

# Loyalty and What Law Demands: Self Interest, Sole Interest or Best Interest

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## **Abstract**

A typology of the principal conceptions of loyalty and behavioral agency in economic theory is developed. Three distinct modalities are identified: first is structural loyalty—essentially an incentive-based approach to limit the temptations of disloyal conduct by agents motivated exclusively and unrelentingly by the pursuit of their self-interests; second is self-serving loyalty, which seeks to encourage or enlist persons with perceived loyal character or preferences for pursuing observationally loyal actions and choices. Pursuit of self-interest continues to motivate behavior but these agents may possess a sense of loyalty to others. Moving away from incentives and preferences, a third modality is suggested, allegiant loyalty, i.e., other-regarding behavioral obligations and adherence to conduct rules that, unlike the first two modalities, may contravene the imperatives of self-interests. The typology is used to inform the debate regarding the economic support for competing legal requirements of loyalty placed on fiduciaries.

[Dear Reader: the extensive endnotes following the conclusion of the document may be skipped without loss of the argument; No need to read them unless you are curious. I look forward to your comments and questions. Thank you. Best, -Rick]

# 1 Introduction

Loyalty, as a matter of law, has traditionally placed strict obligations on fiduciaries to act *not* in their own self interest, but in the sole interest of their beneficiaries. Common law doctrine stipulates that an agent, absent contrary agreement, must “act solely for the benefit of the principal in all matters connected with his agency.”<sup>1</sup> Agents are not the only fiduciaries subject to this strict rule. Sole interest defines the legal requirement of loyalty owed by conservators, executors, guardians and other administrators acting on behalf of beneficiaries. Trust law’s duty of loyalty, which obligates the trustee “to administer the trust solely in the interest of the beneficiary,”<sup>2</sup> goes even further, pronouncing what has come to be known as the “no further inquiry rule.” That is, once a trustee’s conflict is established, courts need make ‘no further inquiry’ into other matters, such as fairness, good faith or otherwise compelling exigencies attending the circumstances, in order to affirm the beneficiary’s power to void any conflicted transaction. Conflicted fiduciaries are subject to presumptions of liability—irrefutable under the ‘no further inquiry’ rule—as a time honored prophylaxis.<sup>3</sup>

When, in 1928, Judge Cardozo famously announced the conduct rule of a “punctilio of an honor the most sensitive [as] the standard of behavior” placed on the co-venturers in *Meinhard v. Salmon*, he was not invoking the legal norms of contracts, partnerships or joint venture law (as often assumed) but rather the strict equitable fiduciary standards for trustees.<sup>4</sup> “A trustee is held to something stricter than the morals of the market place,” Cardozo wrote of the law’s commitment to the sole interest rule and the resistant “attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ‘disintegrating erosion’ of particular exceptions.”<sup>5</sup> Equity’s resolve against forces eroding the rule of undivided loyalty in 1928 (only months before the great stock market collapse) today appears nearly exhausted from necessary concessions, we are told, for marketmakers and market efficiency. Exceptions have swallowed the rule for many fiduciaries engaged in commercial activity.<sup>6</sup>

Corporate and company law in many states currently allow, and in some cases, encourage fiduciaries to take self-interested positions in transactions pursued on behalf of their beneficiaries.<sup>7</sup> Even within trust law, exceptions have multiplied with the ever-increasing magnitude of assets held by commercial trusts, including pensions, hedge funds and mutual funds among other entities.<sup>8</sup> A vigorous debate has been sparked by the continuing proliferation of exceptions and categorical exclusion of the sole interest rule.<sup>9</sup> Those pushing for change argue that it is time to completely abandon the sole in-

terest rule in favor of a best-interest standard that would allow fiduciaries to rebut presumptions of disloyalty in conflicted transaction by showing good faith and prudence, care, competence or fairness to beneficiaries. Sole interest overdeters fiduciaries, detractors claim, discouraging efficient and fair transactions to the ultimate harm of beneficiaries.<sup>10</sup>

Proponents of the sole interest rule argue there is little reason for its abandonment. Beyond the numerous carve-outs created by existing exceptions and categorical exclusions, fiduciaries can always undertake self-dealing or conflicted transaction by securing, either expressly or impliedly, *ex ante* authorization or *ex post* ratification from their beneficiaries, as well as by seeking and securing court approval. All told, given the numerous avenues available to pursue efficient and fair interested transactions, sole interest proponents see no cause to discard an ancient rule that offers protection to beneficiaries (against opportunists) as well as to fiduciaries themselves (against self-doubt, temptation and uncertainty).<sup>11</sup> These old sensibilities, however, continue to suffer under the disintegrating erosion of the tides of change. While courts have yet to shift entirely from sole interest to best interest (outside of the now settled exceptions and categorical exclusions),<sup>12</sup> roughly two dozen state have adopted the recent Uniform Trust Code, which like the Uniform Power of Attorney Act, adopts a best interest stance.<sup>13</sup>

It is often suggested, by both proponents and detractors of the sole interest rule, that an economics approach always favors the efficiency and incentives entailed in the best interest rule.<sup>14</sup> They are wrong. Sole interest is entirely consistent with an economic approach to loyalty. Moreover, the sole interest rule wherein, in the absence a of contrary agreement, conflicted fiduciaries are subject to disgorgement of gains on a ‘no further inquiry’ basis can both inform and inculcate appropriate dispositional attitudes of fiduciaries who take an internal point of view with regard to ethical conduct rules of loyalty, while still encouraging efficient behavior by strictly ‘rational’ self-interested agents. These points are demonstrated briefly at the conclusion of this draft. In the next section, which comprises the bulk of the analysis, a typology of the principal conceptions of loyalty in economic theory is developed and applied to the matter of sole interest versus best interest.

## 2 Agency & Loyalty in Economic Theory

All economic models of exchange entail a theory of loyalty. Although often implicit, one of three theoretical tracts becomes apparent on close inspection.

First, and most frequently, questions of disloyalty are treated structurally in models occupied by economic agents unable to choose or act in any manner than that dictated by narrow self-interest. These agents unsympathetically pursue their own interests, unrestrained by the interests of others or by other independent values.<sup>15</sup> They can allow for the theoretical possibility of loyalty in others, but treat it as a nonbinding constraint over their own actions and choices, like men in a vacuum conceding a theory of gravity while gravity itself exerts no force on them. In the moral vacuum of their internal workings, loyalty, or what appears to be so, is determined entirely by external structures and the contexts where these agents find themselves.

In place of context or situation, the second theoretical tract accounts for loyalty in terms of personal character. Loyalty is treated as an aspect of an economic agent's identity or personality, or more formally as a direct expression of preferences. Recognizing that preferences are malleable, this approach expands the scope of loyalty in interesting and distinct directions from that of the structural approach. One way to see the difference between self-serving and structural loyalty is that the latter seeks to discourage disloyalty while the former aims to encourage loyalty. There is more to this difference than semantics. Safeguards and incentives are used to deter behavior that would occur in their absence, behavior that (even if rational or natural) is considered disloyal. Safeguards and incentives are unnecessary when actors are virtuous, possessing good character or having preferences, for whatever reason, to engage in behavior that seen as loyal. Loyalty in this case is realized by influencing an individual's character, tastes and preferences or by empowering individuals who already possess these positive traits.

Allegiant loyalty, the label for the third tract, looks at loyalty in light of behavioral commitments to relationships and associations, or more specifically, commitments to the prescribed rules of conduct for various relationships or associations. These commitments, according to this view, are explained neither by context nor character alone. Allegiant loyalty goes beyond the situational determinism and revealed preferences of the structural and the self-serving tracts. Self-interest is the engine that drives conduct under the pull and push of incentives and safeguards (structural) and the internal forces of character and preferences (self-serving). But allegiant loyalty allows for the possibility of self-abnegation and therefore may dislodge actions and choices from the grip of self-serving behavior taken for granted in conventional economic thought.

These three theoretical tracts of loyalty in economic theory may be distinguished from accounts of loyalty and fiduciary law advanced in the

economic analysis of law (or “law & economics”).<sup>16</sup> Conventional law & economics models of loyalty have largely relied on economic theory to explain existing legal institutional rules and practices concerning loyalty and other nominal duties of fiduciaries. Law and legal institutions in those models are objects, subject to economic analysis. By contrast, economics is the object of analysis in this section; specifically, the aim here is to analyze the ways in which economists (often implicitly) have theorized the loyalty of agents who intentionally undertake inadequate or otherwise inappropriate actions and choices. Hence, “loyalty” here is notionally broader than its conventional usage in fiduciary law. Across legal jurisdictions there are nominally many fiduciary duties—including obligations of candor, care, confidence, disclosure, impartiality, among many others—that are sometimes separated and sometimes subsumed under a common law duty of loyalty. Though useful in practice as well as perhaps elsewhere, these juridical partitions are not maintained here. Any intentional failure to exercise adequate care, keep confidences, demonstrate impartiality, avoid self-dealing and so on is treated as a breach of loyalty here.

A final disclaimer: while loyalty is herein broadly conceived, there is no aim here to provide a comprehensive survey of its usage in economics. Theories of class loyalty (in familiar works by Engels, Marx, and Veblen among others) are not meaningfully addressed, nor are more recent price-discrimination models based on brand or consumer loyalty (and much else besides). Beyond the constraints of space, an exhaustive review would exceed the scope and purpose of this section, which is simply to rough out the principal economics approaches to loyalty in agency and other relations. That said, the summaries and gloss on the literature covered will no doubt slight important scholarship and subtleties. Future drafts will hopefully fill in the most glaring omissions and fix remediable flaws in the characterization that follows.

## 2.1 Structural Loyalty

Modern economic thought was inspired by reflections on the eternal burdens of disloyal servants. Contemplating the ethics of self-serving agents, seeming to advance their own interests above those of their one true master, Pierre Nicole, the seventeenth-century pragmatic theologian, arrived at a radical insight. Pursuit of individual self-interest, Nicole argued, was not only part of the divine plan, it is the only part accessible to these fallen servants. Acting on self-interests could, in some cases, be seen an expression of loyalty to God’s plan. There launch the idea of enlightened self-interest, *amour-*

*propre*, later taking a more secular form in Bernard Mandeville’s irreverent *Fable of the Bees* (1714), which was then perfected in Adam Smith’s *The Wealth of Nations* (1776).<sup>17</sup> Self-interest begins, with Nicole, in service of a divine lord, but later, with Smith, it becomes the sources of ultimate appeal. “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner,” Smith famously concluded, “but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love.”<sup>18</sup>

Whether Smith is rightly charged with ushering self-interest from the sacred to the profane, his sober conclusion could only shift, not satisfy, economic inquiry into loyalty—that is, not unless butcher, brewer and baker were each content to work alone. Questions of loyalty, if not to God, were bound to resurface, “like lumps of butter coagulating in a pail of buttermilk.”<sup>19</sup> Division of labor demands agency. As the marginal costs of transacting through contracts and markets increase individuals will engage the assistance of agents, enlisting them in a manner that cannot be accomplished by the very contractual and market relations the limitations of which gave rise to the demand for agency in the first place. Loyalty is non-transferrable and cannot be procured through markets or by contract.<sup>20</sup>

When market and contractual incentives are inadequate, the loyalty of agents is all that remains, the last resort of principals and beneficiaries whose welfare is entrusted to agents. Agency, to be sure, has its own limits. Smith was well-aware of these limitations. His critiques of apprenticeships, university lectureships and directorships of joint stock companies characterize all the basic concerns of so-called “agency problems.”<sup>21</sup> Smith’s clearest statements on the nature of agency and loyalty are, perhaps, found in his comments on the governance of European colonial interest by local agents (i.e., “clerks”) in the Americas and East Indies:

Nothing can be more completely foolish than to expect that clerks quite out of sight, should, upon a simple order from their masters, give up at once doing any sort of business upon their own account, abandon for ever all hopes of making a fortune, of which they have the means in their hands[.]<sup>22</sup>

These agents, stressed Smith, were not properly seen as corrupt or disloyal.<sup>23</sup> Blame should be steered toward “the nature of their situation.”<sup>24</sup> Placed in a context where their interests diverged so greatly from those of their masters,<sup>25</sup> “[t]hey acted as their situation naturally directed,”<sup>26</sup> Smith wrote, “and the most perfect information would not necessarily put an end to their oppressions.”<sup>27</sup>

Self-serving disloyalty was now seen as a ‘natural’ response (not an enlightened embrace of role and place in a greater plan as pictured by Nicole). Redemption lay not in correcting the character of clerks, but rather the conditions that naturally tempted their conceit. “It is my impression,” George Stigler wrote of this changing view of servants and their salvation, “that the clergy of former times devoted their finest efforts to mending the behavior of individuals, but that in recent times they have sought rather to mend social policy.”<sup>28</sup> Conceptions of self-interested behavior shifted, subtly and over many years, from being an enlightened “moral” *choice* to a natural “rational” *response* to one’s situation, and with that shift critical attention also moved from the conduct of agents to the context they inhabited. Seeds of a false dichotomy between “moral” and “rational” action were planted at this time, with economists increasingly confining themselves to the domain of the latter.<sup>29</sup> Questions of personal loyalty and trust were then largely eclipsed in the search for optimal incentives and better structural design to remedy the natural and inevitably misaligned interests of agents and their principals.

Almost all of the models in the economic principal-agent literature are oriented around redressing this structural misalignment.<sup>30</sup> With minor variations in assumptions from model to model, they all take the essential problem as one revolving around a principal who can neither observe nor infer what actions agents take (or what knowledge agents possess) simply by looking at outcomes *ex post*, making it difficult to impossible to efficiently condition their arrangements on realized states.<sup>31</sup> Second-best contractual and market solutions then look to *ex ante* incentives as a tool to align the interests of principals and their agents. Incentive alignment is necessary because all models assume agents never sacrifice their own interests for the benefit of their principals—not without some expectation of compensation or punishment. Systems or, as economists often say, “menus” of rewards and penalties are put in place to guide the conduct of agents toward the ends of their principals. It is these guiderails, and not the agents themselves, that determine whether agents behave ‘loyally.’ Any observed disloyalty is then not the fault of rational agents, but rather a failure of an incentive structure that left them exposed to moral hazard.

Moral hazard is an expression that economists borrowed from nineteenth and twentieth-century insurers, for whom it captured two distinct meanings, as Tom Baker has written. First was the problem of identifying “bad character” among those applying for insurance. Second was the problem of “temptation” created by the insurance itself. Insurers “would refuse to insure ‘moral hazards’—that is, people with bad characters. And they would structure the insurance contract so that it did not create a ‘moral hazard’—

that is, [so as to not] tempt good people to do wrong.”<sup>32</sup> After economists appropriated the usage, Baker writes, they “dispensed with the insurers’ notion of ‘character’ and changed the theologically loaded ‘temptation’ into an insurance ‘incentive’.”<sup>33</sup> Actually, these two themes, bad character and temptation, remain central in economics and are the twin pillars around which the economic principal-agent literature has been built. Bad character (or bad characteristics) in economics is today studied under the heading of *adverse selection* or “hidden information,” while structural temptation falls under *moral hazard* or more generally “hidden action.”<sup>34</sup>

Frank Knight (1921) was an early promoter of the importance of moral hazard in economic thought, but it was Kenneth Arrow (1963) who clarified its ethical and moral meaning in the context of formal models with strictly rational actors.<sup>35</sup> Arrow insisted on the “moral” modifier as much as the more actuarial “hazard,” retaining both halves of the venerable expression, which has since largely become an empty slogan among economists. Today most might agree with an early critic of Arrow, who argued that moral hazard “has, in fact, little to do with morality[.]” Acting on self-interest, the critic observed (invoking an illusory distinction), “is a result not of moral perfidy, but of rational economic behavior.”<sup>36</sup> Moral perfidy and rational economic behavior, however, are not mutual exclusive categories, as Arrow pointedly replied to his critic: “No doubt Judas Iscariot turned a tidy profit from one of his transactions, but the usual judgment of his behavior is not necessarily wrong.”<sup>37</sup> That Judas acted on rational self-interest, obviously, did not put his conduct beyond reproach. His disloyalty, moreover, is subject not only to conventional moral and ethical criticism, but also to the critical assessment of an economist concerned exclusively with efficiency.

Moral hazard illustrates the limits to which self-serving conduct can be relied upon as an organizing principle for an efficient society—to say nothing of the morals and ethics of such a society. It highlights the value (from an economic perspective) of loyalty and other moderating norms against runaway self-interest. These norms, “whether internalized as moral principles or externally imposed, are to some extent *essential for efficiency*,” Arrow observed, because the lesson of moral hazard is that “complete reliance on economic incentives does not lead to an optimal allocation of resources in general.”<sup>38</sup> Though he casts a wide net, it is important to recognize that Arrow’s moral and ethical approach remains within the structural loyalty framework. He is interested in identifying and improving the structures that deter disloyalty. By conscripting “systems of ethics” Arrow sought to expand the menu of rewards and penalties to better guide conduct in those places where self-interest and situational impulses lead agents astray. It is

a familiar insight and long-held aspiration of economists. “Those general rules of conduct,” Adam Smith (1759) wrote, “are of great use in correcting misrepresentations of self-love[.]”<sup>39</sup>

Loyalty is revealed only through observable actions and choices. That fact is what makes the structural approach described above a plausible theory of loyalty. Since loyalty is observed solely in actions and choices, structuralists seeking to promote fidelity see a straightforward answer to concerns of disloyalty. Design the menu of available options so as to induce loyal conduct and decisions. It is a design solution grounded in the strong behavioral assumption well-captured by the American satirist, Christopher Rock, who scandalously remarked that “men are only as faithful as their options.”<sup>40</sup> Continuing the menu-options metaphor, it is a commonplace that people respond differently to menu items. Some people display a greater appetite or preference for actions and choices that are deemed loyal, suggesting another approach to loyalty to which we now turn.

## 2.2 Self-serving Loyalty

Rather than presuming a neutral effect of loyalty on the internal calculus of agents, the self-serving approach begins with loyalty as an aspect of an individual’s identity or personality. In other words, some agents simply have a taste for loyalty.\* Treating loyalty as expressions of agents’ preferences and character widens the scope of economic inquiry. Loyal preferences and character under this approach, moreover, needn’t be given or fixed. George Akerlof (1983) describes this commonsensical point fact in writing, “[w]hen people go through experiences, frequently their loyalties, or their values, change.” He recalls Max Weber’s discussion of the “Protestant ethic” as the “classic description of how different experiences result in different personality types, with important economic consequences.”<sup>41</sup> Akerlof referred to these value-changing experiences as “loyalty filters” in an article by the same name, and then raised the less obvious point that “persons, by having a choice over their experiences, can exercise some choice over their values.”<sup>42</sup>

Loyalty itself now becomes a choice available to agents,<sup>43</sup> which is not to say that they always freely and consciously determine their own loyalties and values, though sometimes they may. More often the determination is made by others, such as a parent, pastor or other authority figures who ex-

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\*Revealingly, none are modeled as having a taste for disloyalty. An absence of loyalty remains a rational neutral, and never a negative, characteristic.

ercise influence over the experiences of those under their charge. Akerlof's key contribution to the economic loyalty literature lies in his emphasis that "values are not fixed, as [assumed] in standard economics, but are a matter of choice." As something that may be chosen, both in kind and degree, loyalty then becomes subject to conventional rational choice analyses. Akerlof undertakes such an analysis to develop a theory of endogenous loyalty. He motivates his theory with accounts of parents who to teach their children to be honest and loyalty to their social class, and similarly situated academies, such as "military service academies, prestige universities, and other institutions that not only give technical training, but also teach loyalty to these institutions and the type of persons who are their faculty or alumni."<sup>44</sup>

Akerlof formalizes these accounts through signaling models, like Michael Spence's (1973) well-known education model, wherein loyalty, trustworthiness or honesty are taken to be desirable but unobservable qualities.<sup>45</sup> Those who seem to possess these qualities are rewarded for the appearance of such, as signaled by traits that are correlated with the underlying desirable qualities. Individuals (or their promoters, e.g., parents, leaders of elite academies and other institutional actors) may invest in "acquiring traits that cause them to appear honest. And the cheapest way to acquire such traits," these models assume, "is, in fact, to be honest!"<sup>46</sup> That honest and loyal persons can acquire relevant observable traits at less cost is an essential part of the equilibrium that (on average) separates them from dishonest and disloyal actors in the population.

Although intrinsically loyal persons can acquire these traits at lower cost than others, there must still be some perceived benefits of having these traits to justify the costs, however small, of their acquisition. A prior question must therefore be addressed. Why would it make sense, from an economic perspective, for firms and other presumably rational actors to seek out, retain and reward apparently loyal agents? To non-economists the answer may be both unsurprising and non-obvious: loyalty is sought out when it promotes efficiency, not a surprising aim for economists, but how this aim is pursued (i.e., through dynamic efficiency) may not be obvious. Consider the case of public corporations. These firms and their rational shareholders gain more wealth when stakeholders (e.g., employees, suppliers, communities to which the firms are tied and so forth) make appropriate relationship-specific investment in their transactions with firms. However, if these stakeholders anticipate that firms will engage in hold up or opportunistically breach their agreements after investments are made, then stakeholders will rationally underinvest in the joint enterprise.<sup>47</sup> It is this problem, "the hold up problem," that turns loyal agents into a useful tool for rational actors.

In order to “ensure appropriate investment by stakeholders,” Andrei Shleifer and Lawrence Summers (1988) argue, firms “must be trusted not to breach contracts even when it is value maximizing to do so.”<sup>48</sup> Corporations led by intrinsically or, as they say, “irrationally” honest, trustworthy or loyal individuals will encourage more (appropriate) counterparty investments because employees and other stakeholders trust that these honest and loyal managers will keep their word. As a consequence, Shleifer and Summers conclude, firms with irrationally honest or loyal managers will tend to perform better than firms with only strictly rational managers. It is a conclusion applicable not only to corporations, but to whole economies. A key “characteristic of a successful economic system,” argued Arrow, is its capacity to support “relations of trust and confidence,” providing assurance that counterparties “will not cheat even though it may be ‘rational economic behavior’ to do so.”<sup>49</sup> Importantly, Arrow was not describing any kind of *rational* trust or honesty,<sup>50</sup> but rather pointing to the “nonrational” or “allegiant” variety, something closer to the ancient doctrine of *fides* — keeping one’s word and conformity to ethical norms not because of self-interest, but in spite of it.

Loyalty is exploited here to increase the wealth and welfare of others. Even a small probability that some people are irrationally loyal, while most remain unwaveringly ‘rational’ could be enough to encourage counterparty confidence and cooperation, as demonstrated by Kreps’s et al. (1982).<sup>51</sup> Returning to the corporate case, stakeholders may, for instance, find sufficient assurance to justify their investment with just a small number of appropriately irrational managers randomly distributed in the general population (Kreps 1984).<sup>52</sup> Firms, of course, don’t have to rely on dumb luck to end up with appropriately irrational managers. They, or the academies and institutions from which firms recruit, can “produce” loyal and trustworthy managers by putting them through “loyalty filters.” Firms may also select intrinsically loyal managers by running them through screens that sieve out strictly rational types. Screening out rational types is easier said than done, to be sure, since it is profitable and strictly rational to mimic the behavior of loyal and trustworthy types given the greater rewards they command.

Mimics will pull off their rouse for only so long, however, as Shleifer and Summers submit. “There are no lifetime moles.”<sup>53</sup> Personality types eventually reveal themselves and a lifetime of consummate mimicry may be economically indistinguishable from the real thing. After all, neither type is actually loyal to their principals. Both strictly rational and irrationally loyal types are ultimately committed to the pursuit of their own interests. Rational types are simply unburdened by the self-satisfying ‘integrity’ that defines the character of loyal types. These unyielding personalities may nonetheless

be of use to principals. By installing irrationally loyal agents as irrevocable proxies, principals may commit to maintain a course otherwise susceptible to redirection or renegotiation (Maskin and Tirole, 1999).<sup>54</sup> It is an ancient strategy. Odysseus made his men bind him to the mast with rope and put beeswax in their ears so they could hear neither his countermands nor the Sirens' songs. Irrationally loyal agents are akin to rope and beeswax; simple-minded contrivances serviceable as commitment devices. These tools may, moreover, be shaped and molded (with filters) or sought out and selected (through screens) as needed in order to serve these limited purposes.<sup>55</sup>

### 2.3 Allegiant Loyalty

No plausible survey of loyalty in contemporary economics could fail to mention Albert Hirschman's (1970) *Exit, Voice and Loyalty*. In a chapter entitled "A Theory of Loyalty," Hirschman offers thoroughgoing economics approach to loyalty, treating it as barrier to exit from relationships and associations. Loyalty, as a barrier to exit, encourages individuals to stay put, to stay the course and speak up when dissatisfied. In the face of falling quality, Hirschman's main concern, loyalty exerts a moderating force by raising the costs of exit and fostering discourse.<sup>56</sup> But to what end? "As a result of loyalty," answers Hirschman, insiders "stay on longer than they would ordinarily, in the hope or, rather, *reasoned expectation* that improvement or reform can be achieved 'from within'."<sup>57</sup> As a strictly rational strategy for attaining and preserving quality goods and services, however, loyalty would appear misplaced in circumstances of decline.

To speak of loyalty simply as a means of procuring quality goods and services offends basic market logic. On the one hand, when quality goods and services may be readily procured elsewhere, loyalty would seem unnecessary or, worse — keeping individuals tied to inferior suppliers or locked in deteriorating arrangements. On the other hand, when there are no alternative providers, it hardly makes sense to refer to loyalty. Loyalty requires "the possibility of disloyalty, that is, exit."<sup>58</sup> When there are no plausible alternatives, exit barriers are functionally redundant and observational loyalty is meaningless. When there are many suitable or superior alternatives (lots of easy exits) exit barriers, including loyalty, hinder access to better quality goods and services. It is paradoxical, Hirschman observes, that "loyalty is at its most functional when it looks most irrational."<sup>59</sup>

Why show loyalty when better alternatives are readily available? From a functionalist perspective, if not a strictly rational one, the answer must in-

volve commitment to ongoing relationships and associations themselves, and not simply the quality of goods and services derived from them.<sup>60</sup> Hirschman gives it away with his references to “attachment” and “cohesive ideology.” Discouraging exit through loyalty or other means is necessary for maintaining certain relationships and associations. Burdensome dissolution proceedings, like loyalty, non-coincidentally extends partnerships and marriages, even inefficient and dysfunctional ones. These barriers to exit, in no small part, exist for the sake of those relationships, for their continuation—to simply keep them going. All sorts of relationships and associations are necessarily so perpetuated. Exit barriers address, as Knight put it, the “problem of social continuity.”<sup>61</sup> A society or culture from which “exit is entirely costless,” Jacob Levy rightly tells us, is “no culture at all.”<sup>†</sup>

Seen in this light Hirschman’s functionalist approach to loyalty expresses an implicit notion of commitment, yet not commitment to individuals or to things or to quality, but rather to relationships, associations, organizations, communities and other going concerns.<sup>62</sup> Commitment to these groups often prescribes certain beliefs, practices, behavioral obligations and

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<sup>†</sup>Jacob T. Levy, *The Multiculturalism of Fear* 112 (2000). It may be useful here to clarify Knight’s understanding of loyalty to conduct rules (allegiant loyalty) as a solution to problem of social continuity by contrasting it with the approach suggested by Arrow seeking in seeking to enlist trust or *fides* to address problem of moral hazard (structural loyalty). “This trustworthiness of the common man, depending on competence and the elementary morality of respecting the freedom of others, is valid only up to a point,” Knight wrote (in *Risk, Uncertainty and Profit*, Preface for the Reprint of 1957, at p. lv). Trustworthiness here entails two separate concerns: first, a concern for practical competence, which allows one to trust that an agent *can* get things done (i.e., care and prudence); second, is the concern for moral competence, which offers assurance that the agent *will* take the appropriate and prescribed action (loyalty and obedience). Now recall Arrow’s conclusion that resolving this difficult problem of trust was essential for the efficient organization of society. Knight agreed the problem was difficult, but viewed it as strictly second-order. “It is a hard problem, yet on the whole a minor one,” he wrote. “Harder is provision for the defense of a society against external enemies.” *Id.* Not only external threats but also internal dissension and dissolution. The problem that every society, culture and other going-concern must, first and foremost, address itself to is “the problem of social continuity.” Loyalty to conduct rules offers a solution: one way to address “[t]he social problem is,” Knight observed, to “preserve respect for the rules [which] is a moral problem.” Frank H. Knight, *Risk, Uncertainty and Profit*, Reprints of Economic Classics, Augustus M. Kelley Bookseller, New York (1964), Preface to the Re-issue (1933) p. xxxi. Similarly, the institutional economist John Commons argued that Wesley Hohfeld’s conceptualization of entitlements was nothing short of a general theory of conduct rules, describing “the way in which the common practices of *any* going concern control the individual members of that concern and hold them to the conduct necessary to *preserve the existence of the concern.*” (emphasis added) “These principles are just as applicable to the shop rules of an industrial concern, or to the ethical rules of a family or any of the many cultural concerns, as they are to the supreme political concern.” John R. Commons, *Law and Economics* YALE L.J. (1925) at 375.

approved rules of conduct (call the whole “conduct rules” for short) as a condition of membership and continued good standing within the group.<sup>63</sup> Members may internalize these prescriptions (e.g., through loyalty filters) such that their preferences lead them to follow the conduct rules and potentially sanction those who fail to follow, thereby providing additional compliance incentives.<sup>64</sup> Conduct rules, however, needn’t be internalized or incentivized to be followed. People also comply with conduct rules out of loyalty or commitment to social groups. That is “[o]ne of the ways in which the sense of identity can operate,” says Amartya Sen, “through making members of a community accept certain *rules of conduct* as part of obligatory behavior toward others in the community.”<sup>65</sup> Where membership require acceptance of conduct rules, loyalty demands compliance.

Loyalty to a group or concern can lead individuals to follow conduct rules even in cases where their preferences and the incentives they face would draw them in other directions. Strictly speaking, it is not blind loyalty when one acts (with eyes wide open) on the dictates of allegiance to conduct rules calling for actions and choices contrary to self-interest. We may call these behavioral dictates “ethics,” say says George Stigler, or at least “[w]hat we [economists] call ethics, on this approach,” which “is a set of rules with respect to dealings with other persons, rules which in general prohibit behavior which is only myopically self-serving, or which imposes large costs on others with small gains to oneself.”<sup>66</sup> Sen prefers the term “commitment,” and adds “it is not a matter of asking each time, What do I get out of it? How are my own goals furthered in this way?, but of taking for granted the case for certain patterns of behavior toward others.”<sup>67</sup> Here, I use the term “allegiant loyalty.” Whatever the usage, however, the implications are largely the same. Actions and choices may be taken independently from considerations of self-interests.

When socially called-for conduct goes against the demands of self-interest, agents under the allegiant loyalty approach may comport themselves with the approved rules and abnegate their self-interest. Although they have not internalized the conduct rules, they may still regard these rules from an internal point of view, wherein an agent “accepts and uses them as guides to conduct.”<sup>68</sup> Still not every agent need accept and follow conduct rules under this approach. To be sure, “some people will gain by violating the rules” and many may occasionally do so, particularly with regard to rules seen as trivial, but, Stigler hypothesized, “few people violate important rules often.”<sup>69</sup> Stigler was attentive to the worry that his hypothesis might spring the familiar trap of revealed preference reductivism—“the constant temptation to define the utility of the individual in such a way that the hypothesis

is tautological”—but he said little here about how to avoid it. Elsewhere, fortunately, he offered some useful guidance: “it takes a theory to beat a theory.”<sup>70</sup>

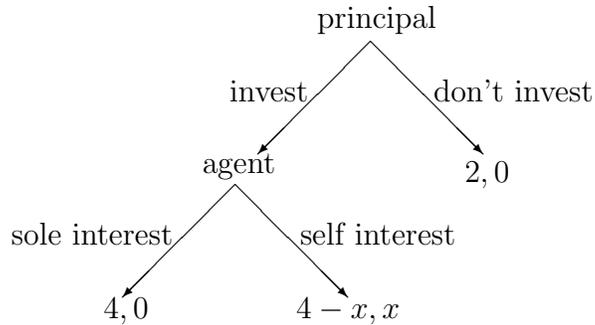
It is difficult to illustrate allegiant loyalty with conventional economic theory. Much of this theory rules out the very possibility of self-abnegation, *by assumption*. Confounding matters more, there are often multiple such assumptions, some of which concealed by what is purported as pure method or analysis. Sen alerts us to the fact that “notions of ‘equilibrium’ (Nash equilibrium, strong equilibrium, the ‘core,’ etc.), ‘optimality’ (Pareto optimality, bargaining-game ‘solutions,’ etc.), ‘dominant’ strategies, and other basic concepts of the theory are interpreted in the light of these behavioral assumptions.”<sup>71</sup> But the difficulty here goes beyond basic questions of interpretation. Nash equilibria and related refinements can only make sense of actions and choices seen by individuals as ‘best responses’ from an inherently self-regarding stance (even when these individuals incorporate the welfare of others or other values within their own utilities or payoffs). Other-regardingness, irreducible to this self-focused orientation, is unintelligible within the Nash equilibria conceptual framework.

To demonstrate this point, and further illustrate the allegiant loyalty approach, consider the following “loyalty game.” Imagine a party, called the principal, possessing assets, which may double in value if placed under the management of a second party, the agent. Assume the agent acts either in the “sole interest” of the principal (i.e., she acts loyally) or in her own self-interest (i.e., disloyally).<sup>‡</sup> When the agent acts loyally the principal gets the entire return on invested assets, while disloyalty lowers the principal’s return by some amount,  $x$ , which is appropriated by the agent.<sup>§</sup> The interaction is depicted in the game tree below, where the principal’s initial asset value is 2, which will double to 4 under the agent’s management.

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<sup>‡</sup>Assume further all actions fit exclusively and obviously (obvious to the agent) within the loyalty or disloyalty dichotomy. These strong assumptions may be relaxed without losing the basic point, but are maintained for economy and expositional clarity.

<sup>§</sup>Compensation for the agent is also suppressed for simplicity, but could be assumed to be a competitive salary, normalized to zero, representing the amount she would earn in the market for her services if the principal did not invest with her.



Game theorists have been known to refer to interactions (i.e., games) having this structure as the “Trust Game” or “Boxed Pigs” or One-sided Prisoner’s Dilemma, which unlike the conventional Prisoner’s Dilemma game is not solvable with strictly dominant strategies—that is, each party cannot take an action that is best irrespective of what the other party does. In this case, the principal will find it best to invest only if the agent does not act too much in her own self-interest (i.e., so long as  $x \leq 2$ ). To simplify matters further and focus our discussion, let  $x = 3$ , and consider the interaction converted to the matrix (normal form) below.

		agent	
		sole interest	self interest
principal	invest	4 0	1 3
	don't invest	2 0	2 0

Each cell in the matrix depicts the payoff results of strategy combinations between the parties, with the principal’s payoff appearing first, followed by the agent’s payoff. Hence, when the principal chooses to invest and the agent acts in the sole interest of her principal, the former receives 4 and the latter 0. Had the agent instead pursued her own self-interest, then the principal would have received 1 and the agent 3. When the principal does not invest, the payoffs are the same (2 and 0) irrespective of whatever action the agent would have taken had she the opportunity.

To solve this interaction in a non-cooperative game theoretic framework, researchers almost always rely on the Nash Equilibrium solution concept (or one of its various refinements), which requires that each player makes the best possible decision for herself, given the decisions of all other players

in the game. The Nash solution concept is compelling for many reason, but note its implicit reliance on self-interest. For instance, in the matrix above, following Nash play, the agent must consider which of her strategies maximize her payoff given the choice made by the principal. So when the principal chooses to invest, the agent will act in her own self-interest (going after a payoff of 3 instead of settling for 0 by acting in the principal’s sole interest), and given that, the principal will choose not to invest (getting a payoff of 2 instead of 1), which results in a stable outcome (an equilibrium, depicted by  $N^*$  in the matrix) where neither party has incentive to alter their strategy given the strategy of the other. This is the only stable outcome identifiable under the Nash solution concept and it is a robust equilibrium.

		agent	
		sole interest	self interest
principal	invest	4 0	1 3
	don't invest	2 0	$N^*$ 2 0

As compelling as the Nash solution concept may be, there is considerable experimental and other empirical evidence suggesting that sensible people often do not behave according to its predictions. Consider an alternative “non-cooperative” approach, known as the Berge Equilibrium solution concept, which requires that each player makes the best possible decision for the other parties, given the decisions of all others players in the game.<sup>72</sup> In this case, the agent must now focus on the first number in each cell (that is, on the the principal’s payoff instead of her own) in order to determine which of her strategies would maximize the principal’s payoff given the choice made by the principal. So when the principal chooses to invest, the agent will not act in her own self-interest, but rather in the sole interest of the principal (generating a payoff of 4 for the principal and zero for herself), and given that, the principal will have no incentive to deviate from the strategy of investing because she cannot make the agent any better-off (assuming that the principal also follows Berge behavioral rules). Hence, a stable outcome (a Berge equilibrium, depicted with  $B^*$  in the matrix) results where neither party has incentive to alter their strategy given the strategy of the other.

Observe that the equilibrium outcome depicted above is the same irrespective of whether the principal follows Berge behavioral rules or Nash behavior. Namely, given the strategy-aim of the agent to act in the sole in-

		agent			
		sole interest		self interest	
principal	invest	$B^*$ 4 0	1 3		
	don't invest	2 0	2 0		

terest of the other party, the principal's best (Berge or Nash) response is to invest. Which behavioral rule should the principal follow? It depends. Nash conduct norms may be the appropriate behavioral disposition for a beneficiary in some fiduciary relationships, such as agency and trusts. Were the parties "partners" or in some other communal relationship, however, calling for mutual "other-regarding conduct," then Berge behavioral rules may be appropriate.

		agent			
		sole interest		self interest	
principal	invest	$B^*$ 4 0	$\dagger$ 1 3		
	don't invest	2 0	2 0		

What about the behavioral disposition of the agent? Note that, unlike the choice involving the principal, the outcome above is not the same whether the agent follows Berge or Nash behavioral rules. When the agent adopts Nash (self-interested) behavioral rules the outcome is a payoff of 1 for the principal and 3 for the agent (depicted with a  $\dagger$  in the matrix above), and when the agent adopts Berge (other-regarding) behavioral norms the outcome is a payoff of 4 for the principal and 0 for the agent (marked  $B^*$ ). All of this suggests a simple, even obvious, strategy for a principal playing the loyalty game: when the principal faces a self-interested agent, whom we might call Agent Nash, then the principal should rationally not invest; and when facing an other-regarding agent, call her Agent Berge, then investing is a best response for the principal.

### 3 Sole Interest’s Conduct & Decision Rules

Two critical questions must be addressed in order to pursue the mundane strategy described above. First, how does the principal know what type of agent she is facing—Berge or Nash? Second, and perhaps more important, how does the agent know what type of behavioral disposition to adopt—Berge or Nash? Answers to both questions may be found in the conduct rules associated with the relationship or association between the principal and the agent. That is, the allegiant loyalty approach may provide answers, which will often be determined at the level of the transaction within identified relationships. For this approach to make sense, however, we must imagine a world with nuanced individuals — it needn’t be everyone, just some persons who are not intrinsically and always self-serving or reflexively and mindlessly loyal (as presumed in the structural loyalty and self-serving loyalty approaches, respectively). What if, for a given transaction, agents were able to adopt a behavioral disposition or follow conduct rules as directed by salient aspects of their relationships with principals? Were that the case, then the agent’s and principal’s problem would become one of mainly learning the relevant conduct rule for the transaction.

#### 3.1 Conduct Rules & the Psychological Matrix

Fiduciary law plays a distinctive role in providing and publicizing appropriate conduct rules to agents, trustees and other fiduciaries. As a conduct rule, the sole interest directive calls attention to behaviors and strategies toward beneficiaries. An agent is instructed to consider **not** her own payoffs in deciding how to conduct herself. Actions and behaviors for and toward beneficiaries are supposed to be the singular focus of fiduciaries under the sole interest rule (not the weighing of their own payoffs in any degree). Any desirable outcome for a beneficiary may be reached by adjusting a fiduciary’s payoffs and, to be sure, reinterpreting payoff structures to make them align with desirable consequences is a tempting expedient. But that too is inadequate under the sole interest rule. To see this, consider the notion of the psychological matrix, described by John Thibaut & Harold Kelley in their work on social exchange theory.

Thibaut & Kelley emphasized that parties don’t all see the numbers in the cells in the same objective way. One fiduciary may take a completely egoistic view of the payoff matrix, considering only her own payoff as contributing any direct value or utility (i.e., only the utility of the fiduciary,  $u_f$ ,

directly matters to the fiduciary) as typified in conventional law and economics arguments; another may take a cooperative view (where the sum of the parties' utilities,  $u_f + u_b$ , directly matters to the fiduciary); another may take a competitive-comparative view (seeking to maximize the positive difference of her payoff and that of the other party's,  $\max\{u_f - u_b\}$ ) or an equality focus (seeking to minimize the difference between payoffs,  $\min\{u_f - u_b\}$ ) or even a completely altruistic or other-regarding orientation (i.e., the fiduciary's payoffs take on the values of the beneficiary's, i.e., the fiduciary sets  $u_f$  equal to  $u_b$ ).<sup>¶</sup>

The last (psychological) payoff transformation, the altruistic or other-regarding orientation, would seem to capture the directive of the sole interest rule. But that's misleading and wholly inadequate. Converting one's own payoff to fully reflect another party's payoff and then acting in a self-regarding manner with respect to the transformed payoff misses the point. Sole interest is a rule of conduct: it tells fiduciaries to look at no other party's interest, including their own (even in transformed form), when deciding a course of action on behalf of beneficiaries. Moreover, as a conduct rule, sole interest both inculcates and informs. Which is to say, the conduct rule trains or socializes agents toward adopting other-regarding behaviors, not payoffs. This is the inculcating function.

Finally, fiduciary law's conduct rules inform parties about when it is appropriate to be self-regarding. Not all agents are subject to strict sole interest duties—interested agents, agents with proxies and corporate agents are all granted significant leeway to pursue self-interested behavior—but law demands of other fiduciaries that they look away from their own interests (and that of third parties) when acting on behalf of their beneficiaries. Corporate fiduciaries may act like Agent Nash; traditional trustee should follow Agent Berge. There is room for both types of agents.

## 3.2 Decision Rules & Economic Welfare

Conventional law & economics arguments in favor of the best interest approach would suggest that the Berge behavioral norms (as reflected in the sole interest rule) are grossly inefficient and inappropriate to the demands placed on modern fiduciaries. Supporters of this suggestion would get rid of the sole interest conduct rule and replace it everywhere with Nash behav-

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<sup>¶</sup>[Discuss, John Geanakoplos, David Pearce and Ennio Stacchetti, *Psychological Games and Sequential Rationality*, 1 GAMES & ECON. BEHAV., 60-79 (1989) and related subsequent literature.]

ioral norms that combine with incentives for fiduciaries to act in the best interest of beneficiaries. The fiduciary's reasons for action would then follow from those incentives within a self-interested (structural loyalty) framework, rather than conduct rules taken from an internal point of view. In the remainder of this section, I challenge this broad claim about what is required for efficient behavior and what the law requires, with particular emphasis on the decision rule that follows from violations of the sole interest conduct rule.

The argument in favor of Nash behavioral norms stems from the concern that fiduciaries will not have sufficient incentive to act in the best interest of their beneficiaries when the optimal course of conduct for the beneficiary coincides with the individual or personal interests of the fiduciary. In such cases, because the decision rule requires the fiduciary to disgorge any gains from conflicted transactions, she will have little incentive, it is argued, to act in the best interest of beneficiaries. It is important to note that fiduciaries are often allowed to retain their compensation in these cases of conflict, unless there is a clear showing of bad faith in the conflicted transaction. They are simply not allowed to hold on to any profits from these efficient conflicted transactions,<sup>||</sup> and consequently, the argument goes, fiduciaries avoid these transactions, even though they are in the best interest of beneficiaries.

The classic case of *Boardman v. Phipps*,<sup>73</sup> is often presented as the prime example of overdeterrence and inefficiency caused by the sole interest rule (see also *In re Kilmer*). The *Phipps* case involved a trust which owned roughly one-quarter interest in a closely held corporation. The defendants, acting as agents for the trust, proposed a plan to reorganize the corporation for the benefit of all shareholders, including the trust. The success of the plan was threatened when the trust declined to purchase additional shares, at which point the defendants purchased the additional shares in their individual capacity. By doing so, they assured the success of the plan, generating sizable profits for all shareholders, including the trust and, of course, for themselves based on their additional purchases.

Subsequently, the defendants were sued and held liable under the sole interest rule. Although they were allowed to retain a generous compensation for their efforts, the defendants were forced to disgorge to the trust their profit earned on their individual holdings. As Professor Langbein argues, notwithstanding the fact that the outcome well served the interests of all

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<sup>||</sup>I will assume the transaction is both efficient and in the best interest of the beneficiary. Otherwise—since few commentators argue against the sole interest rule when it serves to discourage inefficient transactions and those not in the best interest of beneficiaries—there is nothing to argue over.

parties, sole interest rule stood to undermine the efficiency of the transaction and the best interest of the trust. “Because, however, the conduct at issue in the transaction in Boardman was (and was at all times meant to be) value enhancing for the trust, the policy of deterring the overlap or conflict of interest was contrary to the best interest of the trust. But for the conflict-tainted conduct, the trust would have been worse off.”<sup>74</sup>

The claim that the fiduciary will lose incentive to engage in efficient (conflicted) transactions on behalf of beneficiaries when forced to disgorge any profits earned from breach of the sole interest conduct rule is similar to arguments made about efficient breach of contractual promises.<sup>75</sup> Yet, contrary to the often expressed and implied assumptions about efficient breach, the promisor does not require all of the gains of breach to behave efficiently.<sup>76</sup> Indeed, based on the rational self-interested structure that underlies the efficient breach hypothesis, it is sufficient for the promisor to receive an amount that is indistinguishable from nothing! Give up this implication and one is forced to also give up all efficiency claims and marginal analyses based on continuity, which is to say the entire theoretical apparatus of law and economics. Now there may be reasons—based on fairness, efficiency or some justice consideration—to allow the promisors to capture the gains of efficient breach.<sup>77</sup> Similarly, there may be reasons to give the promisee some or all of the gains from breach, based on fairness, efficiency or some justice consideration. The distribution of gains from breach is a separate matter from the question of efficient allocation through breach.

The same argument applies to a fiduciary who breaches the sole interest conduct rule and is forced to disgorge her gains under the decision rule that follows violation of the sole interest command. Even if the fiduciary finds all of her reasons for action in a self-interested incentivized formula, even this Nash-inspired agent, will not be discouraged from taking efficient actions (as I will demonstrate below). The disgorgement decision rule preserves the incentives of fiduciaries following Nash behavioral norms, while the sole interest conduct rule provides reasons for action to agents capable of finding motivation for action from Berge behavioral norms. Of course, often the same individual may adopt a Nash behavioral disposition in one context and a Bergean disposition in another context—for instance, acting as an agent in a commercial context as compared to acting on behalf of a child or elderly parent—and some times the individual will not know what is the proper disposition and may look to law for guidance.<sup>78</sup>

The point above concerning the efficiency of the disgorgement rule is illustrated in the following simple abstraction. Let  $\Delta$  represent the total

gains from efficient breach of the sole interest rule, i.e., when the fiduciary participates in the transaction. That is, assume the underlying transaction leaves the beneficiary no worse off in addition to generating a surplus gain of  $\Delta > 0$ , which is realized or captured by the fiduciary as a consequence of the value-enhancing transaction for the beneficiary. Assume (without loss of generality) that the next best (less efficient) alternative course of action produces zero profits (i.e.,  $\Delta = 0$ ) while the underlying transaction again leaves the beneficiary no worse off. An other-regarding Berge agent would be indifferent between the two courses of action because the beneficiary's payoff, which is the sole interest of the agent, is exactly the same in either case.

The question now is, how much of  $\Delta$  must the self-regarding Nash agent capture to pursue the efficient value-enhancing transaction? It is often suggested that offering the fiduciary anything less than the entire surplus,  $\Delta$ , would lead to inefficiencies, but that is patently false. To see this, let the fiduciary's share of the gains from efficient breach of the sole interest duty be represented by  $\frac{1}{N} \cdot \Delta$ , where  $N \in \{1, 2, 3, \dots\}$ . In this case the fiduciary gets the entire gain when  $N = 1$ , which of course leads her to take the efficient course of action. Yet the fiduciary also takes the efficient course when  $N = 2$ , even though she gets only half of the, which is better than nothing from taking the less efficient course. Note that the beneficiary is also better off, getting one-half of  $\Delta$ .

Therefore, continuing the argument, the Nash-inspired fiduciary will take the efficient course of action when  $N = 3$ , where she gets a third of the gain, and when  $N = 4$ , where she gets only a quarter of the gain, and so on. This sequence may fairly represent the default division of the surplus for breach of contracts within  $N$ -party partnerships and joint ventures. As  $N$  approaches infinity the fiduciary's share of the gain approaches 0 and the remedy becomes indistinguishable from the disgorgement remedy (the conventional remedy issued for breach of the duty of loyalty by fiduciaries). Yet even as her share of the surplus races toward 0 in the limit, the hyper-rational self-interested Agent Nash fiduciary, which is assumed in the standard law and economics models, will continue to breach the sole interest duty rule whenever its breach is efficient.

## Conclusion

[to be completed].

## Notes

<sup>1</sup>RESTATEMENT (SECOND) AGENCY §387 (1958); *see also* RESTATEMENT (THIRD) AGENCY §§8.01-8.06 (2006).

<sup>2</sup>*See* RESTATEMENT (SECOND) OF TRUST §170(1) (1959; *see also* RESTATEMENT (THIRD) OF TRUSTS §78 [date]

<sup>3</sup>On the traces of presumed liability in Roman and Medieval law *see* Sir Henry Maine ANCIENT LAW (1861) and Oliver Wendell Holmes, Jr. THE COMMON LAW (1881). On economic arguments, mostly based on asymmetric information, *see*, Robert Cooter and Bradley J Freeman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences* 66 N.Y.U. L. REV. 1045 (1991); Frank Easterbrook and Daniel Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425 (1993); Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L. J. 277 (1998) and Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039 (2011); Richard R.W. Brooks *Knowledge in Fiduciary Relations*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW (Andrew S. Gold and Paul B. Miller, eds) Oxford Univ. Press, at 225. *See also* Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency* 28 J. CORP. L.565 ( 2003) (finding justification for no further inquiry, if on balance, subject transactions “are so frequently undesirable that the costs of extirpating the entire class of transaction (a rule) are less than the costs of case-by-case adjudication (the fairness standard). *Id.* at 573-574. Psychological claims, going beyond the hidden actions and information of agents, tend to stress the bounded rationality, judgment and information impactedness of fiduciaries themselves. The no further inquiry rule, writes Lionel Smith, exist because the law has an insight into the way the human mind works when it is exercising judgment. When a person exercises judgment in a conflict situation, it is impossible for that person to be certain that they have excluded extraneous [self-interested] considerations. Lionel Smith, *Fiduciary Relationships: Ensuring the Loyalty Exercise of Judgment on Behalf of Another*, 130 L. Q. R. 608, 624 (2014) [check quote]. *See also* Sung Hui Kim, *Fiduciary Law’s Anti-Corruption Norm*, WORKING PAPER (June 6, 2016). Reporters for the most recent Restatement of Trust Law emphasize the often irresistible temptation faced by all too human fiduciaries (“The rationale [for no further inquiry] begins with a recognition that it may be difficult for a trustee to resist temptation when personal interests conflict with fiduciary duty. In such situations, for reasons peculiar to typical trust relationships, the policy of the trust law is to prefer (as a matter of default law) to remove altogether the occasions of temptation rather than to monitor fiduciary behavior and attempt to uncover and punish abuses when a trustee has actually succumbed to temptation. The RESTATEMENT (THIRD) OF TRUSTS §78 cmt. b (2007).)

<sup>4</sup>Contracts, partnerships and joint venture law are subject to their own conduct rules, as Cardozo observed: “Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties.” 164 N.E. 545, 546 (NY 1928).

<sup>5</sup>164 N.E. 545 (NY 1928). While it is debatable whether Judge Cardozo was correct in his application of the unyielding fiduciary loyalty rule that binds trustee to this particular controversy; his characterization of the law of loyalty for trustees, however, was without question correct.

<sup>6</sup>In its strongest form, the old rule, known also as the English rule, viewed compensation for fiduciary services as contrary to the sole interest mandate. English courts of equity questioned whether a trustee’s undivided loyalty could be maintained if “the trustee were allowed to perform the duties of the office and to claim remuneration for his services.”

JOHN MOWBRAY ET AL., LEWIN ON TRUSTS §20-132, at 503 (17th ed. 2000). This view evolved from particular conceptions of status and wealth in English law. Trustees were *gentlemen* gratuitously fulfilling the office, not marketmen seeking pay for professional services. Changes in wealth management and professionalization of the field naturally led to the American rule allowing compensation for trustees. See John H. Langbein, *Questioning the Trust-Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L. J. 929, at 939-941.

<sup>7</sup>Delaware's allow partners in general, limited and limited liability partnerships (along with members of limited liability companies) to limit or eliminate the duty of loyalty entirely. [cites, plus add reference to statutory trust and corporate law].

<sup>8</sup>Corporate bonds and special purpose vehicles for pooled securitized assets organized under the federal Trust Indenture Act or state business trust statutes are among numerous other ventures opting for the trust form. For an accessible description of the commercial trust proliferation, see John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce* 107 YALE L. J. 165 (1997). While personal trusts in the U.S. manage assets on the order of hundreds of billions, commercial trusts manage assets on the order of tens of trillions. [cites]

<sup>9</sup>"In their totality, the exclusions and the categoric exemptions from the sole interest rule ... make it increasingly fictional to continue to treat the sole interest rule as the baseline norm." John H. Langbein, *Questioning the Trust-Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L. J. 929, at 980. *But see*, Henry E. Smith (2014) *Why Fiduciary Law Is Equitable*, at 276 (observing that "[t]he 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) and Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541, 567-571 (2005).

<sup>10</sup>[Cites.] See Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541, 550-554 (2005) (arguing that Langbein greatly overstate the over-deterrence claim.

<sup>11</sup>"The rule sends a clear message to trustees: absent unusual circumstances, you may not profit from your position (aside from trustee commissions). If you want to transact business with the trust, you must obtain advance authorization from a court or the trust beneficiaries." Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541, 546 (2005); See also Charles E. Rounds, Jr., *Sole Interest or Best Interest: Equity's Traditional Default Loyalty Principle is Under Attack* (June 2, 2016), Henry E. Smith (2014) *Why Fiduciary Law Is Equitable*; Lionel Smith, *Fiduciary Relationships: Ensuring the Loyalty Exercise of Judgment on Behalf of Another*, 130 L. Q. R. 608 (2014). Frances H. Foster, *American Trust Law in a Chinese Mirror*, 94 MINN. L. REV. 602 (2010). Frederick R. Franke, Jr., *Resisting the Contractarian Insurgency: The Uniform Trust Code, Fiduciary Duty, and Good Faith in Contract*, 36 ACTEC L.J. 517 (2010).

<sup>12</sup>Delaware, for instance, which has might been predicted to be among the first to abandon the sole interest rule in favor of best interest, given the state's corporate statute and jurisprudence, has shown continuing fidelity to traditional sole interest presumptions. A case in Delaware's Chancery Court, *Mennen v. Wilmington Trust Company*, 2015 WL 1914599, (2015), in which (interestingly) John Langbein served as an expert, clearly affirms the continuing vitality of the no further inquiry rule in Delaware. Moreover, Delaware's statutory trust code has not adopted it's corporate code's more permissive standard for conflicted transactions. See 12 DEL.C. §3583(a) ("a trustee is accountable to a beneficiary for any profit made by the trustee arising from the administration of the trust, even absent

of a breach of trust.”) However, a recent California opinion, regrettably uncitable under state law rules, *Cohen v. Cohen* (2015) concludes that §16440 of the state’s Probate Code allows the court to “excuse the trustee in whole or in part from liability,” in the court’s discretion, if it believes “the trustee has acted reasonably and in good faith under the circumstances as known to the trustee.” In *Cohen* the court further observed that §16440 applies to the duty of loyalty and explained that a beneficiary is entitled to damages if they can establish a breach of the duty of loyalty even without establishing bad faith. However, unlike the more traditional no further inquiry rule, this is not the end of the matter. The burden then switches to the “breaching trustee to establish that, under the circumstances of the case, it would be equitable to excuse the trustee from damages because it acted reasonably and in good faith.” *Cohen*, 2015 WL 2227808, at 9. In a relatedly vein, the Louisiana Civil Law Treatise points to a 2012 case, *em Thomas v. Kniepp*, that the Treatise says may be an example of a “court relaxing the ‘unbending rigidity’ with which the duty of loyalty is enforced.” LA. CIV. L. TREATISE, TRUSTS §14:4 (2d ed.)

<sup>13</sup>See Uniform Power of Attorney Act §114(d): “An agent that acts with care, competence, and diligence for the best interest of the principal is not liable solely because the agent also benefits from the act or has an individual or conflicting interest in relation to the property or affairs of the principal.” [Add Uniform Trust Code language]. Other statutory and regulatory statements may also be found to deviate from the common law’s strict requirements. See George Gleason Bogert, George Taylor Bogert and Amy Morris Hess, THE LAW OF TRUSTS AND TRUSTEES §543. For instance, under Regulation 9 of the U.S. Comptroller of the Currency, national banks may engage in certain self-dealing arrangements; the Uniform Trustees’ Powers Act allows a trustee may make loans to a trust that she administers as well as pursue transacts between distinct trusts for which she is a trustee. “In the statutes of a few states the trustee is specifically authorized to sell property owned individually by the trustee to his trust.” Bogert et al., THE LAW OF TRUSTS AND TRUSTEES §543 (Loyalty Statutes) [get pincite]. [Review discussion of DOL and SEC recent fiduciary definition].

<sup>14</sup>See [cite Langbein and others]. Foster, a proponent of the sole interest rule observes,

Under the influence of law and economics theory, prominent scholars and reformers are rapidly dismantling the traditional legal and moral constraints on trustees. Trusts are becoming mere “contracts,” and trust law nothing more than “default rules.” “Efficiency” is triumphing over morality. In the law and economics universe of foresighted settlers, loyal trustees, informed beneficiaries, and sophisticated family and commercial creditors, trusting trustees may make sense. In the real world, however, it does not. A trust system that exalts trustee autonomy over accountability can and increasingly does impose significant human costs on all affected by trusts.

Foster, *American Trust Law in a Chinese Mirror*, 94 MINN. L. REV. 602, 651.

<sup>15</sup>Sen refers to this as “Goal-priority: Each player pursues his or her goal subject to feasibility considerations, *without being restrained by any other values.*” Amartya Sen, “Goals, Commitment, and Identity,” *Journal of Law, Economics, & Organization*, 1(2): 341–355 (1985), at 343 (emphasis added). This is not to claim that loyalty is itself a value (see Fenner), but but rather that loyalty, however understood, places no constraint on their actions and decisions. James E. Penner, “Is Loyalty a Virtue, and Even If It Is, Does it Really Help Explain Fiduciary Liability?,” in *Philosophical Foundations of Fiduciary Law* (Andrew Gold & Paul Miller eds., 2014).

<sup>16</sup>[An appendix apply the economic loyalty typology to conventional law & economics analyses is available upon request].

<sup>17</sup>Jacob Viner (1978, pp. 131-140), Faccarello (1986), *Eighteenth Century Economics*, by Peter Groenewegen, 2002 Routledge, pp. 78-79, Grewal, (2017)

<sup>18</sup>The Wealth Of Nations, Book I, Chapter II, pp. 26-7, para 12.

<sup>19</sup>R.H. Coase, “The Nature of the Firm,” *Economia* 386–405, at 388 (1937) (quoting D. H. Robertson’s description of the near certain propensity of coordinated economic activity).

<sup>20</sup>Cite to Patrick Bolton for the point about non-transferability.

<sup>21</sup>Lacking what Oliver Williamson calls ‘high-powered incentives’, Smith argued apprenticeships cultivated “habits of idleness” and “aversion to labour.” (See Emma Rothschild, (2002), *Economic Sentiments: Adam Smith, Condorcet, and the Enlightenment*, at 95-6.) Describing some of the “inconveniences” resulting “where the division of labour is brought to perfection,” Smith writes, “when a person’s whole attention is bestowed on the seventeenth part of a pin or the eightieth part of a button . . . [i]t is remarkable that in every commercial nation the low people are exceedingly stupid.” On the system of university instruction at Oxford, Smith wrote: “It is the interest of every man to live as much at his ease as he can; and if his emoluments are to be precisely the same, whether he does, or does not perform some very laborious duty, it is certainly his interest either to neglect it altogether, or . . . to perform it in [a] careless and slovenly a manner” Adam Smith, *The Wealth Of Nations*, Book V, Chapter I, Part III, Article II. With respect to directors of joint stock companies, Smith observed, that they “being managers rather of other people’s money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of such a company. Adam Smith, *The Wealth of Nations*, Book V, Chapter I, Part III, Article I.

<sup>22</sup>Adam Smith, *The Wealth of Nations*, “Book IV: On Systems of Political Economy — Continuation of Chapter VII (Part III): On the Advantages which Europe has derived from the Discovery of America, and from that of a Passage to the East Indies by the Cape of Good Hope.

<sup>23</sup>“I mean not, however, by anything which I have here said, to throw any odious imputation upon the general character of the servants of the East India Company, and much less upon that of any particular persons.”

<sup>24</sup>“It is the system of government, the situation in which they are placed, that I mean to censure, not the character of those who have acted in it.”

<sup>25</sup>“The real interest of their masters, if they were capable of understanding it, is the same with that of the country, ... [b]ut the real interest of the servants is by no means the same with that of the country[.]”

<sup>26</sup>Smith continues, “and they who have clamoured the loudest against them would probably not have acted better themselves.”

<sup>27</sup>It is curious that Smith mentions that even “the most *perfect information* would necessarily” correct the problem. In a sense, it seems the problem that Smith was describing was one of “moral hazard” as the term is used by contemporary economists (see discussion in text). Today, economists draw a distinction between “perfect information” and “complete information.” Perfect information being knowledge of all actions and events that have previously occurred, while complete information is knowledge of the values and preferences that parties place on all states of the world, as well as their types, strategies and payoffs. Moral hazard may be effectively addressed in a context of “perfect information” (in the modern sense) assuming there are adequate rewards and punishments;

but “complete information” (as defined above) ‘would not necessarily put an end to its oppression,’ so to speak.

<sup>28</sup>Stigler, 148

<sup>29</sup>Sometimes morality was treated as a subset of rationality as a way of addressing the former while holding fast to established notions of rationality. “[M]oral behaviour itself is a special form of rational behaviour.” As John Harsanyi observed, “a rational pursuit of common human and humane interests, which, in my view, is the very essence of morality.” John C. Harsanyi, “Morality and the Theory of Rational Behaviour” in *Utilitarianism and Beyond*, (Amartya Sen & Bernard Williams, eds.) Cambridge Univ. Press, 1982 at 40-1. RELATE: “The social problem is [to] preserve respect for the rules ... This is a moral problem and no reasonable stretching of the word intellectual [i.e., rational] will bring it under that category [as attempted by Harsanyi]. Indeed, if intelligence is to be taken in the instrumentalist sense of power (to get what one wants) now philosophically fashionable (particularly in America, but it is the essence of the whole utilitarian tradition, of which price-theory economics was an integral part) then it is definitely and clearly anti-social in tendency.” Frank H. Knight, *Risk, Uncertainty and Profit*, Reprints of Economic Classics, Augustus M. Kelley Bookseller, New York (1964) in Preface to the Re-issue of (1933) at p. xxxi

<sup>30</sup>See e.g., Michael Spence and Richard Zeckhauser, “Insurance, Information, and Individual Action,” *American Economic Review*, 61(2): 380–87 (1971); Stephen A. Ross, “The Economic Theory of Agency: The Principal’s Problem,” *American Economic Review*, 63(2): 134–139 (May, 1973); Michael Rothschild and Joseph Stiglitz, “Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information,” *Quarterly Journal of Economics*, 90(4): 629–49 (1976); Milton Harris and Artur Raviv, “Optimal incentive contracts with imperfect information,” *Journal of Economic Theory*, 20(2): 231-259 (1979); Steven Shavell, “Risk Sharing and Incentives in the Principal and Agent Relationship,” *Bell Journal of Economics*, 10(1): 55-73 (1979); Bengt Hölmstrom, “Moral Hazard and Observability,” *Bell Journal of Economics*, 10(1): 74–91 (1979); Sanford J. Grossman and Oliver D. Hart, “An Analysis of the Principal-Agent Problem,” *Econometrica*, 51(1): 7–45 (1983).

<sup>31</sup>Most models further assume that the principal is risk-neutral and the agent is risk-averse or judgement-proof. Hence “[t]he principal-agent problem combines two inextricable elements, risk-sharing and differential information.” Kenneth J. Arrow, “The Economics of Agency,” in *Principals and Agents: The Structure of Business* (eds. John W. Pratt and Richard J. Zeckhauser), Boston, MA: Harvard Business School Press (1985) 37–51, at 44. When the agent is risk-neutral the problem dissolve to a relatively trivial case, where the solution is for the principal to sell her interest to the agent for its expected value under the optimal action (this idea was stated in a 1976 working paper by Harris & Raviv, later published in 1979; see also Shavell, 1979). The principal might even finance the transaction if the agent has limited funds. Mechanism design approaches have suggested complex solutions under some information structures, but the basic problem is quite robust.

<sup>32</sup>Tom Baker, “On the Genealogy of Moral Hazard,” *Texas Law Review*: 75(2): 237–292, at 241-2 (1996)

<sup>33</sup>Tom Baker, “On the Genealogy of Moral Hazard,” *Texas Law Review*: 75(2): 237–292, at 241 (1996)

<sup>34</sup>Baker’s claim that economists dispensed with “bad character” needn’t be read as incorrect. Baker’s focus was on the economics of moral hazard—not the economics of information more generally, where bad character (or characteristics) is extensively studied under the headings “adverse selection” and “hidden information”—and so a narrow

reading of the claim would seem most fair. And surely he is correct in asserting that moral hazard in economics today gives no weight to character. “While Arrow clearly demonstrated some regard for character, character nevertheless has disappeared from the economists’ moral hazard analysis. In the process, moral hazard has become exclusively a property of insurance arrangements and not a property of the individuals who enter those arrangements . A second, and related, difference occurs in the metamorphosis of the insurance ‘temptation’ into an ‘incentive.’ Where the insurance writers’ ‘temptation’ evoked a confrontation between good and evil, the economists’ ‘incentive’ evokes a cost-benefit calculation. Both temptation and incentive are matters of degree, but the concept ‘temptation’ gives greater attention to the moral worth of the individual who responds (or not) to the temptation. ‘Temptation’ also leads to a search for a trip point, the point up to which it is safe to go without concern that the individual will succumb to that temptation. 165 Hence, the fire insurer’s concern about ‘gain through loss.’ That gain was a specific one: the ability to get more money from the insurance company upon the destruction of the insured property than through continued operation or sale of the property. The economists’ ‘incentive,’ in contrast, is a force that acts on a population.” [271]

<sup>35</sup>Kenneth J. Arrow, “Uncertainty and the Welfare Economics of Medical Care,” *The American Economic Review*, Vol. 53(5): 941–973 (1963). Though Arrow was unlikely the first economists to use the term, he is rightly credited with popularizing and elaborating its meaning within the discipline of economics.

<sup>36</sup>Mark V. Pauly “The Economics of Moral Hazard: Comment,” *The American Economic Review*, Vol. 58(3): 531-537 at 531, 535 (1968); “Arrow appears to consider moral hazard as an imperfection, a defect in physician control, rather than as a simple response to price reduction.” [535, fn 3 Pauly]

<sup>37</sup>Arrow Reply at 538.

<sup>38</sup>Arrow Reply, 538 (emphasis added).

<sup>39</sup>[pincite]. Frank Knight also appreciated the “beneficent limitation” of moral and ethical conduct rules. “Competitive industry is or hitherto has been saved by the fact that the human individual has been found normally incapable of wielding to his own-advantage much more industrial power than, aided by legal and moral restraints, society as a whole can safely permit him to possess.” Frank Knight, *Risk, Uncertainty and Profit*, at 193. Incorporation of these rules within the rigorous models of conventional economic theory (see e.g., Kaplow & Shavell (2007) and Benabou & Tirole (2011)), argued Arrow, “may ultimately be one of the greatest accomplishments of the principal-agent literature.” Kenneth J. Arrow, “The Economics of Agency,” in *Principals and Agents: The Structure of Business* (eds. John W. Pratt and Richard J. Zeckhauser), Boston, MA: Harvard Business School Press (1985) 37–51, at 50. Louis Kaplow and Steven Shavell, “Moral Rules, the Moral Sentiments and Behavior: Toward a Theory of a Moral System that Optimally Channels Behavior,” *Journal of Political Economy*, 115: 494–514 (2007); Roland Benabou and Jean Tirole, “Laws and Norms,” *NBER Working Paper Series*, Working Paper 17579, (2011) National Bureau of Economic Research, Inc.: Cambridge, MA.

<sup>40</sup>Consider another currently popular American witticism—i.e., “Don’t hate the player, hate the game”—as an indication of the cultural penetration of the acceptance of finding fault with the structure faced by agents, rather than the agents themselves.

<sup>41</sup>Akerlof, 56

<sup>42</sup>“He may be conscious or unconscious of the effect of the experience on his loyalties. And the experience may not only be chosen by himself (or an agent such as his parents acting on his behalf), but instead by another agent acting in his own selfish interest, such as an advertiser interested in fostering brand loyalty to the product he sells, or an employer interested in extracting unselfish performances from his employees.” 55

<sup>43</sup>In contrast to the traditional structuralist view of choices simply reflecting existing and given loyalties.

<sup>44</sup>[54] “Parents wish to maximize their children’s welfare. They can train their children to be dishonest, or they can train their children to be honest.” [56] It is important to stress that in his model, Akerlof assumes that “parents can train their children to *appear* honest. But to make children appear honest, it is easiest to make them also be honest. There is a return to *appearing* honest, but not to *being* honest. It pays parents to teach their children to be honest because the individually functional trait of appearing honest is jointly produced with the individually dysfunctional trait of being honest.” 57

<sup>45</sup>Michael Spence, “Job Market Signaling,” *The Quarterly Journal of Economics*, 87(3): 355–374 (1973).

<sup>46</sup>The importance of this “distinction between appearance and actuality of honesty has been discussed by Max Weber.” 56

<sup>47</sup>For further description, *see e.g.*, Richard R.W. Brooks, “The Holdup Game,” in *The Elgar Companion to Ronald H. Coase* (Claude Ménard and Elodie Bertrand, eds., Edward Edgar, 2016)

<sup>48</sup>[38] Andrei Shleifer and Lawrence H. Summers, “Breach of Trust in Hostile Takeovers,” reprinted in *Corporate Takeovers: Causes and Consequences*, (Alan J. Auerbach, ed.) University of Chicago Press, 1988.

<sup>49</sup>Kenneth J. Arrow, “The Economics of Moral Hazard: Further Comment,” *The American Economic Review*, Vol. 58(3): 537-539 (1968), at 358.

<sup>50</sup>For notions of rational trust or loyalty, *see e.g.*, Russell Hardin’s characterization of *encapsulated trust*, where one party “trusts” a second party because the first knows that it is in the economic interest of the second party to act in a trustworthy manner with respect to the first. Russell Hardin, *Trust and Trustworthiness* (Sage, 2002). Avner Greif similarly characterized this economic incentive (as opposed to an ethical or social motive) to develop a reputation of honesty in his study of the medieval Maghribi Traders. Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders*, 49 J. ECON. HIST. 857 (1989). *See also* Avner Greif, (1993) “Contract enforceability and economic institutions in early trade: The Maghribi traders’ coalition,” *American Economic Review*, 83(3), 525–548.

<sup>51</sup>David M. Kreps, Paul Milgrom, John Roberts and Robert Wilson, “Rational Cooperation in Finitely Repeated Prisoner’s Dilemma,” *Journal of Economic Theory*, 27: 245-252 (1982).

<sup>52</sup>Shleifer and Summers mention Kreps’ (1984) model relaxing the strict rationality assumption (“a rational reputation is modeled as a small probability that the manager is *irrationally honest*,” [at 39, emphasis added].)

<sup>53</sup>pincite

<sup>54</sup>Parties’ ex ante desires are often subverted by their ability to renegotiate arrangements ex post. Whether they can credibly commit to “no renegotiation” and what form that commitment might take are questions that economists have given much attention. Eric Maskin and Jean Tirole suggest that contracting parties could include irrevocable clauses in their contracts, prohibiting renegotiation and stipulating large legally enforceable penalties (i.e., liquidated damage clauses) if renegotiation occurs. Of course, these clauses may themselves be renegotiated by the parties (unless one party will simply not respond to invitations to renegotiate (e.g., persons with beeswax in their ears or with personalities disallowing such considerations). Maskin and Tirole respond to this challenge by pointing out that “the parties could in principle register their contract [clauses] publicly and play out the mechanism before an arbitrator.” American courts, however, have shown great

reluctance to enforce large liquidated clauses. Yet despite this institutional constraint, it is certainly true that parties can credibly commit to “no renegotiation” in varying forms and degrees.

<sup>55</sup>“Whatever the exact mechanism,” loyalty filters, screens or other schemes, “it is essential to see that shareholders *deliberately choose* as managers individuals for whom value maximization is subordinate to satisfaction of stakeholder claims, and then surrender to them control over the firm’s contracts.” Shleifer and Summers, 40

<sup>56</sup>Countering an impulse to leave, Hirschman observes, “loyalty hold exits at bay and activates voice.” [78]

<sup>57</sup>[check quote; Hence, “far from being irrational,” loyalty “can serve [a] socially useful purpose.” [79 (emphasis added)]

<sup>58</sup>[82]

<sup>59</sup>pincite. “This conclusion is a little unexpected[:] ... when loyalty means strong attachment to an organization that does not seem to warrant such attachment because it is so much like another one that is also available.” 81

<sup>60</sup>“Such seemingly irrational loyalties are often encountered, for example, in relation to clubs, football teams, and political parties. . . . Loyalty to one’s country, on the other hand, is something that we can do without, since countries can ordinarily be considered to be well-differentiated products.” 81

<sup>61</sup>“The ultimate difficulties of any arbitrary, artificial, moral, or rational reconstruction of society center around the problem of social continuity in a world where individuals are born naked, destitute, helpless, ignorant, and untrained, and must spend a third of their lives in acquiring the prerequisites of a free contractual existence. The distribution of control, of personal power, position, and opportunity, of the burden of labor and of uncertainty, and of the material produce of social industry cannot easily be radically altered, whatever we may think ideally ought to be done. The fundamental fact about society as a going concern is that it is made up of individuals ‘who are born and die and give place to others; ... The existing order, with the institutions of the private family and private property (in self as well as goods), inheritance and bequest and parental responsibility, affords one way for securing more or less tolerable results in grappling with this problem. They are not ideal, nor even good; but candid consideration of the difficulties of radical transformation, especially in view of our ignorance and disagreement as to what we want, suggests caution and humility in dealing with reconstruction proposals.” Frank Knight, 374-375

<sup>62</sup>Corporate directors, for instance, owe loyalty to their corporations, which is to say to corporate bodies, not to shareholders, individually or the sum of them, or any other affiliated persons.

<sup>63</sup>“Community, nationality, class, race, sex, union membership,” among other social identities, observes Amartya Sen, “can be, depending on the context, crucial to our view of ourselves[,] our welfare, goals, or *behavioral obligations*.” Amartya Sen, “Goals, Commitment, and Identity,” *Journal of Law, Economics, & Organization*, 1(2): 341–355 (1985) [348] (emphasis added) check pincite.

<sup>64</sup>George Akerlof and Rachel Kranton lay the foundation for this model in their model of identity associated with “prescriptions,” which dictate utility-maximizing actions. [cite]

<sup>65</sup>349 (emphasis added)

<sup>66</sup>It is difficult to determine Stigler’s view of the precise relationship between “rationality” and the “ethics” that he identifies in his Tanner lectures. A committed neo-classical theorist, Stigler departs from strict view basic human motivation: “Man is eternally a utility-maximizer, in his home, in his office—be it public or private—in his church, in his

scientific work, in short, everywhere.” However, because utility-maximizing man “can and often does err”, as he observes, Stigler appears to suggest a bounded rationality hypothesis for the existence of these “ethics.” Yet at the same time he warns against “surreptitiously” introducing an implausible “theory of mistakes” as well as “the constant temptation to define the utility of the individual in such a way that the hypothesis is tautological.” 189

<sup>67</sup>[349] Sen’s comment brings to mind John Kennedy’s famous invocation of national loyalty: “ask not what your country can do for you—ask what you can do for your country.” Unlike Stigler, Sen specifies a precise relationship between “rationality” and “commitment.” Cf., Philip Pettit, (2005) “Construing Sen on Commitment,” *Economics and Philosophy*, 21: 15–32, questioning whether Sen’s specification is sustainable.

<sup>68</sup>H.L.A. Hart, *The Concept of Law* at 91 (1961). Again, “internalized” here means internalized into preferences as in the allegiant loyalty approach. Cf. Scott J. Shapiro, “What is the Internal Point of View,” *Fordham Law Review*, 75: 1157–1170 (2006). Rebecca Stone, “Economic Analysis of Contract Law From the Internal Point of View,” *Columbia Law Review*, 116(8):

<sup>69</sup>[189].

<sup>70</sup>George J. Stigler, “The Process and Progress of Economics,” Nobel Memorial Lecture, *Economic Sciences*, 57–76, 8 December, 1982, at 67.

<sup>71</sup>Sen [pincite]. Sen unpacks these assumptions in characteristically insightful and careful manner in [cites].

<sup>72</sup>Named for French mathematician Claude Berge, who first characterized it in his 1957 book, *General Theory on N-Player Games*, the Berge Equilibria has largely evaded the attention of game-theorist for a variety of reasons, including that it was published in French and that it was largely followed up on by Russian scholars, writing in relative isolation from most western game theorist. See, Pierre Courtois, Rabia Nessah and Tarik Tazdat, *How to Play the Games? Nash versus Berge Behavior Rules*, WORKING PAPER [nd]; Andrew M. Colmana, Tom W. Körnerb, Olivier Musyc, Tarik Tazdaït, *Mutual support in games: Some properties of Berge equilibria*, 55(2) J. MATH. PSYCH. 166–175 (2011)

<sup>73</sup>[1967] 2 A.C. 46 (Eng. H.L.), affg [1965] 1 Ch. 992 (Eng. C.A.).

<sup>74</sup>Langbein, John H., *Questioning the Trust-Law Duty of Loyalty: Sole Interest or Best Interest?* 114 YALE L.J. 929, 954-5 (2005).

<sup>75</sup>See D. Gordon Smith, *Efficient Breach of Fiduciary Duty*, WORKING PAPER (2016)

<sup>76</sup>“The theory clearly assumes that the promisor should be allowed to keep his gain, for otherwise he would lose interest in committing the breach that is supposedly so desirable.” Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 4 (1989). See also Posner, ECONOMIC ANALYSIS OF LAW.

<sup>77</sup>When the promisor’s enrichment is not “unjustified,” even the very skeptical RESTATEMENTS (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT would allow retention of profits from breach. [Discuss §39 R3RUE and comments].

<sup>78</sup>At what point in a divorce proceeding should a perviously dependent spouse expect his partner to adopt a non-other-regarding attitude in their related affairs? When are siblings at arms-length or in a confidence relation in a sale of goods or property between the two?