunism a good place to start is the traditional lore of the concerns of equity. A couplet attributed to Thomas More, the first lawyer to serve as Chancellor, has it that “Three things are to be helpt in Conscience; Fraud, Accident and things of Confidence.”<sup>8</sup> Another version of the equitable domain recites “fraud, accident, and mistake.”<sup>9</sup> As we will see, the proxies for triggering the potential for equitable intervention are keyed to fraud, accident, and confidence. Very suggestive is how Justice

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<sup>7</sup> Smith, *supra* note 5.

<sup>8</sup> 1 ROLLE’S ABRIDGEMENT 374; *see also* Caco vs. Clark, [1969] RPC 41 (Ch. Div.) (Justice Megarry) (quoting More’s couplet); ANTHONY LAUSSAT, JR., AN ESSAY ON EQUITY IN PENNSYLVANIA 67 (1826) (stating that “Sir Thomas More used to say that the following doggerel contained all the heads of chancery jurisdiction”). William Blackstone, more a fan of the common law than of equity gets a little defensive in making the legitimate point that the triggers for equity were not ignored by the common law:

Again, it hath been said, that *fraud*, *accident*, and *trust* are the proper and peculiar objects of a court of equity. But every kind of *fraud* is equally cognizable, and equally adverted to, in a court of law: and some frauds are only cognizable there, as fraud in obtaining a devise of lands, which is always sent out of the equity courts to be there determined. Many *accidents* are also supplied in a court of law; as, loss of deeds, mistakes in receipts or accounts, wrong payments, deaths which make it impossible to perform a condition literally, and a multitude of other contingencies: and many cannot be relieved even in a court of equity; as, if by accident a recovery is ill suffered, a devise is ill executed, a contingent remainder destroyed, or a power of leasing omitted in a family settlement. A technical *trust* indeed, created by the limitation of a second use, was forced into a court of equity, in the manner formerly mentioned: and this species of trusts, extended by inference and construction, have ever since remained as a kind of *peculium* in those courts. But there are other trusts, which are cognizable in a court of law: as deposits, and all manner of bailments . . . .

<sup>3</sup> WILLIAM BLACKSTONE, COMMENTARIES \*431 (footnotes omitted). Interestingly Blackstone cites to 1 Roll. Abr. 374 despite the slight alteration.

<sup>9</sup> 47 AM. JUR. 2D JUDGMENTS § 718 (“Generally, claimants seeking equitable relief from judgments through independent actions must meet three requirements [the third of which is that] they must establish a recognized ground, such as fraud, accident, or mistake, for the equitable relief.”) (footnotes omitted, citing cases); *see also* WILLIAM F. WALSH, A TREATISE ON MORTGAGES 6, 11 (1934) (relief from mortgages in equity on grounds of fraud, accident, or mistake); Val D. Ricks, *American Mutual Mistake: Half-Civilian Mongrel, Consideration Reincarnate*, 58 LA. L. REV. 663, 717 & n.277 (1998) (speculating that Chief Justice Allen in *Swift v. Hawkins*, 1 Dall. 17 (Pa. 1768), “considered ‘mistake’ to be representative of all categories of equity”).

Joseph Story, who was aware of the importance of equity's role in countering what we could call opportunism,<sup>10</sup> sets out equity jurisdiction by starting with the trust (and confidences), works outward to "mistake, accident, and fraud," and then adds "many cases of penalties and forfeitures; many cases of impending irreparable injuries, or mediated mischiefs; and many cases of oppressive proceedings, undue advantages and impositions, betrayals of confidence, unconscionable bargains; in all of which Courts of Equity will interfere and grant redress; but which the Common Law takes no notice of, or silently disregards."<sup>11</sup> Again these formulations of the general concerns of equity are susceptible to the broad "fix-it" and narrow anti-opportunism interpretations, and the former are especially natural if one forgets that formulations like More's couplet delineate a general field of equitable concern, not a rule of its operation. Thus, Roscoe Pound sounds vaguely proto-Realist when he argues:

It has been said that the common law will not help a fool. But equity exists to help and protect him. It is because there are fools to be defrauded and imposed upon, and unfortunates to meet with accidents and careless to make mistakes, that we have courts of equity. Surely what equity has done to abridge freedom of contract, legislation may do likewise.<sup>12</sup>

And the Realists and their successors did in effect broaden equitable contextualism, in part to prevent unequal bargains and protect the vulnerable.<sup>13</sup> But equity, even historical equity, is susceptible to another narrower interpretation – one that does not threaten to swallow all of law. It is true that courts efforts against forfeitures winds up helping what Carol Rose calls "mopes" and "ninnies,"<sup>14</sup> but as she and other commentators have noticed, courts pay more attention to the sharp practices of the person taking advantage of

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<sup>10</sup> See *infra* notes 33-34 and accompanying text.

<sup>11</sup> See 1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE, AS ADMINISTERED IN ENGLAND AND AMERICA §29, at 28-29 (Boston 1836).

<sup>12</sup> Roscoe Pound, *Freedom of Contract*, 18 YALE L.J. 454, 483 (1909).

<sup>13</sup> Roscoe Pound, *The End of Law as Developed in Legal Rules and Doctrines*, 27 HARV. L. REV. 195, 226 (1913) ("Equity sought to prevent the unconscientious exercise of rights; today we seek to prevent the anti-social exercise of rights."); *id.* at 227 ("Equity imposed moral limitations. The law today is beginning to impose social limitations."). See Owen M. Fiss, *The Supreme Court, 1978 Term—Foreword: The Forms of Justice*, 93 HARV. L. REV. 1, 2 (1979) ("The structural suit is one in which a judge, confronting a state bureaucracy over values of constitutional dimension, undertakes to restructure the organization to eliminate a threat to those values posed by the present institutional arrangements. The injunction is the means by which these reconstructive directives are transmitted."); *but see* *Bisciglia v. Kenosha Unif. Sch. Dist. No. 1*, 45 F.3d 223, 228 (7th Cir. 1995) (denying temporary injunction in suit over employment termination and stating: "[T]his court does not possess a roving commission to do good. It must make a decision based upon the record and the law."); Douglas Laycock, *The Triumph of Equity*, 56 L. & CONTEMP. PROBS. 53 (Summer 1993) (denying "that a court of equity has a roving commission to do good once it identifies a threshold violation of law that justifies its intervention").

<sup>14</sup> Carol M. Rose, *Crystals and Mud in Property Law*, 40 Stan. L. Rev. 577, 587-88, 598-99 (1988).

them than of their vulnerability directly.<sup>15</sup> “Equity abhors a forfeiture,” and as we will see one of the main and most interesting proxies for opportunism is “disproportionate hardship,” but this is in the service of rooting out opportunistic behavior, rather than as an exercise in free-ranging rewriting of rules and contracts in the interest of amorphous and idiosyncratic notions of fairness.

Before turning to the proxies, how should we define opportunism? Nobel laureate Oliver Williamson defines opportunism as “self-interest seeking with guile,”<sup>16</sup> but for our purposes this is too broad and too narrow. Too broad, because Williamson takes opportunism to include all sorts of rule breaking. But some rule breaking is easily anticipated *ex ante* and detected *ex post*, so there is no reason for equity to be particularly involved. Likewise, other definitions of opportunism based on contravening the spirit of the law or defeating a counterparty’s legitimate expectations are helpful, but potentially quite broad,<sup>17</sup> leading to familiar fears of equity’s overbreadth, vagueness, and consequent chilling effect (the Chancellor’s Foot<sup>18</sup>). On the other hand, Williamson’s definition is narrow if it is taken to require full-blown deception. Sometimes the opportunist takes advantage of an unexpected opportunity. Conditions change in an unforeseeable way and the opportunist uses the letter of the law or a contract to gain

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<sup>15</sup> *Id.*; Seana Valentine Shffrin, *Paternalism, Unconscionability Doctrine, and Accommodation*, 29 PHIL. & PUB. AFFAIRS 205, 205, 235 (2000). *See also* Henry E. Smith, *Rose’s Human Nature of Property*, 19 WM. & MARY BILL RTS. J. 1047, 1049-52 (2011).

<sup>16</sup> OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 47 (1985).

<sup>17</sup> *See, e.g.*, Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 957 (1992) (defining “opportunism” as “any contractual conduct by one party contrary to the other party’s reasonable expectations based on the parties’ agreement, contractual norms, or conventional morality”) (footnote omitted); Timothy Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981) (opportunism is conduct that is “contrary to the other party’s understanding of the contract, but not necessarily contrary to the agreement’s terms”); *see also, e.g.*, Samuel W. Buell, *Good Faith and Law Evasion*, 58 UCLA L. REV. 611, 623 (2011) (“In common parlance, the evasive actor is one whose project is to get around the law. She seeks to avoid sanction while engaging, in substance, in the very sort of behavior that the law means to price or punish.”). For a wider definition, *see, e.g.*, RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.1, at 103 (5th ed. 1998) (defining “opportunism” in the contracting context as “trying to take advantage of the vulnerabilities created by the sequential character of the contract”).

<sup>18</sup> The most famous critique is Selden’s humorous one:

Equity is a Roguish thing: for law we have a measure, know what to trust to; Equity is according to the Conscience of him that is Chancellor, and as that is larger or narrower, so is Equity. 'Tis all one as if they should make the Standard for the measure we call a Foot, a Chancellor's Foot; what an uncertain Measure would be this. One Chancellor has a long Foot, another a short Foot, a Third an indifferent Foot: 'Tis the same thing in the Chancellor's Conscience.

John Selden, *Equity*, in *TABLE-TALK: BEING THE DISCOURSES OF JOHN SELDEN, ESQ.* 43, 43-44 (London, J.M. Dent & Co. 2d ed. 1689). *See generally* J.H. BAKER, *AN INTRODUCTION TO ENGLISH LEGAL HISTORY* 112-33 (3d ed. 1990).

unintended advantage at someone else's expense (More's "accident").<sup>19</sup> Likewise with betraying a confidence: there is some deception in appearing to be trustworthy while not actually being so, but it's a stretch.

Opportunism that is relevant to equity is the kind that is hard to capture *ex ante*. Elsewhere I have defined opportunism as "behavior that is undesirable but that cannot be cost-effectively captured – defined, detected, and deterred – by explicit *ex ante* rulemaking. . . . It often consists of behavior that is technically legal but is done with a view to securing unintended benefits from the system, and these benefits are usually smaller than the costs they impose on others."<sup>20</sup> The intervention of a court based on an equitable proxy can lead non-opportunists to take fewer precautions, thereby improving overall welfare.<sup>21</sup> In contracting, equity can support a "substantial compliance" equilibrium: sellers will substitute into technically noncompliant but less costly and equally high-quality performance (which increases total surplus) but will be discouraged from contracting if they have to pay a cross-subsidy to opportunists who will sue for technical non-compliance.<sup>22</sup> (As where a contractor substitutes a different brand of pipe than the one called for even though it is of equal quality, when the first brand is suddenly much more costly.) The more accurate the proxy for this type of behavior and the more opportunists there are, the more equity is called for.<sup>23</sup>

### C. Proxies and Presumptions

Equity as anti-opportunism takes a page from history in that it, like the earlier equity courts, focuses on "near fraud" or "quasi-fraud," and, based on certain proxies, shifts the presumption against actors who are both well informed and seek to invoke a disproportionate hardship on another. Perhaps the area of equity where this is still half remembered is unconscionability. Modern theories of unconscionability tend to be very broad (expanding historic equity) or narrow (reflecting a formalist backlash), but historical equity employed presumptions keyed to potential opportunism. Two discussions of unconscionability reflect this more historically grounded view, and the theory of equity as anti-opportunism can be regarded as a more general version of them. And this paper's theory of fiduciary law is a particular stringent version.

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<sup>19</sup> There is a tendency to call any nefarious behavior with an element of concealment fraud, which includes breach of trust and underground mining. *See* *Livingston v. Rawyards* (1880) L.R. 5 App.Cas. 34, *quoted in* *Marengo Cave v. Ross*, 10 N.E.2d 917, 923 (Ind. 1937).

<sup>20</sup> Smith, *supra* note 5, at 10-11.

<sup>21</sup> Kenneth Ayotte, Ezra Friedman & Henry E. Smith, A Safety Valve Model of Equity as Anti-Opportunism (Draft, March 30, 2013) Northwestern Law & Econ Research Paper No. 13-15, available at SSRN: <http://ssrn.com/abstract=2245098>; *see also* Rose, *supra* note 14, at 599.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*



Traditionally, the concern with near fraud centered on conduct that carried indicia of the danger of fraud but did not establish fraud. This could be either because activity was close to the line of fraud or might well be fraud but cannot be proved as such.<sup>24</sup> Or disproportionate hardship sometimes coupled with a particularly vulnerable party would raise the danger of opportunism so as to set the presumption against the one trying to benefit. As Arthur Leff put it in his famous treatment of unconscionability:

To summarize, there are two separate social policies which are embodied in the equity unconscionability doctrine. The first is that bargaining naughtiness, once it reaches a certain level, ought to avail the practitioner naught. The second is directed not against bargaining conduct (except insofar as certain results often are strong evidence of certain conduct otherwise unproved) but against results, and embodies the doctrine (also present in *laesio enormis* statutes) that the infliction of serious hardship demands special justification.<sup>25</sup>

Leff notes that equity courts would focus on stock characters like the old, the young, the ignorant, etc., which Jane Mallor summarizes as “particular classes of people who were deemed to be easily duped, such as widows, orphans, farmers, sailors on leave, and the weakminded.”<sup>26</sup> Leff calls these classes of persons “presumptive sillies,” meaning that the presumption is against enforcing their deals with specific performance.<sup>27</sup> Leff points out that contrary to the assumptions behind the Uniform Commercial Code, most of these traditional equity cases involved land, which is not only often unique but involves one of the parties in a high stakes and once-in-a-lifetime transaction.<sup>28</sup>

In a fashion similar to Leff, Richard Epstein draws out unconscionability’s use of presumptions in his theory of procedural unconscionability based on near-fraud.<sup>29</sup> He argues that certain classes of transactions picked out by indicia of near fraud are worth so little and carry with them so much danger of fraud (or what we would call opportunism) that they are worth banning at least presumptively. He analogizes unconscionability to the Statute of Frauds, which likewise makes unenforceable a category of transactions,

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<sup>24</sup> In the nineteenth century view, “unconscionability” referred to fraud that could not readily be proved, see, e.g., *Seymour v. Delancey*, 3 Cow. 445, 521-22, 15 Am.Dec. 270 (N.Y. Sup. 1824) (“Inadequacy of price, unless it amount to conclusive evidence of fraud, is not itself a sufficient ground for refusing a specific performance of an agreement”) (citing cases); James Gordley, *Equality in Exchange*, 69 CAL. L. REV. 1587, 1639 (1981). See also Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 293, 293-301 (1975).

<sup>25</sup> Arthur Allen Leff, *Unconscionability and the Code—The Emperor’s New Clause*, 115 U. PA. L. REV. 485, 539 (1967) (footnote omitted).

<sup>26</sup> Jane P. Mallor, *Unconscionability in Contracts Between Merchants*, 40 SW. L.J. 1065, 1066 (1986).

<sup>27</sup> Leff, *supra* note 25, at 532.

<sup>28</sup> *Id.* at 537.

<sup>29</sup> Epstein, *supra* note 24.

based on a combination of content and the fact of being not in writing.<sup>30</sup> The traditional approach to the defense of incompetence works similarly: contracts with someone underage, insane, or drunk were voidable because of the danger, not the certainty, of fraud, such that not enforcing them minimized decision and error costs (including the costs of not enforcing legitimate deals).<sup>31</sup> Interestingly, Epstein offers as an example of how the doctrine of unconscionability must be flexible a case in which the defendants offered unattractive municipal bonds to returning Vietnam veterans, who were vulnerable because of their long captivity and who suddenly came into money in the form of accumulated back-pay.<sup>32</sup> Sharp dealers and unsophisticated purchasers with sudden money fit well into Leff's traditional categories but only loosely. Again it is a combination of a very strange looking deal and vulnerability that makes the transaction voidable.

Finally, opportunism poses a special problem that requires equity to be at least somewhat open-ended within its domain. Equity would not act when the law was adequate and equitable orders were in personam, but the nature of "fraud, accident, and mistake" means that opportunism cannot be specified *ex ante*. This is more than a difficulty in description. It is the strategic interaction between the opportunist and those operating the legal system that precludes a wholly *ex ante* approach. The older courts and commentators on equity too were well aware that equity was aiming at a moving target. As Justice Story put it, "[f]raud is infinite" given the "fertility of man's invention,"<sup>33</sup> and he quoted one explicit judicial pronouncement about the nature of equity:

Now equity is no part of the law, but a moral virtue, which qualifies, moderates, and reforms the rigour, hardness, and edge of the law, and is an universal truth; it does also assist the law where it is defective and weak in the constitution (which is the life of the law) and defends the law from crafty evasions, delusions, and new subtillies, invented and contrived to evade and delude the common law, whereby such as have undoubted right are made remediless; and this is the office of equity, to support and protect the common law from shifts and crafty contrivances against the justice of the law. Equity therefore does not destroy the law, nor create it, but assist it.<sup>34</sup>

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<sup>30</sup> *Id.* at 302.

<sup>31</sup> *Id.* at 300-01.

<sup>32</sup> *Id.* at 304.

<sup>33</sup> 1 J. STORY, COMMENTARIES ON EQUITY JURISPRUDENCE, AS ADMINISTERED IN ENGLAND AND AMERICA 184 n.1 (9th ed. 1866) (quoting a Letter from Lord Hardwicke to Lord Kaims (June 30, 1759)). Or, as Chancellor Ellesmere put the point: "The Cause why there is a Chancery is, for that Mens Actions are so divers and infinite, That it is impossible to make any general Law which may aptly meet with every particular Act, and not fail in some Circumstances." *The Earl of Oxford's Case*, 21 Eng. Rep. 485, 486 (Ch. 1615).

<sup>34</sup> *Dudley v. Dudley*, (1705) 24 Eng. Rep. 118, 119 (Ch.) (U.K.), *quoted* in 1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE 18-19 (Arno Press Inc., reprint ed. 1972) (1836).

Further, closing nine loopholes out of ten ex ante will do no good if crafty opportunists will all rush through the one remaining open. And, as Williamson pointed out, the more a situation can be characterized by true uncertainty, the more scope there is for opportunism.<sup>35</sup> If risk involves a range of future possibilities that can be captured with a probability distribution, Knightian uncertainty cannot: the probabilities or even the state space is unknown.<sup>36</sup> Uncertainty is important in the theory of the entrepreneur as well, and we can consider the opportunist an entrepreneur in doing bad.<sup>37</sup>

Because of the strategic nature of opportunism, the major features of equity – its operation ex post, its open-endedness at the margin, its grounding in morality, good faith and notice – receive a unified explanation. These features of equity run the danger of overexpansion and chilling legitimate behavior, and equity is therefore supposed to intervene only when the law is inadequate and only in a targeted in personam fashion. It turns out that the problems historical equity had to solve with faithless fiduciaries in early trusts partake of these problems and their solutions, as does modern fiduciary law more generally.

## II. The Structure of Fiduciary Law

As we have seen, fiduciary law was historically at the heart of equity, and historic equity partook to a great extent of the equitable decision-making mode in the service of countering opportunism. In this Part, I show that equity as anti-opportunism helps explain and justify fiduciary law. Trusts and trust-like relationships present great dangers of opportunism that call for a broader and more stringent version of equity.

### A. The Equitable Contours of Fiduciary Law

Consider first the characteristic features of equity. As an outgrowth of equity, it is not surprising that fiduciary law is ex post and morally inflected. But the connection is more than mere path dependence; it is functional. Because trustees present the greatest dangers of opportunism, they are at the core of equity and the trust is equity at its high-water mark. Deborah DeMott is right that analogies abound in this area,<sup>38</sup> and these analogies are, as Peter Birks argues, based on similarity to the trust and the trustee-beneficiary relationship.<sup>39</sup> Fiduciary relationships are “trust-like” in presenting a similar danger of opportunism and therefore call for ex post intervention of a morally inflected

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<sup>35</sup> OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 3-4, 56-59 (1985).

<sup>36</sup> FRANK H. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* 19-21, 197-232 (1921).

<sup>37</sup> *Id.* at 267-85, 369-73.

<sup>38</sup> Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 891.

<sup>39</sup> Peter Birks, *The Content of Fiduciary Obligation*, 34 ISR. L. REV. 3, 8 (2000).

sort.<sup>40</sup> The safety valve theory of equity leads us to expect that the analogies in fiduciary law will be premised on the theme of threats of opportunism.

The invocation of a high moral standard, associated with Judge Cardozo's ringing endorsement of the highest sense of honor being the standard to which fiduciaries are to be held ("the punctilio of an honor the most sensitive"), is a stronger version of the morals reflected in equity (e.g. clean hands, not profiting from one's own wrong). Fiduciary law is like the rest of equity but more so. Indeed, Judge Cardozo explicitly invoked the traditions of the court of equity in his famous pronouncement in *Meinhard v. Salmon*.<sup>41</sup> Also, as we will see, because the ways to be opportunistic as a fiduciary are very hard to foresee in any detail and even difficult to tease part from general conditions *ex post*,<sup>42</sup> fiduciary law is vague and open-ended around the edges.<sup>43</sup> Like the rest of equity, fiduciary law uses principles like substance over form in order to counter opportunism, or in the words of one treatise "[i]n deciding whether a given transaction is tainted with disloyalty the court will look through all the subterfuges and indirections. It will consider the substance and not merely the form."<sup>44</sup> Finally, fiduciary law is in personam. The trust is somewhere in between property and contract, but the fiduciary duty is toward the in personam end of the scale. Fiduciary duties run in the first instance to beneficiaries. An order to a trustee does not set up a general rule, nor does it bind third parties. Indeed, the duties of third parties to be on the look out for trusts so as not to violate them are as minimal as they can be without calling forth opportunists who would like to pass for good faith purchasers.

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<sup>40</sup> Opportunism is one way of specifying what constitutes an "abuse of power." For a theory of fiduciary law built around the notion of abuse of power and the corresponding vulnerability of entrustors, see Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

<sup>41</sup> *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928) (Cardozo, J.). In holding coadventurers to a fiduciary duty, Judge Cardozo opined that:

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. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.

*Id.* at 546.

<sup>42</sup> Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1050, 1057 (1991).

<sup>43</sup> *See, e.g., Guerin v. Canada*, [1984] 2 SCR 335, 341, 13 DLR (4th) 321 ("[T]he categories of fiduciary, like those of negligence, should not be considered closed").

<sup>44</sup> GLEASON BOGERT & GEORGE TAYLOR BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 543(T), at 410. Note that "substance over form" is one of the anti-avoidance doctrines in tax, which aims at the exploitation of loopholes. *See Smith, supra* note 5, and the sources cited in note 46 *infra*.

Even more striking is the similarity in overall contours of the proxies and presumptions in fiduciary law and those that operate in equity generally, with fiduciary law being a beefed up version of equity. Robert Sitkoff usefully distinguishes “subsidiary rules” or presumptions within the overall fiduciary standard, which as he points out, avoids letting the rules become a “roadmap for strategic avoidance behavior.”<sup>45</sup> Similarly, where loophole finding is at its most serious, in tax law, a case can be made for general anti-avoidance standards.<sup>46</sup> Equity is an all-purpose anti-avoidance standard, and fiduciary law not unexpectedly partakes of this approach. The main difference between fiduciary law and general equity is that the proxies in fiduciary law are even more prophylactic than those in equity generally. One need not show there is an actual injury, which takes the form of declaring that gains belong to the beneficiary because it was the beneficiary’s means that were used.<sup>47</sup> In the core area of trusts, self-dealing or conflict of interest on the part of the fiduciary makes the transaction in question voidable and makes available disgorgement remedies; no showing of fraud or even harm in a narrow sense to the beneficiary is required.<sup>48</sup> If equity seeks to ensure that one not profit from one’s own wrong,<sup>49</sup> traditional fiduciary law goes a step further in not allowing one to profit from a situation in which it is hard to tell whether one profited from one’s own wrong. Or in the words of one treatise on trusts, “equity deems it better to . . . strike down all disloyal acts, rather than to attempt to separate the harmless and the harmful by permitting the trustee to justify his representation of two interests.”<sup>50</sup>

The duty of loyalty is closely tied to the danger of opportunism, while at the same time sweeping broadly. Under the duty of loyalty, self-dealing leads to per se liability

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<sup>45</sup> Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1045 (2011).

<sup>46</sup> See David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860 (1999); see also Sarah B. Lawsky, *Probably? Understanding Tax Law’s Uncertainty*, 157 U. PA. L. REV. 1017, 1032 (2009) (arguing that tax law uses probabilistic doctrines because “the essence of a tax shelter is that it technically complies with the law while nonetheless violating the substance or intent of the law, which is no easy thing to determine.”); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L. & CONTEMP. PROBS. 673, 707 n.31 (1969).

<sup>47</sup> See Paul B. Miller, *Justifying Fiduciary Duties*, at 64 (June 13, 2012, forthcoming, McGill L.J. 2013), available at SSRN: <http://ssrn.com/abstract=2083855>.

<sup>48</sup> See, e.g., *Fulton Nat’l Bank v. Tate*, 363 F.2d 562, 571 (5th Cir. 1966) (“[T]he beneficiary need only show that the fiduciary allowed himself to be placed in a position where his personal interest might conflict with the interest of the beneficiary. It is unnecessary to show that the fiduciary succumbed to this temptation, that he acted in bad faith, that he gained an advantage, fair or unfair, that the beneficiary was harmed. Indeed, the law presumes that the fiduciary acted disloyally, and inquiry into such matters is foreclosed.”); see generally 3 AUSTIN WAKEMAN SCOTT, WILLIAM FRANKLIN FRATCHEL & MARK L. ASCHER, SCOTT AND ASCHER ON TRUSTS §17.2, at 1078-80 (5th ed. 2007).

<sup>49</sup> See, e.g., *Riggs. v. Palmer*, 22 N.E. 188 (N.Y. 1889).

<sup>50</sup> GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543, at 228 (rev. 2d ed. 1993).

and disgorgement. Conflicts of interest in general lead to a presumption against the fiduciary, and often per se liability. In the corporate context, Delaware law more recently provides that the burden shifts to the fiduciary to prove the entire fairness of the transaction.<sup>51</sup>

The duty of care works in tandem with the proxies and presumptions that get us into fiduciary law in the first place. Again, where the danger of opportunism is high it makes sense to tailor presumptions to counter the danger. With the duty of care, though, the proxies for opportunism potentially sweep more broadly and more damagingly. Indeed, as in equity generally, the problem is sometimes potential opportunism on both sides. Is the person complaining of a breach just invoking the contract or other law in order to profit from a lawsuit and not out of any true injury?<sup>52</sup> For this reason, the proxies in the area of the duty of care are less sweeping, and in specialized contexts they are reversed, as in the business judgment rule.<sup>53</sup> And, it is worth pointing out that there are even narrower proxies that flip the presumption back into regular fiduciary mode (or prevent the business judgment rule from applying; these include lack of business purpose, conflict of interest, and substantively and procedurally egregiously bad decision making.<sup>54</sup>) Likewise, it is easier to contract out of the fiduciary duty of care than the duty of loyalty – much less the duty of good faith.

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<sup>51</sup> Weinberger v. OUP, Inc., 457 A.2d 701 (Del. 1983); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); *see also* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).

<sup>52</sup> Ayotte, Friedman & Smith, *supra* note 21.

<sup>53</sup> *See* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (Winter, J.) (“[T]he fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule.”). Judge Winter goes on to offer several reasons for the business judgment rule, including the implications of portfolio theory:

[B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.

*Id.* at 886 (footnotes omitted).

<sup>54</sup> Again, Judge Winter:

Whatever its merit, however, the business judgment rule extends only as far as the reasons which justify its existence. Thus, it does not apply in cases, e.g., in which the corporate decision lacks a business purpose, is tainted by a conflict of interest, is so egregious as to amount to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision. Other examples may occur.

Finally, if good faith is considered a separate fiduciary duty, we should expect it to be similar to but stronger version of the general duty of good faith and to involve similar proxies and presumptions. Like the duty of good faith in contract law, the fiduciary duty of good faith cannot be contacted away entirely. I return to this question in the next Part.

Practically speaking, what is important is to find proxies for unforeseeable exploitation of rules. Situations of fraud, accident, and mistake give rise to the problem of near-fraud and exploitation of uncertainty. More particularly, proxies relating to bad faith and disproportionate hardship can be used to invalidate actions or to throw the burden of justification on a party who wishes to take advantage of them. Fiduciary law is concerned with situations where the discretion of the fiduciary and the vulnerability of the beneficiary call for a gimlet eye on the issue of good faith and disproportionate hardship: any showing that a fiduciary profited from the relationship leads to disgorgement.

## **B. Equity and Reforms**

Equity as anti-opportunism suggests caution in loosening traditional stringent rules about fiduciary duties. There has been a tendency to soften some of the per se rules of liability and the strength of some presumptions. Sometimes this is warranted. Thus, in trusts the older prudent investor rule was too cautious in light of modern portfolio theory, and the tendency was for judges to engage in ex post hindsight when an ex ante standard of appropriate investment of trusts assets would allow for higher returns without opening the door to opportunism. The older prudent man rule required that a trustee acts as “men of prudence, discretion and intelligence, manage their own affairs,”<sup>55</sup> and became encrusted with sub-rules putting entire kinds of investments off limits.<sup>56</sup> The danger in the context is of judicial hindsight bias,<sup>57</sup> not trustee opportunism. Here the ex post perspective is simply not needed to combat opportunism, which means that there should be no obstacle to the newer “prudent investor” rule, advocated by scholars like Jeffrey Gordon, John Langbein, and Richard Posner,<sup>58</sup> promoted by law reform bodies, and now

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*Id.* (case citations omitted). Interestingly, these categories are versions of the equitable proxies, and are likewise somewhat open-ended. Compare them to disproportionate hardship and forfeiture, which similarly rely on an unexplained extreme imbalance to shift the presumption to one who would benefit from it.

<sup>55</sup> *Harvard College v. Amory*, 26 Mass. 446 (1830).

<sup>56</sup> Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Trust Asset Allocation: An Empirical Analysis*, 35 AM. C. TR. & EST. COUNS. J. 314, 35-36 (2010).

<sup>57</sup> Daniel B. Kelly, *Toward Economic Analysis of the Uniform Probate Code*, 45 U. MICH. J.L. REFORM 855, 870 (2012); see also Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich, *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 804 (2001).

<sup>58</sup> See, e.g., Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y. U. L. Rev. 52 (1987); John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*,

enacted in all the states.<sup>59</sup> The prudent investor rule sets forth an objective standard for investments appropriate to a trust in light of risk-return tradeoffs and the trust portfolio as whole. The main effect is to increase the proportion of stocks held in trusts,<sup>60</sup> and it is hard to see how this significantly increases the dangers of opportunism.

In contrast, the loosening of the no further inquiry rule in trust law, proposed most prominently by John Langbein, is questionable. In keeping with his contractarian view of the trust, he proposes that fiduciaries who engage in conflicts of interest should be able to prove entire fairness, just as they can in more recent corporate law.<sup>61</sup> The result would be a rule that required trustees to act in the best interests rather than sole interests of the beneficiary. His justifications rely mostly on an improved ability of courts to find facts and on the benefits of conflicted transactions as reflected in statutory exceptions to the no further inquiry rule and the possibility of getting judicial re-approval. The exceptions do not, however, prove the rule is unfounded, because they might reflect other policies or are not inconsistent with the no further inquiry rule.<sup>62</sup> To this we can add that statutory exceptions Langbein points to – allowing trustees to earn commissions and to pool funds for investment purposes – are quite far from the main concerns about opportunism and so dovetail nicely with equitable anti-opportunism. The exceptions do suggest the costs of a sweeping rule – which are true of any prophylactic rule – and, as we have seen, in a system of presumptions there is no reason not to have sub-presumptions that flip the other way. Even though many trustees are financial institutions and many trusts involve financial assets, the no further inquiry rule has a purpose beyond making up for historically bad fact finding procedures. It would be surprising if better civil or even administrative procedures could eliminate the problem of opportunism – they certainly haven't in the area of tax.<sup>63</sup> The worry perhaps should be the opposite: that, as equity judges always feared, the judicial process itself has become a plaything for opportunists.

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81 IOWA L. REV. 641 (1996). John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 ABF RES. J. 1 (1976).

<sup>59</sup> UNIFORM PRUDENT INVESTOR ACT (1994); 3 RESTATEMENT (THIRD) OF TRUSTS 287-92 (2007) (Introductory Note to Chapter 17).

<sup>60</sup> Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 J.L. & ECON. 681 (2007); Schanzenbach & Sitkoff, *supra* note 56 (finding a 3 to 10 percent increase in trust stock holding at the expense of “safe investments” in the period after the introduction of the prudent investor rule).

<sup>61</sup> John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929 (2005).

<sup>62</sup> Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541, 567-71 (2005).

<sup>63</sup> Langbein also dismisses equity with some standard references to *Bleak House*. Langbein, *supra* note 61, at 945-57. Again, my defense of the equitable element in fiduciary law is not meant to be historic. The problems leading to the breakdown of equity do, as Langbein suggests, flow from the organization of the equity court. In particular, there was only one Chancellor, later joined by one Vice Chancellor. This allowed for more uniformity of judgments, but at the cost of huge delay and expense. I would suggest that



So the question remains whether it is appropriate for situations called fiduciary, and trusts in particular, to be identified as ones in which the danger of opportunism requires a prophylactic rule. Again, the traditional rule was based, as were other equitable proxies and presumptions, on “near fraud,” or the danger of opportunism. In Chancellor Kent’s words, the sole interest rule “is founded on the danger of imposition and the presumption of the existence of fraud, inaccessible to the eye of the court.”<sup>64</sup> Perhaps there is scope for defining a class of trusts to be similar enough to corporations, and corporate fiduciaries usually do face greater competitive pressures than do trustees.<sup>65</sup> And statutory carve-outs from the equitable prophylactic “no further inquiry” rule do not conflict with equity as a backstop, either historically or functionally. That reformers like Langbein have – in keeping with the post-fusion loss of awareness of how and why equity does what it does – overlooked the role of opportunism and its special relationship to equity,<sup>66</sup> suggests we should reevaluate such proposals in light of equity as anti-opportunism before taking the plunge. We should not lose sight of the danger of opportunism in the historical core of fiduciary law. At the very least, a residual category of fiduciary liability for the open-ended class of new forms of mischief will be very hard to do without.

### C. Fiduciary Proxies and Presumptions

Let us now consider the proxies. Paul Miller divides previous approaches to fiduciary relationships into status-based and fact-based and argues that neither offers a

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the equitable decision making mode does not require separate courts, and one should concentrate on defining the proxies and presumptions defining the decision making mode. Perhaps the lesson to be drawn from Langbein’s critique is that we should question whether it is wise to give equitable precedents the same weight in terms of stare decisis, which was also a development of the later equity courts – and which put greater pressure on them to achieve consistency. Perhaps the sorry history of nineteenth-century equity is more a matter of those courts not being equitable enough in the sense of limiting themselves to acting as a safety vale against opportunism.

<sup>64</sup> 4 JAMES KENT, COMMENTARIES ON AMERICAN LAW \*438. Langbein finds this and related arguments as reflecting a “logic” that is “dubious,” because he finds it weird that “because some trustee misbehavior might be successfully concealed, the law should refuse to examine the merits of the trustee’s conduct even in a case in which there has not been concealment.” Langbein, *supra* note at 945. This begs the question. Because we cannot know which case is which we have to make a policy judgment (as in Epstein’s theory of procedural unconscionability) that given the possibility of errors on both sides and their seriousness (in terms of not getting at opportunism, mislabeling and chilling legitimate behavior), it makes sense to have a prophylactic rule. Langbein’s aspersions prove far too much. In any case, as he says, he rests his argument on the changed circumstances, in terms of better courts and more need for conflicted transactions, which I address in the text.

<sup>65</sup> For an argument that corporate law without the Efficient Capital Markets Hypothesis would look like trust law, see Robert H. Sitkoff, *Trust Law, Corporate Law, And Capital Market Efficiency*, 28 J. CORP. L. 565 (2003).

<sup>66</sup> See the discussion in note 64 *supra*.

principled account of fiduciary law.<sup>67</sup> That is true, but on the present account of equity, we should not expect that the status- or fact-based approaches would produce a principle, let alone a rule. Instead, status and facts reflect different types of proxies for opportunism, with status-based proxies being the more sweeping and stable and fact-based proxies being more targeted and open-ended. What equity needs to avoid is being sweeping and open-ended at the same time. General invocations of loyalty run this danger. James Penner argues for skepticism that loyalty is the content of the duty of fiduciaries.<sup>68</sup> Indeed, if the duty of loyalty is really a shorthand over the system of equitable proxies and presumptions, then we should not expect the “duty” to be infused with content directly. Instead, as he notes, the no-conflict rule is aimed at the human capacity for rationalization.<sup>69</sup> Self-serving rationalization can shade off into evasion,<sup>70</sup> and, as we have seen, fiduciary law needs to be more sweeping than general equity. So the idea that fiduciary duty includes contexts in which self-serving rationalization is the danger, rather than more raw forms of evasion and opportunism should come as no surprise.

Start with status. Whole categories of relationships have been deemed to be similar enough to the trustee-beneficiary relationship to warrant fiduciary treatment. But analogies require imply some basis for considering some similarities more important than others. In the case of fiduciary relationships, the similarities invoked are the same ones that come to the fore when the more open-ended fact-based approach is employed. This is no accident. In equity as anti-opportunism, we can say that sometimes the problem of opportunism as reflected in the most important proxies like disproportionate hardship, hidden action, vulnerability and the like, point toward a broad shift in the presumption against the one in the informationally advantaged position – the trustee-like actor. Thus, in addition to trustees, fiduciaries include corporate officers and directors, partners, attorneys, and various agents.

Now consider the fact-based fiduciary relationships. The facts in question usually relate to one party’s vulnerability and the discretion wielded by the candidate for fiduciary. As with equity, scholars have criticized fiduciary duty for being unpredictable around the edges.<sup>71</sup> And, again as with equity, courts and commentators often state that fiduciary law is not closed, but nervousness about its open-endedness probably explains

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<sup>67</sup> Paul B. Miller, *A Theory of Fiduciary Liability*, 56 MCGILL L.J. 235, 241-52 (2011).

<sup>68</sup> J.E. Penner, *Is loyalty a virtue, and even if it is, does it really help explain fiduciary liability* (ms.).

<sup>69</sup> *Id.* at 8.

<sup>70</sup> Yuval Feldman & Henry E. Smith, *Behavioral Equity* (May 20, 2013), available at SSRN: <http://ssrn.com/abstract=2267613> or <http://dx.doi.org/10.2139/ssrn.2267613>.

<sup>71</sup> Peter Birks, *Equity in the Modern Law: An Exercise in Taxonomy*, 26 U. W. AUSTRAL. L. REV. 1, 17-18 (1996); Miller, *supra* note 67, at 249-50; Sarah Worthington, *Fiduciaries: When Is Self-Denial Obligatory?*, 58 CAMB. L.J. 500, 505 (1999).

why courts try to hew to the established categories based on known status relationships.<sup>72</sup> This makes fiduciary law, like equity in general, seem like “a concept in search of a principle.”<sup>73</sup>

From the point of view of equity as a safety valve against opportunism, the question is whether the proxies for opportunism and the effect of the presumptions based on them are unpredictable enough to keep the opportunists guessing but without destabilizing the law of which it is a safety valve. Fiduciary law is broader than the general equitable safety valve, as noted earlier, but unlike the rest of the law it has certain special features. First, it is usually difficult to become a fiduciary, so the stringent liability of a fiduciary does not affect the mine run of behavior.<sup>74</sup> It is an empirical question whether the proxies implicitly identified by Leff and Epstein are so broad that they chill too much behavior to make the wide prophylactic presumptions worthwhile. Normatively, courts should not forget that fiduciary law has established categories of fiduciary and that the residual open-endedness is simply a protective buffer aimed at opportunism, not a roving commission to rewrite deals in the name of ex post fairness. In this sense as in many others, fiduciary law presents in stark form the dilemma facing equity.

#### **D. Other Equitable Features of Fiduciary Law**

As in the case of equity, the fact-based analysis is somewhat constrained by reliance on external standards. Common sense morality goes some way toward cabining equity, but there has long been skepticism that morality alone would constrain equity judges sufficiently in order to prevent equity from becoming threatening and uncertain.<sup>75</sup> Courts in fiduciary case look to “community or industry standards.”<sup>76</sup> Equity has also long has a role in enforcing community and industry custom.<sup>77</sup>

Moreover, in terms of information costs, there is reason to think that fiduciary law is less threatening to the stability of the rest of private law than is equity in its most general applications. Much of the worry about the role of morality in equity stems from

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<sup>72</sup> SARAH WORTHINGTON, EQUITY 134-35 (2003); *see also* Miller, *supra* note 67, at 241.

<sup>73</sup> WORTHINGTON, *supra* note 72 at 135 (quoting Justice Wilson).

<sup>74</sup> *See, e.g.*, Frankel, *supra* note 40, at 801.

<sup>75</sup> *See supra* note 18 and accompanying text.

<sup>76</sup> Hodgkinson v. Simms, [1994] 3 SCR 377, 411-13, 423-2117 DLR (4th) 161; *see also* Miller, *supra* note 67, at 245; Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303, 340 (1999) (“Today as well, many fiduciary relationships are structured outside the positive law: by custom, for example, and by authorities on professional ethics. Social fiduciary relationships are supported by traditional social virtues such as loyalty, civility, self-sacrifice, vocational excellence, and high standards of honesty.”).

<sup>77</sup> *See* Henry E. Smith, *Custom in American Property Law: A Vanishing Act*, 48 TEX. INT’L L.J. 507 (2013).

the fear that it will make general declarations, especially in the area of property.<sup>78</sup> These fears are limited in the case of fiduciary law because of the largely in personam effect of the fiduciary duties. Impacts on third parties are legally limited to those who knew they were dealing with a trustee qua trustee and those who receive, either gratuitously or with notice, an asset subject to an equitable right transferred in violation of a fiduciary duty. Because the duty to inquire into these matters is minimal, such parties can be expected to avoid involvement in violations of fiduciary duty without great burden substantively or informationally. Returning back to the trust itself, the origin of fiduciary law, the trust itself is perched between in rem and in personam, property and contract, and the fiduciary duties relate more to the latter.<sup>79</sup> This is why the contractarian approach to fiduciary law has had the success it enjoys, even though it excessively downplays the residuum of mandatory law that equity as anti-opportunism, by contrast, can handle well.<sup>80</sup>

Notable features of fiduciary law follow from this equitable set of proxies and presumptions. First, the notion that property or a “critical resource” is important receives an explanation.<sup>81</sup> We worry more, as Leff noted, about sharp dealing – opportunism – where the transaction is a large one-off for the (not coincidentally) less informed party. The equitable theory also suggests why fiduciary law is not totally confined to property or critical resources, important though these are. Situations in which the potential for opportunism arise out of an important discretionary agency relationship of great dependence are not limited to ones involving a conventional property interest or other identifiable resource. Thus, the treatment of physicians as fiduciaries is understandable, and it makes sense to apply quite prophylactic proxies and presumptions against physicians who profit from a physician-patient relationship in any fashion that does not involve informed consent.<sup>82</sup>

Note that because of the nature of the opportunism problem, fiduciary law is “gappy” in the sense that the proxies for opportunism are overinclusive. This leads to the characteristic flavor of fiduciary law as not being based on actual harm. I turn to remedies shortly. It also lends fiduciary law its “exclusive” and perhaps “propertarian” character.<sup>83</sup> In property itself, the exclusion strategies are in many ways overinclusive

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<sup>78</sup> See, e.g., Charles M. Gray, *The Boundaries of the Equitable Function*, 20 AM. J. LEGAL HIST. 192, 202-06 (1976).

<sup>79</sup> Ming Wai Lau, *The Nature of the Beneficial Interests: Historical and Economic Perspectives* (ms. 2013), available at: [http://www.law.harvard.edu/programs/about/privatelaw/related-content/the\\_nature\\_of\\_the\\_beneficial\\_interest-historical\\_and\\_economic\\_perspectives.pdf](http://www.law.harvard.edu/programs/about/privatelaw/related-content/the_nature_of_the_beneficial_interest-historical_and_economic_perspectives.pdf).

<sup>80</sup> See *infra* notes 87-91 and accompanying text.

<sup>81</sup> D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002); see also Daniel Friedmann, *Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong*, 80 COLUM. L. REV. 504 (1980).

<sup>82</sup> See, e.g., *Moore v. Regents of Univ. of Calif.*, 793 P.2d 479 (Cal. 1990).

<sup>83</sup> Paul B. Miller, *Justifying Fiduciary Remedies* (ms. 2012) at 43; Weinrib; see also Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 CORNELL L. REV. 767 (2000).

and prophylactic.<sup>84</sup> Famously the law of trespass does not require a showing of actual harm. In a sense, the problem of someone with access leads to such a large problem of potential opportunism that we flip the presumption against intruders in a very sweeping way in the law of trespass, such that basic entitlements are much lumpier than they would be in a world of much lower transaction costs.<sup>85</sup>

Finally, the equitable theory points to stringent remedies. Violations of fiduciary duties can lead to disgorgement of gains, the imposition of a constructive trust, or the payment of supracompensatory damages. As with the exclusion strategy in property law, a broad proxy calls for remedies with a steep drop-off.<sup>86</sup> Tailoring in the rules should be expected to be paired with tailored remedies, and vice versa. The broad proxies and presumptions not coincidentally sound in morality. Robert Cooter distinguishes between “sanctions,” which are payments or even punishments for doing what is not allowed, and “prices,” which are payments made to do something permitted.<sup>87</sup> As Cooter shows, the more the law focuses on a defined standard of conduct, rather than aiming at measurable external harm, the law employs sanctions, and the violation of the standard is considered wrong. With sanctions, liability takes a jump at the standard, in contrast to prices, which vary continuously with harm (assuming harm is a continuous variable). When it comes to liability in the presence of potential opportunism, a defined standard coupled with a sanction in Cooter’s sense can be more robust in the face of manipulation than a price. Thus, the opportunistic fiduciary is not invited by fiduciary law to consider whether the proxies a court would use for harm might fail to capture the particular kind of opportunism. A blanket approach makes such considerations irrelevant to the fiduciary’s thinking.

## E. Summary

Overall, then, equity as anti-opportunism combines the best in other accounts. It lies somewhere between the contextualization of factors and policy on the one hand and the more formal principled approach on the other. For functional reasons, fiduciary law is both contextual and principled, but the one or the other element dominates depending on the factors that point to or away from equitable anti-opportunism – the danger of

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<sup>84</sup> See, e.g., Henry E. Smith, *Mind the Gap: The Indirect Relation Between Ends and Means in American Property Law*, 94 CORNELL L. REV. 959 (2009).

<sup>85</sup> See, e.g., Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315, 1327-28 (1993); Lee Anne Fennell, *Lumpy Property*, 160 U. PA. L. REV. 1955, 1964 (2012); Carol M. Rose, *Rethinking Environmental Controls: Management Strategies for Common Resources*, 1991 DUKE L.J. 1, 9-36; Smith, Henry E. Smith, *Exclusion Versus Governance: Two Strategies for Delineating Property Rights*, 31 J. LEGAL STUD. S453, S467-74 (2002).

<sup>86</sup> Henry E. Smith, *Property and Property Rules*, 79 N.Y.U. L. REV. 1719, 1748-53 (2004).

<sup>87</sup> Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984); see also GUIDO CALABRESI, *THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* 68-69 (1970) (outlining scheme of price-like specific deterrence and sanction-like general deterrence).

opportunism itself, the availability of cost-effective proxies, and the informational burden on third parties. What sets fiduciary law apart from equity is a matter of degree: the danger of opportunism is high enough to warrant broader and more stringent prophylactic proxies and presumptions, and at the same time the informational burden on third parties to the fiduciary relationship are light.

### III. The Place of Fiduciary Law in Private Law

Seeing fiduciary law as an extreme example of equity as anti-opportunism allows us to situate fiduciary law within private law. It suggests some new perspectives on the age-old question of how contractarian fiduciary law is (and should be), and it draws out the similarities in fiduciary law to unjust enrichment.

#### A. Relation to Other Theories

Overall, seeing fiduciary law as a core of equitable anti-opportunism helps explain how and why fiduciary law is a hybrid of status- and fact-based approaches. Like equity, fiduciary law is moral but not unboundedly so. Like equity, anti-opportunism lies between open-ended fix-it contextualism and principled formalism, but like equity this relationship has been obscured since the fusion of law and equity.

Strikingly, equity as anti-opportunism can explain why fiduciary law is mostly but not entirely contractarian. Is fiduciary law simply a default contractual term, even in trust law?<sup>88</sup> Or is it mandatory in keeping with its moral flavor?<sup>89</sup> Equity as anti-opportunism suggests that we look for some meta-rule (or meta-standard) for distinguishing situations in which parties have put the problem in question within a domain of contracting (that does not suffer from fraud, unconscionability, and the like), from those that do not (potential opportunism). Particularly in the corporate area, we can expect sophisticated parties to be able to deal with opportunism ex ante, and Delaware law in particular takes a broad opt-out approach.<sup>90</sup> Nevertheless, even in Delaware one

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<sup>88</sup> See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90-108 (1991); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. U.L. REV. 1 (1990); see also Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1991) (“Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings.”); Langbein, *supra* note 1, 657-60; see also Sitkoff, *supra* note 45, at 1045-48 (arguing for broadly contractarian approach to fiduciary duty but recognizing need for mandatory standardization of unrecorded interests).

<sup>89</sup> See, e.g., DeMott, *supra* note 38; FitzGibbon, *supra* note 76; see also Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard J. Zeckhauser eds., 1985); T.P. Gallanis, *The Trustee’s Duty to Inform*, 85 N.C. L. REV. 1595 (2007); J.C. Shepherd, *Toward a Unified Concept of Fiduciary Relationships*, 97 L.Q. REV. 51 (1981).

<sup>90</sup> Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123 (2006).

cannot contact out of the duty of good faith altogether, just as in contract law.<sup>91</sup> This mandatory kernel protects the domain of contracting from an unscrupulous party who might do something outside that domain that defeats the contract's purpose. To the extent we can characterize this problem as one of true uncertainty (as opposed to risk), the rationale for some small mandatory core of fiduciary law makes sense.<sup>92</sup>

Equitable theory also helps explain why fiduciary law has been resistant to the type of theorizing that successfully unifies branches of the common law. Thus, many have complained about the unprincipled character of fiduciary law. They seek a principle that will tie the various fiduciary situations or relationships together. But we should only expect a loose tie. These situations are the ones in which, as in unconscionability but more so, the danger of opportunism is great enough compared to the foregone transactional benefits that we are warranted in flipping the presumption against the fiduciary.

One reason for the frustration with fiduciary law is its corresponding open-endedness. Some courts and commentators have asserted that some open-endedness is a necessity in fiduciary law to handle new situations. Thus is correct but can be overdone. What we need is for fiduciary law, like equity generally, to receive its proper scope based on proxies for opportunism, but the edges of this domain should be somewhat fuzzy and open-ended to respond to the strategic nature of opportunism. There is a need to mirror the open-endedness of opportunism itself. The result looks fuzzy from up close but less so in the larger picture.

Stepping back from this picture, we can see why fiduciary law veers between contextualism and formalism, and commentary is split between contextualizers and contractarians on the one hand and formalists and moralizers on the other. Like equity after the fusion of law and equity, it is hard to justify the mix of formalism and contextualism in a hybrid system if the purpose of the safety-valve architecture – along with its very status as a safety valve – has been obscured.

## **B. A Comparison to Unjust Enrichment**

The equitable approach to fiduciary law also helps explain its similarity and connections with unjust enrichment. This is a plus for the theory, both because there is a general sense that fiduciary law and unjust enrichment share a lot in common and because the theory explains the similarities in detail as reflecting similar justifications.

In private law generally, equity is exceptional. In property, torts, and (especially) contract – in the last of which people can sometimes be expected to contact over possible opportunism – equity is a narrow exception in its role as a safety valve. But there are

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<sup>91</sup> *Id.*

<sup>92</sup> Smith, *supra* note 5.

areas of law in which the problem of opportunism is central. As we have seen, fiduciary law is one such area. Unjust enrichment is another.

This paper is not the place to offer a theory of unjust enrichment, but I will sketch here how the architecture of unjust enrichment reflects an equitable approach to opportunism. This is true even where aspects of unjust enrichment trace back to the law side of the law versus equity divide.<sup>93</sup> Even areas of the common law like quasi-contact – the main strand along with the constructive trust that were brought together to form the law of restitution – partook functionally of the equitable decision-making mode.

Unjust enrichment employs broad proxies to set the presumption against the potential opportunist. In unjust enrichment, a major class of these proxies can be cast in terms of a property entitlement. Thus, on Daniel Friedman’s theory of unjust enrichment, most of the law is aimed at vindicating property or quasi-property entitlements, with a residual of cases that he dubs “deterrence”.<sup>94</sup> The latter refers to egregious wrongdoing that violates public policy and calls forth a restitutionary remedy. Moreover, unjust enrichment law looks like a collection of disparate situations, such as mistaken payments, with an open-ended fact-based inquiry into bad behavior (wheedling the farm out of the farmer), just as in fiduciary law and equity. This structure has been celebrated as contextual judicial reasoning or as threatening to the rule of law, just like fiduciary law and equity.<sup>95</sup> Both unjust enrichment and fiduciary law, like equity, feature a heavy moral flavor and a concern with individualized justice.<sup>96</sup> I suggest that unjust enrichment is a similar hybrid of narrower and broader proxies and presumptions that respond to similar problems of opportunism. The overall architecture of the equitable theory of unjust enrichment is similar to that of fiduciary law but differs in the dividing line between the more per se and rule-of-reason style proxies and the terms in which they should be couched. Fiduciary law paints with an especially broad brush because the danger of opportunism is at its starkest.

## Conclusion

Fiduciary law is and has always been at the heart of equity. The equity courts got their start in dealing with opportunists like faithless proto-trustees. The characteristic approach of morally inflected, ex post intervention directed in an in personam way, based on proxies and presumptions, is characteristic of both fiduciary law and equity generally. Fiduciary law employs especially broad proxies and stiff presumptions because the

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<sup>93</sup> Andrew Kull, *James Barr Ames and the Early Modern History of Unjust Enrichment*, 25 OXFORD J. LEGAL STUD. 297, 304 (2005).

<sup>94</sup> Daniel Friedmann, *Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong*, 80 COLUM. L. REV. 504 (1980).

<sup>95</sup> Compare HANOCH DAGAN, *THE LAW AND ETHICS OF RESTITUTION* (2004) with Emily Sherwin, *Restitution and Equity: An Analysis of the Principle of Unjust Enrichment*, 79 TEX. L. REV. 2083, 2083-2113 (2001).

<sup>96</sup> See Andrew S. Gold & Henry E. Smith, *How Private Law Is Simply Moral* (ms. 2013), at 41-45.



problem of opportunism is especially acute. Bringing fiduciary law back to its equitable roots promises to allow it to be a hybrid of broader rules and more tailored standards so as to navigate between unconstrained contextualism and rigid formalism. Fiduciary law is central to the role that equity plays in suppressing opportunism.