From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm

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I. INTRODUCTION

"What impertinence!" said the Pudding. "I wonder how you'd like it, if I were to cut a slice out of you, you creature!"

WITH regard to good faith and fiduciary duty, we have historically considered only one of the relevant points of view. What-
ever the jurisprudential stripe of the commentators, they have viewed
good faith from the perspective of the active participant, that is, from
the perspective of the person in control. Despite their vastly different
approaches, both traditionalists as well as law and economics scholars
join in seeing the world that way.2

Because a person who consistently views a problem involving two or
more participants from the perspective of the dominant actor is start-
ing from the perspective of the image reflected in the looking

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mirror,3 the tendency will be to extend that perspective to other areas. In the
business arena, the law and economics scholars, the lawyer-econo-
mists, have been most persistent and successful in propagating this
point of view.4 Their perspective has swung the law towards an analy-
sis that systematically favors the stronger party in the contractual or
organizational relationship,5 and that prevents us from considering the
harm inflicted on the weaker party.6 These scholars are imposing just
that perspective when they insist that fiduciary duties are to be op-
tional,7 or that contracts are to be interpreted according to their plain

See infra Part II.A.1. What perspective to take depends on fundamental assumptions
about law. That assumptions underlie the law is not a new concept. See, e.g., LON L. FULLER &
ROBERT BRAUCHER, BASIC CONTRACT LAW 554-59 (1964).

3. See infra Part II.A.1. The scholars I review below may not recognize themselves in this
portrait. That is not proof that the mirror is wrong—ask any anorexic.

4. Persistent: the law and economics scholars have proposed a system that covers the en-
Successful: evidenced by the felt need even of the traditionalists to devote entire articles to re-
buking the lawyer-economists. See, e.g., Thomas Lee Hazen, THE CORPORATE PERSONA, CONTRACT
lawyer-economists’ success is the prominence of their judicial decisions. See, e.g., Jordan v.
Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987)(majority opinion by Judge Easterbrook and
dissent by Judge Posner; discussed infra Part III.B); Kham & Nate’s Shoes No. 2, Inc. v. First
Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) (Judge Easterbrook; discussed infra Part III.C).

5. See infra Part III.A for a discussion of the changes proposed by the Revised Uniform
Partnership Act (1994) [hereinafter RUPA] and that draft’s origins in the law and economics
school, and Part III.C for a discussion of Judge Easterbrook’s decision in Kham & Nate’s
Shoes.

6. The newness of the perspective is necessarily relative given that theories tend to be cyc-
clical. As is evident from Part II, infra, the law and economics school has had a very significant
influence on focusing any analysis on the actor. However, the perspective for analysis of fiduci-
ary duty as distinguished from good faith has historically started with the interests of the benefi-
ciary. See, e.g., Chiles v. Robertson, 767 P.2d 903, review denied, 784 P.2d 1099 (Or. 1989). See
generally Lawrence E. Mitchell, THE DEATH OF FIDUCIARY DUTY IN CLOSE CORPORATIONS, 138 U. PA.
L. REV. 1675, 1696 (1990). Professor Mitchell focuses less on the minority shareholders as benefi-
ciaries than on the fear that they would use the majority shareholders’ fiduciary duties as a
sword. Id. at 1730.

7. See infra Parts III.A & B; the law and economics scholars support optional fiduciary
duties for partners, see RUPA § 404, and for controlling shareholders, see Jordan, 815 F.2d 429.
For the historical importance of the beneficiary in judiciary duties, see supra note 6. The lawyer-
economists’ reasoning is ostensibly that mandatory fiduciary duties impose costs on society. See
generally infra Part II.A.1 (discussing the lawyer-economists’ devotion to economic efficiency,
and their resultant rejection of mandatory fiduciary duties).
meaning. In each case, the analysis neglects the consequences to the victim in the transaction because those consequences are merely costs, and these costs are deemed to have been accepted by both parties.

If we allow the victim, the person behind the looking glass, to speak, we are automatically providing balance by listening to both parties, not just the actor. It is important to appreciate that, despite the lawyer-economists' assertions to the contrary, a party to a transaction can indeed suffer harm. Further, this harm will be uncompensated if it is permitted. Whenever society permits a particular act, it is simultaneously authorizing all consequences of that act. Therefore, if parties to a business organization are not subject to fiduciary duties, the actor is permitted to compete with its own business organization.

Any harm to the co-owner, the victim, is then permitted. When society interprets a contract to permit the actor to hide information from the other party, any harm inflicted on that victim by the failure to disclose is permitted harm.

This concept of permitted harm is familiar in tort law. The purpose of this Article is to show that the same concept adds a valuable perspective when analyzing performance in business relationships, too. The scope of this Article, therefore, is limited to non-consumer, commercial, and business relationships: the context in which it is

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8. See infra Part II.C; Jordan, 815 F.2d 429 (Posner, J. dissenting); and Kham & Nate's, 908 F.2d 1351 (Easterbrook, J.).
10. See infra Part II.A.1, describing how the law and economics school improperly defines all harm as a relatively neutral "cost."
11. See, e.g., infra Part II.B for a discussion of current doctrine.
12. See infra text accompanying note 69.
14. To facilitate the comparison of fiduciary duty to good faith, even the discussion of good faith focuses on the obligation in the context of performance, not in the context of precontractual dealings or of enforcement. For the relevance of the distinction, see generally Robert S. Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 VA. L. REV. 195, 220-43 (1968); Market St. Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (Posner, J.).
15. Courts have, of course, sought to apply contractual concepts to relationships that have a questionable mercantile feel. See, e.g., Marvin v. Marvin, 557 P.2d 106 (Cal. 1976), on remand, 176 Cal. Rptr. 555 (1981), and Hewlitt v. Hewlitt, 394 N.E.2d 1204 (Ill. 1979). See also Clare Dalton, An Essay in the Deconstruction of Contract Doctrine, 94 YALE L.J. 997, 1096-1113 (1985) (discussing the courts' difficulties with cohabitation arrangements purported to be contracts).
16. I believe that using such ersatz examples simplifies the task of justifying looking from the victim's perspective. It is not by accident that the most famous case in unconscionability depicts the abuse of a consumer. See Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965). For this reason, I will be using cases that are as purely commercial as possible when discussing good faith and fiduciary duty.
hardest to make the case for a victim. Similarly, the discussion of fiduciary duty focuses on the duty of loyalty because it is the most unrelenting duty, and therefore the one that is most difficult to justify in mandatory form.\(^\text{17}\)

Recognizing the existence of harm potentially or actually inflicted on the victim is a first step; however, it fails to answer two questions. First, how does this concept articulate more clearly than do other theories the current status of commercial and business law? Second, to what extent does the permitted harm perspective provide meaningful guidance to both judges and business people in those circumstances not yet embedded in settled law?\(^\text{18}\)

In order to answer these two questions, I introduce a construct that highlights an important reality: that good faith and fiduciary duty now limited liability companies (LLCs), have evolved in the shadow of partnerships and corporations. The Revised Uniform Limited Partnership Act § 1105 (1994), states that the Uniform Partnership Act applies where there are gaps; the former does not explicitly address fiduciary duties. The debate with respect to limited liability companies is ongoing. See Robert R. Keatinge et al., The Limited Liability Company: A Study of the Emerging Entity, 47 Bus. Law. 375, 401 (1992). The authors suggest that fiduciary duties for members of LLCs will probably evolve in a bifurcated fashion: general partnership version for member-managed LLCs, corporate director version for the managers of manager-managed LLCs. Presumably, in the category of manager-managed LLCs, the non-manager members would have shareholder-style fiduciary duty. \(^{\text{Id.}}\) For a brief discussion of specific state LLC statutes as they apply to fiduciary duties, see \textit{id.} at 416-17.

\(^{\text{17}}\) In this Article, the terms "fiduciary duty," "duty of loyalty," and "fiduciary duty of loyalty" are used interchangeably. In addition to the duty of loyalty, the only other major candidate for a fiduciary standard is the duty of care. \textit{Restatement (Second) of Agency} §§ 377-398 (1957) (describing other fiduciary duties, but these are essentially subsets of the duties of care and loyalty). See generally Claire Moore Dickerson, \textit{Is it Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act,} 64 U. Colo. L. Rev. 111, 117, 120 (1993). The conflict of interest aspect of fiduciary duty is not inevitable there. For example, the agent's duty to act with the skill typical for the locality and for that kind of work, after taking into account the agent's particular degree of skill, is a duty that must be met even if the agent has no reason to want a different result. \textit{Restatement (Second) of Agency} § 379(1) (1957) (referring to paid agents, but, as we are discussing commercial relationships, this seems appropriate). The main thrust of the duty of care is to avoid shirking, \textit{i.e.}, to avoid the sin of omission, rather than to avoid the sin of commission targeted by the duty of loyalty.

Further, the duty of care itself is one that leaves considerable room for varied behavior. The standard proposed by the \textit{Restatement (Second) of Agency} is further weakened by the business judgment rule that some would apply even to partnerships. See, \textit{e.g.}, Dickerson, supra, at 120 & nn.44-45. There has been much development in the duty of care under corporate law, some of it to tighten the application of the duty of care, especially in the context of takeovers. See, \textit{e.g.}, Dickerson, supra, at 137. States have also adopted new statutory provisions permitting opting out of the duty of care. See, \textit{e.g.}, \textit{Del. Code Ann. tit. 8, § 102(b)(7)} (1991); see generally John C. Coffee, Jr., \textit{The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role,} 89 Colum. L. Rev. 1618, 1650-51 (1989). Because the duty of loyalty is the more unrelenting fiduciary duty, it should be the hardest to justify. For ease of discussion, I will therefore focus only on the duty of loyalty.

\(^{\text{18}}\) See \textit{infra} text accompanying notes 152-72 (concerning the need for predictability).
represent application of the same parameters to facts at opposite ends of a single continuum.\(^9\) If the structure of the relationship creates no more power and no greater conflict of interest in the actor than in the other party, the transaction is at the good faith end of the continuum. In contrast, if the structure of the relationship grants extensive power to the actor, and puts it in a position of significant conflict of interest vis-à-vis the other party, the transaction is at the fiduciary duty end of the continuum. Thus, because the power and conflict of a partner inherent to the partnership form is greater than the power and conflict of a party to a garden-variety contract,\(^20\) the partnership is higher on

\(^{19}\) In Market St. Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 594 (7th Cir. 1991), Judge Posner writes that the duty of good faith "is, as it were, halfway between a fiduciary duty (the duty of utmost good faith) and the duty merely to refrain from active fraud." I am not certain that I would place good faith in the middle of the no-fraud versus fiduciary duty continuum, but I agree that good faith and fiduciary duty belong on the same line. The concept of the continuum has been raised before. Professor Hazen attributed the idea to Professor Coffee. See Hazen, supra note 4, at 286. Professor Coffee has discussed good faith and fiduciary duty in the context of corporations, and has compared the consequences of applying these different doctrines from different sources. See Coffee, supra note 17, at 1618, 1653-64. However, while Professor Coffee did reflect on two circumstances where the result could be explained either as good faith or as fiduciary duty, Coffee, supra note 17, at 1655, 1661 (citing Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 88 DUKE L.J. 879, 893 (1988)), he does not consider the different levels of good faith. He focused on the reasons a corporation is not a contract, and on why a pure fiduciary duty is not appropriate either. See, e.g., Coffee, supra note 4, at 1659-62 (disagreeing with the contractarians). On balance, he seems to focus on a discontinuity, rather than on a continuum. Others, too, who have compared good faith and fiduciary duty directly have not discussed the different levels of good faith. See, e.g., Marleen A. O'Connor, Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers, 69 N.C. L. Rev. 1189, 1250-51 (1991). What Professor O'Connor and others (see DeMott, supra note 19, at 900) do emphasize is that there is a substantial procedural difference between good faith and fiduciary duty. Because a plaintiff bears the burden of proof, if it charges that the defendant lacked good faith, the plaintiff must so prove. In contrast, typically, if a plaintiff-beneficiary charges a fiduciary with breach of fiduciary duty, it is the fiduciary who must demonstrate that the transaction was fair. There is an interesting decision of New York's Court of Appeals wherein the dissent implicitly asks whether there is any reason to distinguish between good faith and fiduciary duty. Of course, the dissent takes that position because it believes that the relevant behavior is a breach of good faith as well as of any fiduciary duty. Northeast Gen. Corp. v. Wellington Advertising, 624 N.E.2d 129, 139 (N.Y. 1993) (Hancock, J., dissenting). But the dissent focuses on issues of power and conflict, and these are precisely the issues that identify the place occupied on the continuum by both good faith and fiduciary duty. Id. at 130-39. This particular case is beyond the scope of this Article. Although it is commercial in the sense of being a finder case, it is also arguably less commercial than the cases I am discussing, due to the particular relationships of the parties. Finally, other scholars have more generally questioned how fiduciary duty fits into the different legal disciplines. See, e.g., Deborah A. DeMott, Fiduciary Obligation Under Intellectual Siege: Contemporary Challenges to the Duty To Be Loyal, 30 OSGOODE HALL L.J. 471 (1992).

\(^{20}\) See infra part II.B; the partnership is higher on the continuum. The actor's conflict is in inverse proportion to the actor's investment in the transaction. Id.
the continuum. This first analysis is, however, only the first, rough cut. To refine the process, we must consider the extent of harm perceived by the victim, and the harm that would be permitted.\textsuperscript{21} It is by acknowledging that the actor is permitted to inflict greater harm on the other party if the standard of performance is good faith as opposed to fiduciary duty that we benefit from the additional perspective of the victim. If the harm is or potentially would be significant, it is appropriate to ask whether that harm should be permitted by society. The significance of the actual or potential harm that would be permitted in turn confirms the probable existence of substantial power and conflict in the actor, as well as the appropriateness of a high standard of performance for the actor.\textsuperscript{22}

This Article will show that, although a conscious recognition of the harm permitted to be inflicted on the victim does represent an attitude different from that currently in vogue, the results of the permitted harm perspective explain established doctrine better than do the more descriptive traditionalists.\textsuperscript{23} To that extent, the combination of the perspective with the continuum provides predictability to transactions of a type familiar to the current legal system.\textsuperscript{24} An important value of the permitted harm perspective when used with the continuum is that it also provides guidance to both the parties and the courts in those areas of business law that are unsettled.\textsuperscript{25} A systematic acknowledgement of the victim, and of the harm society permits the actor to visit on the victim, does call for results different from those proposed by the law and economics scholars.\textsuperscript{26} Importantly, the consequence of applying the permitted harm perspective in these new areas results in a balancing of the victim’s interests with those of the actor, in a way that conforms to how businesses actually operate.\textsuperscript{27}

Part II is divided into three sections: a discussion of harm and permitted harm; an explanation of the continuum; and a description of

\begin{itemize}
\item \textsuperscript{21} See infra Part II.B.
\item \textsuperscript{22} See infra Part II.C. An additional aspect of the continuum is that, to increase its effectiveness as a provider of guidelines, and therefore as a predictor of legal consequences, the performance standards vary in quantum leaps and depend in part on the formal structure of the transaction. See infra text accompanying notes 149-51.
\item \textsuperscript{23} See infra note 165 and accompanying text.
\item \textsuperscript{24} See infra Part II.C; the permitted harm perspective and continuum together track current doctrine to the extent that doctrine exists.
\item \textsuperscript{25} See infra Part III for the application of the permitted harm perspective and the continuum to unsettled areas of business law (including contract law).
\item \textsuperscript{26} Part III, infra, shows that the permitted harm perspective and continuum reject RU-PA’s elimination of mandatory duties, and the lawyer-economists’ mechanical adoption of plain-meaning interpretation of bargains.
\item \textsuperscript{27} See infra text accompanying notes 156-60 concerning the relational-contract theorists and, especially, the empiricists.
\end{itemize}
the permitted harm perspective as a necessary refinement that responds to the business community's need for predictability. Part III then applies the permitted harm system to three areas of the law currently in flux. Toward the fiduciary end of the continuum, part III considers both the recent proposals to overhaul partnership law to permit opting out of fiduciary duties, and the standard of performance applicable to controlling shareholders seeking to purchase directly or indirectly the shares of co-owners. On the good faith end of the continuum, part III focuses on loan agreements and on the level of good faith obligation owed by an actor who has acquired power over—and is in conflict with—the other party to the transaction.

II. PERMITTED HARM AND THE CONTINUUM

As explained below, the active party in a business transaction is permitted to inflict harm on the other party. Although not articulated, this fact is central to our legal system and to the theories currently in vogue. By also understanding that good faith and fiduciary duty are in fact the same standards of performance at different points on a single continuum, we can refocus our perspective to include that of the victim as well as the actor. If we then recognize the harm permitted to be inflicted on the victim, and acknowledge the actor's power and conflict, we have guidelines by which to identify the standard of performance to be applied to the actor.

A. Permitted Harm

There are two components to permitted harm: harm, and the permitted act that gives rise to permitted harm. The first question is: What is harm?

1. Harm

By definition, harm must be uncompensated. The victim who is fully compensated is not harmed. Second, harm cannot be defined

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28. See Part III.A.
29. See Part III.B.
30. See Part III.C.
31. There is extensive literature concerning compensation, i.e., the inadequacy of contract damages; however, the focus is not on "permitted harm." Instead, at the heart is the concept of efficient breach. See, e.g., infra text accompanying note 52. See generally Jules L. Coleman, Efficiency, Utility, and Wealth Maximization, 8 Hofstra L. Rev. 509 (1980). For a focus on the tort of bad faith, see, e.g., Thomas A. Diamond, The Tort of Bad Faith Breach of Contract: When, if at All, Should it Be Extended Beyond Insurance Transactions?, 64 Marq. L. Rev. 425 (1981). Other literature focuses more directly on the types of remedies. See, e.g., Patricia H.
purely from the perspective of the actor; the victim's perspective is relevant. For example, in a case for breach of contract, it is not only the defendant's perception of its own performance that is considered. To take only the defendant's perspective is to approve the parent who says, "I'm cold; put on your jacket." Despite the evidentiary relevance of the victim's point of view, the structure of contract law and that of the law of business organizations strongly favors the perspective of the actor.

Assume that B (Beneficiary) agrees to sell parcels of land to F (Fiduciary), and that the contract price depends on F's success in reselling the parcels. The active party, the actor, will be F. B receives nothing unless F succeeds in its performance. The actor's image as active participant is what most of us would like to see when we look in the mirror. The law, similarly, is concerned with the active participant, not the relatively helpless victim. For example, the traditionalist scholars who seek to describe the current state of the law on good faith performance, focus on the actor, F in my example. The traditionalist description of contract contained in the Restatement (Second) of Contracts is expressed in terms of the actor's performance. Professor Robert Summers has explained good faith as including avoid-


32. F is either the fiduciary in a fiduciary relationship, or it is the fiduciary-analogue in a contractual one, i.e., the person who owes the obligation of good faith. B is the beneficiary in a fiduciary relationship, or the beneficiary-analogue in a contractual one.


34. The traditionalists are also called neoclassicists. See, e.g., E. ALLAN FARNSWORTH, CONTRACTS § 1.8, at 31 (2d ed. 1990).

35. RESTATEMENT (SECOND) OF CONTRACTS (1979). Although certain sections of the Second Restatement are generally viewed to be innovative, one of the Reporters has confirmed that its policy is to follow precedent. See, e.g., FARNSWORTH, supra note 34, § 2.19, at 96 (concerning § 90 on promissory estoppel). Professor Farnsworth was a Reporter for the Second Restatement from 1971 through 1981; Justice Robert Braucher had been a Reporter from 1964 to 1971, including for Chapter 4 in which § 90 is found. Professor Farnsworth himself describes his own work, including the treatise cited in this note, as "traditionalist." FARNSWORTH, supra note 34, § 1.8, at 31 n.16.
ance of the following: evasion of the spirit of the deal,\textsuperscript{36} a lack of diligence and "slacking off,"\textsuperscript{37} and adoption of a "weaseling" interpretation or construction of the contract language.\textsuperscript{38} Each of these refers to the actor's performance in bad faith (good faith is everything else).\textsuperscript{39} Has F been slacking off or weaseling? This interest in F's doings hides the harm suffered by B, the victim. Harm is not the traditionalist's focus because it is not the law's focus.

The law and economics scholars, as well as the traditionalists, view the issues of good faith and fiduciary duty from the actor's perspective.\textsuperscript{40} They, too, prefer to ignore the image of the victim. What makes the law and economics scholars unique, is that they do consider the issue of harm. However, they generally conclude that the individual players in a business transaction do not suffer any harm. The only "party" subject to harm is society at large.\textsuperscript{41} This is consistent with

\begin{itemize}
  \item \textsuperscript{36} Summers, supra note 14, at 195, 234-35.
  \item \textsuperscript{37} Id. at 235-37.
  \item \textsuperscript{38} Id. at 244-46. There are others which could be open-ended too (e.g., interfering or failing to cooperate with the other party's performance, or taking advantage of another to get a favorable readjustment or settlement), but this is a good representative sample. Id. at 241, 246.
  \item \textsuperscript{39} See Summers, supra note 14. Professor Summers describes his method as defining good faith as an "excluder." That is, the term serves to exclude bad faith, and a judge should first identify what is bad faith, and the rest is good faith. Id. at 201, 207. This is what Professor Summers recommended for the Uniform Commercial Code as well. Id. at 215. If all of this seems circular, that is a result of a purely contextual definition.
  \item \textsuperscript{40} For example, a leading lawyer-economist has reflected the point of view of the actor rather than the victim when emphasizing that partners "often negotiate in detail or are participating in sophisticated, idiosyncratic tax-motivated deals...." Larry E. Ribstein, The Revised Uniform Partnership Act: Not Ready for Prime Time, 49 BUS. L. 45, 58-59 (1993).
  \item \textsuperscript{41} Law and economics scholars have expressly referred to "harm," but have not used it as a technical term. See, e.g., Posner, supra note 4, § 1.2 at 14 (harm as inflicted by the buyer and seller on third parties). As to the uniqueness, the communitarians may argue that they are concerned with the victim's harm, because they believe that the actors must live up to their responsibilities. See, e.g., Amitai Etzioni, The Spirit of Community 9 (1993). In fact, however, the focus remains on the actors and their responsibilities, rather than the perspective of the others.
\end{itemize}
the focus on the actor, but it is incompatible with my proposal that we consider also the victim's perspective. If there is no harm to individual parties, not only do we not need to consider permitted harm, but even the concept of a victim becomes hard to defend. The lawyer-economists' focus on harm to society reflects the law and economics scholar's concern with the allocation of resources on a macro scale: each transaction should be "efficient," so that the goal of societal wealth maximization can be achieved. To be efficient, as the term is used by the lawyer-economists, there must be no other transaction that would make these parties gain more than the third-party losers would lose, assuming the losers were compensated by the winners.

Let us see what happens to the law and economics scholar's rejection of individual harm under efficiency analysis when two parties to a business transaction voluntarily choose to impose the higher fiduciary duties on F, the actor, instead of the lower good faith standard. Assume that F and B intend F's responsibilities in the course of F's resale of B's parcels to include fiduciary duties instead of mere good faith. The law and economics scholars believe that the parties, by agreeing to any increased costs relating to the higher standard of performance, have necessarily been compensated for that cost. Under

42. See, e.g., Posner, supra note 4, § 2.2, at 23.
43. The law and economics scholars assert that a proper system of laws must be efficient in the economists' meaning of that term. To that end they start with the economic concepts of Pareto superiority and Kaldor-Hicks efficiency. See, e.g., Posner, supra note 4, § 1.2, at 13-15; see also Jules L. Coleman, Markets, Morals and the Law 71-72, 84-86 (1988); Coleman, Efficiency, supra note 31, at 512-13. If an allocation of resources hurts no one and at least one person is improved, it is Pareto superior. The allocation is Pareto optimal if there is no possible Pareto superior allocation. In contrast, Kaldor-Hicks efficiency is achieved when the benefit to the winners would exceed harm to the losers, if the winners compensated the losers. See, e.g., Posner, supra note 4, at 13-15; Coleman, Markets, supra, at 71-72, 84-86; Coleman, Efficiency, supra note 31, at 512-13. It does not require that compensation actually be paid to the losers; if it did, the allocation would become Pareto superior. See, e.g., Coleman, Efficiency, supra note 31, at 513. The law and economics scholars relate these concepts of efficiency to fiduciary duty and to good faith because they understand efficiency to require free bargaining. The individual parties are those who best understand the value to them of the subject of the contract. See, e.g., Posner, supra note 4, § 4.1, at 93.


44. See infra part II.B for a discussion of the relative levels of fiduciary duty and good faith as standards of performance.

45. The assumption is that the cost to perform to a standard rises with the standard. For example, fiduciary duties can drive up the cost of stock if the directors demand more compensa-
this analysis, the parties are the persons best suited to value their transaction, and they chose that cost. The cost has therefore been "internalized;" there is no harm. So far, the result is entirely compatible with the lawyer-economists' rejection of individual harm. A core concept of mainstream lawyer-economists is that society consequently does not care whether F is bound to fiduciary duties. If fiduciary duties are not mandatory, B will pay F to impose the duties on F only if B values their benefit more than F fears their burden. Conversely, even if F starts out with the duties, F will pay B to be relieved of them, only if it costs F more to comply with the duties than the value B derives from having F subjected to them. Therefore, say the lawyer-economists, so long as fiduciary duties are the object of bargaining, F will be subjected to them, or not, depending on the relative value placed on those duties by the parties. F and B are the only persons concerned; their freely bargained decision will be efficient because the parties are presumed rational.

If, instead, F has been subjected to fiduciary duties that F and B did not want, F has more costs in the performance of its resale than...
it wanted, assuming that it costs more to perform to a higher standard. F will seek to pass at least some of the costs to B, who will also have more costs than it intended. Because F and B determine the value of their transaction, they have been forced to allocate more to their relationship than the value they receive; that is inefficient. While F and B may be unhappy to be allocating resources other than as they want, this unhappiness is due to increased cost. Because they are in business, they will in turn pass on to their respective customers as much of that cost as possible. To the extent that their competitors are similarly subject to mandatory fiduciary duties, F and B should be able to pass on the costs. Therefore, it is only society that has been harmed by this inefficient allocation of resources, not the individual parties.\footnote{51}

for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

Despite the narrow language of UPA § 21, the courts have found in it a broad-based fiduciary duty, including in particular, a duty of loyalty. Therefore, once there is a partnership, there is fiduciary duty. See generally Bromberg & Kirstein, supra, § 6.07, at 6:72. Dickerson, supra, at 427. See also Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). The UPA was enacted by New York State in 1919, three years before the acts challenged in the case, but then-Judge Cardozo did not refer to the UPA. Cardozo's omission may be because the relationship in question probably was neither a true joint venture nor a partnership. See Dickerson, supra, at 106 n.7; Jennison v. Bierer, 601 F. Supp. 1167, 1177 (D. Vt. 1984) (relations between partner highly fiduciary; trustees in all dealings with partnership property); Cude v. Couch, 588 S.W.2d 554, 555 (Tenn. 1979) (duty in all matters relating to partnership).

51. When law and economics scholars have considered injury to a party that remains uncompensated, they have often preferred to call it an externality, or yet more precisely, an externalized cost. A suggested definition of an externality is "something which cannot be the subject of a transaction (cannot be internalized in the market process) or . . . a harm or benefit to third parties whose costs to transact concerning the effect are greater than the gains from internalization . . . ." Mary L. Lyndon, Secrecy and Innovation in Tort Law and Regulation, 23 N.M. L. Rev. 1, 43 n.218 (1993). To focus on the second clause, consider that a person who tears down a building or a series of buildings to protect the rest of the city from fire will not be liable to the owners for the cost of the destruction; that cost is externalized. Posner, supra note 4, § 6.9, at 190-91. Judge Posner has drawn the illustration from the great fire of London in 1666 where the Lord Mayor refused to order the destruction of houses in order to create a firebreak, saying that he did not know who would pay for the damage. Id. § 6.4, at 174 n.6. Assuming that the Mayor held back because of fear that the city would have to pay the homeowners if he gave such an order, failure to externalize the cost (i.e., imposing the cost on the creator of the firebreak) would create the greater harm.

An externality can be positive too. The person who creates the firebreak cannot collect the benefit derived by those persons whose buildings were protected by that destruction. Posner, supra note 4, § 6.9, at 190-91. However, that is not the focus of this Article. The reason why the firebreak example is useful here is because the destruction of a building to create the firebreak represents an uncompensated injury. Permitted harm will by definition be uncompensated.

The firebreak example of an externality is a particularly easy one because the owners whose buildings are destroyed are not in any direct relationship with the one who creates the firebreak. It is therefore especially difficult to find a transaction in which the cost of the destruction is
The focus of the lawyer-economists, then, is on F’s increased cost when performing, because that ultimately becomes harm to society. Whether F shoulders the increased burden of fiduciary duties should be a matter between F and B only. To include a state-mandated standard decreases efficiency and harms society. As the discussion implies, these conclusions are based on the lawyer-economists’ quest for efficiency. Critics of the law and economics view have questioned the lawyer-economist’s claim that efficiency is an appropriate goal, arguing that efficiency favors the stronger. For example, the efficiency described by mainstream lawyer-economists will not in fact be at-

taken into account. In contrast, as soon as there is a direct relationship between the parties, it is hard to find that the costs have not been internalized. If a cost is internalized, by definition it has been taken into account by the parties. For example, if the parties are allowed to opt out of fiduciary duties, and the parties meaningfully agree to do so, they have taken the costs into account. See generally Burton, supra note 40 (a contract as a promise to forego opportunities). The law and economics scholars would find no externality, no externalized cost. That is, they would find no harm at all. The parties bargained for the elimination of the fiduciary duty and each party was compensated for that waiver.

The lawyer-economists base their conclusion on the view that F and B know best how they value the different standards of performance, and that they are essentially rational. See supra note 49. Society is interested in their decision only to the extent that it desires an efficient allocation of resources. See, e.g., Daniel Friedmann, The Efficient Breach Fallacy, 18 J. LEGAL STUD. 1, 4 (1989). When discussing the law and economics scholars’ approval of the efficient breach (not permitted harm), Professor Friedmann emphasizes: “[t]he ‘right’ to break a contract is not predicated on the nature of the contractual right, . . . [but r]ather on the ground that the breach is supposed to lead to a better use of resources.” Id.

The same analysis applies to good faith, but even Judge Posner says opportunism is not permissible behavior, otherwise the costs to monitor become too high. See, e.g., Market St. Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 594 (7th Cir. 1991) (Posner, J.); Posner, supra note 4, § 4.8, at 117-18. See also Burton, supra note 40, at 372 (less than fraud as violation of duty of good faith). 393 (opportunistic behavior as not socially productive). But see Friedmann, supra, at 4 (challenging the illogic of Judge Posner’s rejection of an opportunistic breach even when it is efficient).

An opportunistic act is one that takes advantage of the other person’s vulnerability. See, e.g., Timothy J. Mutsis, Opportunistic Behavior and the Law of Contracts, 65 MINN. L. REV. 521 (1981); see also Oliver E. Williamson, The Economic Institutions of Capitalism 77 (1985); see infra note 155.”

In that case, B should be compensated, and therefore not be harmed. Considerable ink has been spilled over the inadequacy of compensation in general. See supra note 31.  

See Duncan Kennedy, Cost-Benefit Analysis of Entitlement Problems: A Critique, 33 STAN. L. REV. 387, 424 (1981) (critique by a critical legal studies scholar). See also Markovits, supra note 43, at 1176-77, 1194 (assuming that the goal is utility). For a lawyer-economist who focuses on transactions involving strong, well-established participants, see, e.g., Ribstein, supra note 40, at 60 n.110 (responding to my choice-of-form argument for mandatory fiduciary duties, Professor Ribstein emphasizes that partnerships range “from sophisticated investment partnerships to family grocery stores;” the impact on family grocery stores impliedly is relatively less important). See generally Lynne L. Dallas, Two Models of Corporate Governance: Beyond Berle and Means, 20 J.L. REFORM 19, 26 (1988) (in which she identifies a central question as being “efficient for whom?”).
tained if a party's resources are insufficient. Imagine that B does value being protected by fiduciary duties more than F fears the burden, but that B does not have the money to pay F's valuation. As a practical matter, B will not be able to convince F to adopt or retain fiduciary duties if these are optional. F would be subject only to the lower, good faith standard because of B's lack of resources. F then buys and sells other parcels in competition with those F has contracted to purchase from B. This competition is permitted under the good faith standard.

The law and economics scholars would respond that this scenario can never harm B, where B and F have entered into a contract, as they have done when F agreed to buy B's parcels for resale. F did not want to be subject to fiduciary duties and was not; therefore, F will not have been harmed. As to B, it is inappropriate to suggest, in the context of a commercial relationship between F and B, that B would ever value the protection of fiduciary duties more than it has the resources to pay. In commerce, the profits, including any non-monetary benefits that B expects from the transaction, define the maximum value to B of F's fiduciary duties. B will thereafter always have the necessary resources derived from the benefits expected from that very transaction. B can reduce F's purchase price for the parcels until B's expected benefits approach zero; below that, B will prefer to sell the parcels directly to the customers. If harm means only cost, B is not harmed. While B would have preferred F to be subject to fiduciary

55. See, e.g., Kennedy, supra note 54, at 424; see also, Markovits, supra note 43, at 1193.
56. This is common commercial practice; consider how many different brands of competing products are sold by typical retailers.
57. Some lawyer-economists expressly recognize "'non-monetary values.'" Markovits, supra note 43, at 1174.
58. This conclusion is inherent in the law and economics school's fundamental concept that the parties can best value what they derive under a contract. See, e.g., Posner, supra note 4, § 4.1, at 93. Even if B were to accept a loss in the first part of a longer relationship with F, B will go out of business unless it can expect to recoup its losses later in the relationship. This is the critical difference between F as polluter and B as water-user in Kelman, supra note 47, at 671-72. When there is no relationship between B and F, we can reasonably posit a circumstance where the value that B places on clean water is greater than the cost to F of avoiding polluting, but that B does not have the resources to pay even F's lower cost. That is a distributive inefficiency. See, e.g., Markovits, supra note 43, at 1192-94. However, a B that does have a commercial relationship with F and expects to stay in business could not value the fiduciary duties of F more than B's expected return from the relationship. Even if B is very risk averse and fears liability in excess of its investment, if B calculates that risk, multiplied by its probability to exceed B's expected return, B will not enter into the contract. Therefore, by accepting the contract without F's fiduciary duties, B is expressing that it values the contract in an amount that is not less than B's risk of loss from behavior by F that would be permitted under a good faith standard but not under a fiduciary duty standard. In turn, that amount is the maximum value to B of F's fiduciary duties, since it is the value of the benefit provided by those duties.
duties, B did not pay to have F so subjected. B did get what it paid for. Even society has not been harmed; fewer resources than expected were allocated to that transaction.\(^5\)

But is it truly correct to say that B is unharmed? When the lawyer-economists consider valuation, they assume freedom of contract.\(^6\) When they defend the application of their analysis, they emphasize the parties' sophistication and general ability to decide freely.\(^6\) This highlights the difficulty of analysis when the parties are not of even strength. The lawyer-economists insist on freedom of contract, and assume a level playing field. In fact, the greater B's vulnerability, the more B needs to have F held to a higher and higher standard. Because the lawyer-economists reject a mandatory high standard, a weaker B will have to give up more return than would an inherently stronger B in order to obtain a transaction from F that provides reasonable protection.\(^6\)

The legal system espoused by the lawyer-economists makes it unlikely that a weaker B can have an economically viable transaction with F. The weaker B is, the more expensive B's transaction becomes, since B needs more protection and must pay for it.\(^6\) If the weaker B can and does pay for some protection, for B the transaction has become more expensive and less profitable than that of a stronger B. Even if no B could buy any protection from F in the context of a particular transaction, a weak B's costs still are higher than those of a strong B because the weak B's risks are greater. In either case, a weaker B is at a competitive disadvantage as compared with a stronger B. A weaker B has neither the desired protection of F's full fiduciary duty, nor the protection of the monitoring that it presumably cannot

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59. Because inefficiency is manifested by the allocation of excessive societal resources to a transaction, see supra text accompanying note 51, there can be such harm to society only if B expends more resources to monitor F than F would have spent to perform up to the fiduciary duty. However, we have here stipulated that B does not have the resources to pay F more than B derives from the transaction, let alone to pay any higher amount to monitor F.

60. See, e.g., Posner, supra note 4, § 4.1, at 93.

61. See, e.g., Ribstein, supra note 40, at 59.

62. An obvious example of the weaker B's need for greater protection can be seen in the content of the inherent inadequacy of contract remedies. Any practitioner has war stories about business people who breach with the knowledge that the other party does not have the resources to litigate. The adequacy of contract remedies is referred to in note 31, supra, but is not the focus of this Article.

63. See, e.g., Stewart Macaulay, Non-Contractual Relations in Business: A Preliminary Study, 28 Am. Soc. Rev. 55, 63 (1963) (discussing a purchaser's ownership interest in its supplier as affecting the parties' behavior). Every aspect of the parties' status can affect their relative strength; even the debtor's near-bankruptcy can strengthen its negotiating hand. See, e.g., Stewart Macaulay, An Empirical View of Contract, 1985 Wis. L. Rev. 465, 476-77.
afford. Additionally, a weaker B does have to compete against other Bs who are automatically better protected because of their strength relative to F. The weaker B would claim harm even though all topics were technically subject to free bargaining, and even though F has performed to the requisite standard. Because B's lack of resources amounts neither to duress nor to fraud, the harm remains uncompensated. Again, the stronger F is relative to B, the more likely B will be harmed without adequate recourse.

2. Harm that Is Permitted

To acknowledge that B sees itself as having been harmed does not necessarily mean that the legal system must endorse that claim. Whether society should recognize harm is immediately important if B as victim is seeking compensation, because of the need for direct governmental intervention in awarding a remedy. But if the harm to B were caused by F's permitted acts (for example, by F's competition with B while acting in conformity with the applicable good faith standard), then the harm is itself permitted and will not give rise to a remedy. Instead, the victim's perception of harm is incorporated into the concept of permitted harm.

64. If B sought fiduciary protection, this solution must be cheaper for B than would be the cost of monitoring F. If, as we posited, B cannot afford the fiduciary protection, it necessarily cannot afford the even higher cost of monitoring.

65. Law and economics scholars, too, would approve a cause of action if B could prove duress or fraud. See, e.g., Posner, supra note 4, §§ 4.6 & 4.7.

66. Another aspect of the criticism leveled against the law and economics school's celebration of efficiency is closely related. In real life it does matter whether F starts out subject to fiduciary duties. There will be transaction costs, i.e., any cost that inhibits the attainment of efficient allocation of resources, including any costs that restrain the workings of competitive markets. See, e.g., A. Mitchell Polinsky, Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law, 87 Harv. L. Rev. 1655, 1667 n.67 (1974). If, for example, F is initially free of fiduciary duties, F and B both will have costs to negotiate and finalize the agreement creating the duties. The weaker B is relative to F financially, the more unlikely it is that B will obtain the protection it seeks, because B will have to pay F the value F assigns to the duties, plus F's transaction costs and B's own costs. And even if B benefits from F's fiduciary duties, if B has to sue to recover, the cost of litigation is also a transaction cost, and an expense that may be beyond B's abilities. See generally Linzer, supra note 31. Again, the law and economics system in practice would favor a party (F) because of its strength. This particular example applies factually to the fiduciary context only if F starts out without fiduciary duties. At least some lawyer-economists are stating that partners should not be subject to fiduciary duties unless they have affirmatively agreed to them. According to this view, fiduciary duties would not even apply as default provisions, as provisions that govern unless the parties agree otherwise. See Ribstein, supra note 40, at 53-55. This is contrary to RUPA § 404. I am using the National Conference of Commissioners on Uniform Laws' (NCCUSL) 1994 draft of RUPA.

67. This type of competition is typical of most retailers; they stock their shelves with competing products.
The use of the concept of permitted harm is discussed below in the context of the continuum of good faith and fiduciary duties. But first, if harm is defined in part from the victim's perspective, let us explore further what is meant by permitted harm.

An act, and therefore its consequence, is permitted if it is performed as required or allowed by society. An act that conforms to applicable law is permitted, and the harm it causes also is permitted. In the previous example, any harm to B from F's act in conformity with its performance standard is permitted harm. Because permitted harm is permitted, there is no compensation to nullify the harm. This focus is in contrast to the efficient breach of contract that the law and economics scholars from Justice Holmes onward have endorsed. Even if a breach is efficient, it remains a breach, and, to that extent is not "permitted."

Rather, the focus is on harm inflicted that society permits because the act that caused the harm is permitted. We are forcing ourselves to consider not only the act of F, but also whether it is appropriate for society to allow the harm inflicted on B. We must identify the higher value that is being protected. In the tort context, we are familiar with the concept of harm that is permitted. Absent strict liability, a person who injures another, but who has not acted negligently, will not be held liable under a cause of action.

Regardless of whether lawyers have been trained to consider it thus, the extent of harm that is permitted has similarly been defined, and curtailed, by standards of performance such as the fiduciary duty of

68. See Oliver W. Holmes, The Path of the Law, 10 Harv. L. Rev. 457, 462 (1897); see also Posner, supra note 4, § 4.8, at 118.

69. There still may be, of course, a cause of action outside tort. See, e.g., Sullivan v. O'Connor, 296 N.E.2d 183 (Mass. 1973) (defendant not negligent, but liable in contract). As far as tort law is concerned, however, defendant's act was permitted. Id. at 184.

A related, but still different, concept is the defendant's admittedly bad act that does not give rise to any remedy. For example, a person injured by the defendant has no cause of action unless the defendant's negligent act or omission was the proximate cause of the injury. See, e.g., In re Kinsman Transit Co., 388 F.2d 821, 824 (2d Cir. 1968). Similarly, we know that damages suffered by a plaintiff will not give rise to a cause of action in contract if they are unforeseeable. Hadley v. Baxendale, 9 Ex. 341, 156 Eng. Rep. 145 (1854); Restatement (Second) of Contracts § 351 (1979). See generally Farnsworth, supra note 34, § 12.14. With respect to the sale of goods, a plaintiff will not recover damages unless they result from general or particular requirements, or needs of which the plaintiff at the time of contracting had reason to know and are proximately caused by the defendant's breach of warranty. U.C.C. § 2-715(2) (1992). Subsection (2)(a) also provides that there are no damages even if the loss does result from "general or particular requirements and needs of which the [plaintiff] at the time of contracting had reason to know," if the loss could have "reasonably [been] prevented by cover or otherwise." U.C.C. § 2-715(2)(a) (1992). That is not the same as saying that the tort or contract defendant's act was permitted; there is only no remedy.
loyalty and good faith.\textsuperscript{70} Actions that satisfy fiduciary duty and comply with good faith requirements are permitted,\textsuperscript{71} even if they do cause harm to another. This is inherent in our traditional system of business organizations and contracts. However, when determining whether, for example, F should be held to fiduciary duties or mere good faith, traditional analysis has not consciously focused on the amount of harm F is permitted to inflict upon B.

Imagine that B agrees to sell parcels of land to F at a price fixed by contract, and F agrees to purchase five of those parcels by the end of the twelve-month term. F can also purchase any parcels from any other person, so long as F does comply with its obligation to take the five from B.\textsuperscript{72} In contrast, if B sells the parcels to F at a price equal to a percentage of F's profits on resale, they may have formed the B-F partnership.\textsuperscript{73} In that case, when F purchases for resale any parcels from a third party while the partnership is under an obligation to sell B's five of the parcels within a year, F is in breach of its fiduciary duty of loyalty to B. F is competing with the partnership within the scope of the partnership's business.\textsuperscript{74} In the first scenario, any harm

\textsuperscript{70} This is true in traditional forms of fiduciary duty, such as in the agency context. See, e.g., Tarnowski v. Resop, 51 N.W.2d 801 (Minn. 1952). It is also true in other circumstances where the courts have found a common law fiduciary duty. See, e.g., Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) (Fuld, C.J.). The chairman of the board and the president are found guilty under state law of having breached a fiduciary duty to the corporation by trading on inside information. They are to disgorge their unjust enrichment even if the corporation is not shown to have been injured. In this case, Chief Judge Fuld was willing to consider that the corporation had in fact been injured in its reputation. \textit{Id.} at 912-13.

Put differently, where harm is not required, conduct is prohibited if it merely could lead to harm to the beneficiary. For example, a partner that uses its power and succumbs to the conflict of interest, and therefore obtains profits, will owe all the profits to the partnership. The partner will owe those profits even if the partner can show that it has not harmed the partnership (for example, where the kick-back received resulted in a below-market price for the partnership as buyer). See UPA § 21(1). Of course, the argument can always be made that the partnership was harmed by the lost opportunity to receive the kick-back. After all, the partner who received those profits could have accepted a market price, or a price slightly above market, in order to have the kick-back. As we will see in part II.B, \textit{infra}, it is the ease of engaging in faithless conduct (power), and the difficulty of proof of faithlessness (conflict), that eliminates the need for harm.

\textsuperscript{71} Of course, assuming that the act is not a violation of some other duty to or right of the other.

\textsuperscript{72} The good faith performance obligation, at least presumptively, is to comply with the terms of the contract without an overreaching interpretation. See, e.g., Summers, \textit{supra} note 14, at 232-34.

\textsuperscript{73} Profit-sharing creates a presumption of partnership. UPA § 7(4). RUPA § 202(c)(3) would continue that result. All the elements of partnership must be met. UPA § 6(1); RUPA § 202. \textit{See generally supra} note 50.

\textsuperscript{74} That is the teaching of Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928) (Cardozo, J.). In fact, the relationship that is the subject of that case is not a true partnership and probably is not even a true joint venture. Nevertheless, the case is taken to define fiduciary duty in the
that F inflicts on B by trading in third-party parcels is permitted. In the second scenario, the harm is not permitted. The standards have defined F's permitted acts, and, therefore, the extent of permitted harm.

We have seen that, whether the parties have agreed to fiduciary duties or have had them imposed on their relationship, the law and economics scholars do not consider the extra cost of performing to that level to be a harm suffered by either party individually.

Assume now that the relationship originally called for fiduciary duties because it is a partnership. Assume further that, by valid agreement, the parties can, and do, reduce the standard for their performance of fiduciary duty to simple good faith (a reduction not possible under traditional partnership law). The law and economics

partnership context. For example, it is the principal case in a prominent casebook's section entitled "The Partner's Duty of Loyalty." WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS 56 (6th ed. 1988).

75. See, e.g., UPA § 21; Preston v. Granada Management Corp., 470 N.W.2d 411 (Mich. Ct. App. 1991) (stating that limited partners may not allege breach of fiduciary duty by general partner for collecting reasonable fee agreed upon by all parties so long as general partner's compensation was not based on a fluctuating standard); Starr v. International Realty, Ltd., 533 P.2d 165 (Or. 1975) (consent to a specific commission would be permissible, if disclosed). But see Ribstein, supra note 40, at 57-58. Professor Ribstein views as blanket termination the courts' approval of agreements permitting partners to compete with the partnership (in support, he cites to Singer v. Singer, 634 P.2d 766 (Okla. Ct. App. 1981)) and to engage in self-dealing (in support, he cites to Wilson v. Button, 404 F.2d 309 (5th Cir. 1968); Hooper v. Yoder, 737 P.2d 852 (Colo. 1987); Covalt v. High, 675 P.2d 999 (N.M. Ct. App. 1983), cert. denied, 674 P.2d 521 (N.M. 1984)). I disagree with this interpretation.

With respect to competition, the Singer facts do include an express agreement that the partners can compete with the partnership, and the court did approve it. Singer, 634 P.2d at 772. In effect, the scope of the partnership was limited to whatever the partners placed in the partnership. The cases cited in Singer do not support the idea that any contract fair at formation is enforceable. Id. at 772 n.16 (citing St. Clair Lime Co. v. Ada Lime Co., 162 P.2d 547 (Okla. 1945) (concerning assumption of partnership debts by a successor corporation, not fiduciary duties)); British Am. Oil Producing Co. v. Midway Oil Co., 82 P.2d 1049, 1053-54 (Okla. 1938) (the relationship was not a partnership, and, even if it had been a partnership, the disputed act was outside the scope of that partnership).

With respect to self-dealing, Wilson is a recognition that Indiana's analogue to UPA § 18(f) expressly permits the partners to agree to salary payments. Wilson, 404 F.2d 309. In Hoover the court actually found a breach of fiduciary duty. 737 P.2d 852 (Colo. 1987). The Covalt case is more difficult. Covalt and High each owned 50% of a land-holding partnership. The partnership leased the land to a corporation owned by Covalt (25%) and by High (75%). High was also an officer of the corporation. Covalt demanded that the rent paid by the corporation to the partnership be increased, and, upon High's continued refusal, alleged that High had breached his fiduciary duty as partner. 675 P.2d at 1000-01. There, the court can be seen as approving the failure of partner High to vote in favor of an increase in rent to be paid to the partnership as lessor, by a corporate lessee in which he owned 75%. Because both partners had recognized their inevitable conflict of interest, and therefore they must have understood and impliedly agreed that a fiduciary duty would inevitably be breached. Id. at 1003. However, the Covalt decision looks to me more like a balancing of fiduciary duties by the court than a blanket agreement,
scholars would find this an efficient contract because the lowering of the standard was freely agreed to by the parties. Now assume that F buys other parcels for resale in its own name, and that it therefore competes with its partnership. If the fiduciary duties did apply, F would have breached them. Whatever harm B suffers would not be permitted, would be compensated, and so would not in fact be harm. But that is not our focus. It is stipulated that the fiduciary duties have been waived; therefore, F's act will be permitted because it complies with the good faith standard. Consequently, if B suffers harm (de-
spite the lawyer-economists’ denial of such individual harm) when the partnership sells its parcels more cheaply after F has saturated the market, that harm is permitted.

As indicated, the lawyer-economists will still deny that B has suffered any harm when F’s act is permitted—that is the dissent of Judge Posner, a renowned lawyer-economist, in *Jordan v. Duff & Phelps, Inc.* Supra note 40, at 56. This conclusion itself depends on the lawyer-economists’ two

RUPA § 404 GENERAL STANDARDS OF PARTNER’S CONDUCT.

(e) A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner’s conduct furthers the partner’s own interest.

(f) A partner may lend money to and transact other business with the partnership, and as to each loan or transaction, the rights and obligations of the partner are the same as those of a person who is not a partner, subject to other applicable law.

RUPA section 103 provides a means to limit further the scope of the duty of loyalty. While the duty of loyalty cannot be eliminated, the partners can agree to exclude prospectively from the reach of that duty entire categories of activities, so long as the agreement is not “manifestly unreasonable.”

RUPA § 103 EFFECT OF PARTNERSHIP AGREEMENT; NONWAIVABLE PROVISIONS

(b) The partnership agreement may not:

(i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or

(ii) all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

Under RUPA, if and to the extent that the duty of loyalty is trimmed, there remains the safety net of good faith, and it may be a higher level than purely contractual good faith. See RUPA § 404 cmt. 4 (stating that good faith includes an affirmative duty to disclose); see also Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters’ Overview,* 49 Bus. Law. 1, 24-25 (1993) (the good faith and fair dealing component of RUPA § 404 is deliberately a mixture of fiduciary and contract law, and is higher than the U.C.C. definitions because “RUPA assumes cooperative rather than adversarial relationships”). This leads a lawyer-economist to fear that the standard may be “nicer” than may be economically efficient. See Ribstein, supra note 40, at 56.

79. See Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 446-47 (7th Cir. 1987) (Posner, J., dissenting), cert. dismissed, 485 U.S. 901 (1988). The implication is that Judge Easterbrook believes fiduciary duties are present by default, while Judge Posner believes fiduciary duties either are not present by default or, in the alternative, that their presumptive presence is rebutted by the existence of a contract silent on the topic. From Judge Posner’s language, the second seems the more likely representation of his contractarian views: once there is a contract, what you see is what you get. He writes, “There is no occasion to speculate about ‘the implicit understanding’ between Jordan [the minority stockholder] and Duff and Phelps. The parties left nothing to the judicial imagination.” 815 F.2d at 446.
fundamental assumptions discussed in the prior subsection.\textsuperscript{80} The first is that the agreement reducing the standard was freely established. The second is that the individual victim suffers no harm.

As to the first of these assumptions, the law and economics scholars rely on the common law doctrines of duress and fraud to assure themselves that the agreement was freely established.\textsuperscript{81} But, even absent duress or fraud, B can be vulnerable to F, and therefore need more protection from F than would a stronger party. In the context of the relevant transaction, this weaker B cannot afford the protection that a B as strong as F does not even need.\textsuperscript{82} While this example does in part still raise the issue of whether there was a meaningful bargain when B ultimately agreed to waive F's fiduciary duties, it also addresses the second assumption on which the law and economics scholars rely. When the lawyer-economists conclude that B is not harmed because any injury resulted from a bargained-for reduction in F's standard of performance, they are assuming that a contract freely undertaken creates efficiency, and that the costs agreed to are internalized. They view this efficiency, and, in particular, efficiency based on the individual incentive of wealth-maximization, as the appropriate principle to guide their analysis.\textsuperscript{83} We have seen how the lawyer-economists do

\textsuperscript{80} See supra, part II.A.1.

\textsuperscript{81} See, e.g., Posner, supra note 4, §§ 4.6-4.7. But, as Jordan evidences, they have found it difficult to decide the threshold question: whether the relevant agreement exists. 815 F.2d at 429. The court's opinion was written by Judge Easterbrook. These two judges, Frank H. Easterbrook and Richard A. Posner are former colleagues on the faculty of the University of Chicago School of Law. The case in question has been much analyzed. See, e.g., DeMott, supra note 19, at 884-85 (describing as "unprecedented" the characterization of a fiduciary duty as "the court's guess about what the parties would have agreed to"); Coffee, supra note 17, at 1618, 1680-81 (the "indeterminacy" of the contractarian approach is said to be evidenced by two different results from two contractarians contemplating the same facts). If the judges find that the fiduciary duties have been waived when that was not B's subjective intent, B clearly is harmed by losing a cause of action it deserved. Mental assent and subjective intentions of the parties to a contract normally are irrelevant under the controlling, objective theory of contract law. See, e.g., Eustis Mining Co. v. Beer, Sondheimer & Co., 239 F. 976, 984-85 (S.D.N.Y. 1917) (L. Hand, J.) (interpretation case); Fairway Center Corp. v. U.I.P. Corp., 502 F.2d 1135, 1143 (8th Cir. 1974) (offer and acceptance case). See generally Farnsworth, supra note 34, § 7.9. But see Posner, supra note 4, § 4.1, at 93 (stating that "enforcing the parties' agreement insofar as it can be ascertained may be a more efficient method" of promoting efficiency, and thereby indicating a preference for subjective intent as more accurately reflecting the parties' true valuation of the transaction). This problem of proof, admittedly, is inherent in any legal system, not only in the analysis of the law and economics school.

\textsuperscript{82} See supra text accompanying notes 62-64.

\textsuperscript{83} Posner, supra note 4, § 1.2, at 13-16. Professor Mark Kelman states that liberal welfare economics says that individuals maximize utility only when there is no state regulation (he notes that the focus is based on the Coase Theorem). Kelman, supra note 47, at 673. By implication, he is therefore indicating that the law and economics scholars concentrate on maximization of each individual's utility on the theory that this will maximize production.
find harm, at least to society, from any unwanted increased costs imposed on F due to mandatory fiduciary duty. Here we are focusing on the harm they do not acknowledge, the harm suffered directly by B, and caused by an act F was permitted to take. The prior subsection explained how B can be viewed as personally harmed by F. Now we are looking at F’s permitted act as the cause of that personal harm.

Consider again the difference between a contract for a sale by B to F at a fixed price, and one that calls for profit-sharing and leads to a partnership between B and F. In the first example, F’s standard is good faith, and in the second, fiduciary duty. If B wants F to be subject to a fiduciary level in the first example, but cannot afford to pay what F demands because this B needs more protection than the particular transaction can support, this B perceives itself as harmed. F would continue to sell a third party’s parcels in competition with those of B because B is so weak that F does not fear B’s retaliation. However, the lawyer-economists still do not see harm to B when F, acting as permitted under the good faith standard, competes with B. As we have seen, what B perceives as harm, the law and economics scholars would again view as internalized cost.

What is the consequence of this analysis by the lawyer-economists? In the long run, their concern with F’s costs and with harm suffered by society, and their rejection of B’s harm, results in an F who is permitted by society to inflict significant harm on B. This, in turn, puts a relatively strong B in a better position than a weaker B. Not only is it preferable to be a strong F, it is also better to be a strong B. In part II.A.1 we saw this same result because a weaker B suffers more harm. Here, we learn that this harm has an impact on the weaker B only to the extent that society permits it.

Because the lawyer-economists act as though the playing field were level, and because they believe that wealth-maximization is the appropriate goal, they would systematically permit more harm to be inflicted on a weaker B. Under the system of the law and economics scholars, only elephants can safely dance with elephants, because the potential for harm to B increases as F’s power increases. As F’s financial power rises compared with that of B, it is more likely that F will be permitted to inflict harm on B, and will do so, especially if F has the incentive to use that power. In detective story language, when F has both the opportunity and motive, F is more likely to strong-arm and to take advantage of a lowered standard of performance where available, and B is more likely to need to pay directly or indirectly for protection. By considering permitted harm, we must ask whether society should encourage only elephants to dance with elephants by systematically permitting elephants to step on the smaller species. F’s
perception of its immediate, personal interest in wringing the maximum profit from its transaction with B does not necessarily enhance society as a whole.\textsuperscript{84} First, a system that disadvantages weaker parties presumably disadvantages start-up businesses. Second, wealth maximization is not the only possible value for society to support; other values are potentially relevant.\textsuperscript{85}

What is the solution? Where F's power, and the likelihood that F will use it, increase, B must be given additional protection in the form of an increasingly high standard of performance imposed on F. This variable standard should be mandatory. It is precisely when B needs the protection the most that F will have the most power and motive to demand waiver.\textsuperscript{86} A view that recognizes the harmed party's perspective, and that does not necessarily support the stronger party, is more balanced than the lawyer-economists' efficiency principle. If the perspective applied by society does include that of B in our example, we do not have to tell the harmed party that, contrary to its experience, it has not been harmed.

\textit{B. Good Faith and Fiduciary Duty on the Same Continuum}

The performance standards of good faith and fiduciary duty can be explained through the concept of a continuum.\textsuperscript{87} In order to be on the continuum, there must be an existing legally-recognized relationship between the actor and the harmed party, be it by contract or in the form of a business organization.\textsuperscript{88} It is the actor's power over, and conflict of interest with the harmed party that can together determine

\textsuperscript{84} Judge Posner has identified wealth-maximization for society as a whole as the value inherent in the law and economics school's efficiency principals. Posner, supra note 4, § 2.2, at 23.

\textsuperscript{85} E.g., egalitarianism. See Markovits, supra note 43, at 1176-77.

\textsuperscript{86} Another way for parties to be vulnerable to each other is if they are found to be partners in a partnership despite contrary subjective intent. See UPA § 6; RUPA § 202. If the elements of a partnership are found, a partnership is formed despite the parties' contrary subjective intent. See supra note 50. The result appears unchanged under RUPA § 202. If objective intent to form the partnership can be found, so too can objective intent to contract out of fiduciary duties. Each party is then personally liable for the acts of the other under partnership law. UPA §§ 13-15; RUPA §§ 305-06. These parties are particularly vulnerable, and need the protection of mandatory fiduciary duties. See, e.g., Dickerson, supra note 17, at 155; see also, Allan W. Vestal, Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992, 73 B.U. L. Rev. 523, 562 (1993).

\textsuperscript{87} See supra note 19 for other (albeit less complete and specific) references in the literature to a relationship between good faith and fiduciary duty.

\textsuperscript{88} The purpose is not to grant the victim a wholly new cause of action, as is hypothesized in the following example of a non-legal relationship. A convicted bank robber sues a bank, alleging that it miscalculated the amount he stole and that, therefore, his sentence was too high. He claims $15 million in damages. National Public Radio Broadcast, May 16, 1994. This is not a commercial relationship that would appear on this continuum.
exact placement on the continuum. One additional factor should be recognized in deciding where on the continuum F’s obligation rests: the extent of permitted harm that F can inflict. It is the glance at the party behind the glass—an acknowledgement of the perspective of a person not in our preferred self-image. B is initially making its claim of harm not for the purpose of obtaining recovery, but rather to identify the extent of harm that F would be permitted to inflict if a particular standard were applied to F; therefore, B’s claim should receive significant deference. 89

1. Good Faith on the Continuum

When considering good faith in the context of commercial transactions, several different standards are evident today. At common law, good faith is required in the performance of contracts. 90 The lowest level is notoriously hard to define; 91 it may mean no more than the obligation necessary to prevent the agreement from being meaningless, or, in contract terms, illusory. What is certain is that this standard is similar to, but less stringent than, the other standards on the continuum, and that it prohibits malicious, opportunistic behavior. 92

When B and F enter into their fixed-price contract for the sale of five parcels to F within twelve months, F is subject only to good faith. If that is how the common law defines good faith, what is the effect of the Uniform Commercial Code (U.C.C.) on sales of goods under

89. If the standard is then raised and harm becomes potentially recoverable damages, then normal burdens of proof would apply to the plaintiff victim’s cause of action.

90. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS, § 205 (1979) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”). Professor Summers states that, in fact, courts do consider lack of good faith in the context of negotiation and formation of contracts, but often do so sub rosa. Summers, supra note 14, at 220, 231.

The discussion of good faith in this Article focuses on the obligation in the context of performance, not of precontractual dealings or of enforcement. See supra note 14. For the relevance of the distinction, see, e.g., Summers, supra note 14, at 220-43; Market St. Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 593 (7th Cir. 1991) (citing Summers).

91. Summers, supra note 14, at 196. For example, a cancellation provision stating that termination by the buyer “may be effected at any time,” was interpreted by the court to mean “notice of cancellation within a reasonable time.” Sylvan Crest Sand & Gravel Co. v. United States, 150 F.2d 642, 643 (2d Cir. 1945). See also Summers, supra note 14, at 245. See generally supra note 39 and accompanying text (discussing Professor Summers’ excluder analysis; he is reduced to describing what good faith is not).

92. As to avoiding opportunistic behavior, the traditionalists and lawyer-economists agree. See, e.g., Summers, supra note 14, at 200; POSNER, supra note 4, § 4.1, at 91. The different standards of performance are discussed infra part II.B. See infra note 155 for a precise definition of opportunism.

93. 1992 Official Text of the U.C.C.
its Article 2?\textsuperscript{94} In a commercial setting, section 2-103(1)(b) generally determines good faith, defining it as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."\textsuperscript{95} The section that makes the definition of good faith relevant

94. U.C.C. § 2-102 (1992)("Unless the context otherwise requires, this Article applies to transactions in goods . . . ").

95. This definition applies only to a merchant. U.C.C. § 2-103(1)(b) (1992). In its turn, "merchant" is defined in section 2-104(1) to mean, in the context of good faith, either a person who deals in goods of the kind, or holds him or herself out as "having knowledge or skill peculiar to the practices or goods involved in the transaction." U.C.C. § 2-104(1) cmt. 2 (1992). Basically, a "merchant" therefore includes, for purposes of the definition of good faith, a person who is answering business communications.\textit{Id.} The U.C.C. Article 2 definition will in all likelihood apply to all persons involved in any transaction for the sale of goods, other than in a purely personal capacity, as when a person buys fishing tackle for personal use.\textit{Id.} As indicated by that example, even with so broad a definition of "merchant," it is possible to contemplate a transaction for the sale of goods where the buyer, in particular, is not a merchant. In such a case, the Uniform Commercial Code defines good faith as: "honesty in fact in the conduct or transaction concerned." U.C.C. § 1-201(19) (1992). This is also called the "pure heart, empty head" definition of good faith. See, e.g., E. ALLAN FARNsworth & JOHN HONNOLD, COMMERCIAL LAW 56 (4th ed. 1985). According to the drafters of the U.C.C., the difference between the definition of good faith applicable to a "merchant" transacting in goods, and the definition otherwise applicable under the U.C.C. is that the former is objective, because it relates to commercial standards (see, e.g., ROBERT L. JORDAN & WILLIAM D. WARREN, COMMERCIAL LAW 520-21 (3d ed. 1992), and FARNsworth & HONNOLD, supra at 56), while the latter is intended to be subjective. 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE (describing the reasons for the current version of U.C.C. § 1-201(19), adopted in 1957). See generally FARNsworth & HONNOLD, supra at 57. See also Summers, supra note 14, at 210.

Although the objective definition could prove to be no more stringent than the subjective definition when the commercial standard proves to be very low, it is generally felt to impose a higher obligation. See, e.g., Money Mart Check Cashing Ctr. v. Epicycle Corp., 667 P.2d 1372 (Colo. 1983). See generally Summers, supra note 14, at 211-12. For more on Professor Summers' concern in his 1968 article that the U.C.C. § 2-103 definition would apply only when a code section specifically refers to good faith, see, e.g., Courtesy Enters. v. Richards Lab., 457 N.E.2d 572 at 576-77 (Ind. Ct. App. 1983) (applying that standard in the context of U.C.C. § 2-607 that does not mention good faith explicitly).

To the extent that a non-merchant is considered less in control typically than is a merchant, even in the very broad definition of "merchant" under the U.C.C., the arguably higher standard applied to the merchant fits on the continuum.

Note that the U.C.C. concerns good faith in other contexts too. It is less clear why a holder in due course should necessarily be on the continuum at the arguably higher objective level. Although U.C.C. § 3-302(1)(b) (1992) requires only the subjective § 1-201(19) (1992) good faith (by cross-reference) for a person to become a holder in due course of negotiable instruments, § 3-302(1)(c) (1992) also requires lack of notice for holder in due course status, an objective standard under U.C.C. § 1-201(25) (1992). See generally JORDAN & WARREN, supra at 521. The American Law Institute and the National Conference of Commissioners on Uniform State Laws adopted in 1990 a revised Article 3, including a relatively objective definition of good faith in § 3-103(a)(4). While the explanation may be purely on an evidentiary level (it is easier to submit proof of objective intent), perhaps the holder in due course is seen as a person of relative power.

See also Denise R. Boklach, Commercial Transactions: U.C.C. Section 1-201(19) Good Faith—Is Now the Time To Abandon the Pure Heart/Empty Head Test?, 45 OKLA. L. REV. 647, 650-56 (1992) (summarizing how U.C.C. Articles, other than Articles 2 and 3, incorporate good faith).
as a practical matter is U.C.C. section 1-203, because it imposes the good faith standard on, inter alia, performance of any "contract or duty" under the U.C.C.

If the parcels B is to sell to F were goods, then F would be subject to the good faith standard under Article 2 of the U.C.C. Because the standard of performance is low, many actions by F are permitted. So long as trade practice permits buyers to stock competing products, F can sell other packages along with those of B, provided only that F sells all five of B's packages within the year. Thus, what B could perceive as harm, if caused by a permitted act such as F's competition, also is permitted. Assuming that the relationship truly is arm's length, that result is not shocking. But what if F's power is significantly greater than B's in the context of the transaction?

Under the current common law, if the structure of the transaction raises the power that F as actor exercises over B, the doctrine of good faith imposes on that actor a level of good faith that is heightened. If the sale from B to F is changed so that F obtains the exclusive rights to sell all of B's real estate parcels, then any return to B will depend on F's success in selling B's parcels. By analogy to the percentage lease of realty, especially when there is no other compensation due to B in the form of a minimum annual royalty or the like, the courts have found that F, as the person with the exclusive right to resell the parcels (or, under a percentage lease, to use the leased premises), owes a heightened standard of good faith in its performance.96 F could almost certainly not legally purchase third-party parcels for resale before having disposed of B's parcels.

This clearly is different from the situation where F had a simple purchase agreement with B. But what justifies this different treatment of F when it has exclusive rights? The F in the exclusive context is different from the F of a garden variety contract in two important

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96. See, e.g., Dickey v. Philadelphia Minit-Man Corp., 105 A.2d 580 (Pa. 1954) (stating in dicta that, because there was a minimum rental, the court applied a simple good faith standard and found that it had been satisfied); Stoddard v. Illinois Improvement & Ballast Co., 113 N.E. 913 (Ill. 1916) (lessee must quarry "diligently"); Seggebruch v. Stosor, 33 N.E.2d 159 (Ill. App. Ct. 1941) (lessee to use "reasonable diligence" to operate gas station). However, if a substantial minimum rental is to be paid by the lessee under the lease, there is no good faith standard of any type presumably, except for the normal good faith and fair dealing required in any contract per RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979). See, e.g., Food Fair Stores v. Blumberg, 200 A.2d 166 (Md. 1964). See generally FARNSWORTH, supra note 34, at §§ 7.16, 7.17. But see, Burton, supra note 40, at 384-85 (citing Goldberg, 168-05 Corp. v. Levy, 9 N.Y.S.2d 304 (Sup. Ct. 1938), modified, 11 N.Y.S.2d 315 (N.Y. App. Div. 1939) as a rare case that actually did find the lessee in violation of a duty of good faith in a percentage lease situation). In Goldbergs, the court objected to the lessee's relocation for the "sole purpose" of reducing gross receipts. 9 N.Y.S.2d at 306.
ways. First, as we have seen, the exclusive F is in a position of power relative to B, because B's returns depend on F's performance. Second, the exclusive F is in a position of greater conflict with B. While F and B arguably are in conflict because they are parties to the same transaction in each of my examples, such a definition does not add to our understanding unless we focus on the degree of conflict. The smaller F's investment in the transaction (either in terms of absolute dollars or as a proportion of F's total resources) or the smaller the return expected by F from this transaction, the smaller will be F's desire to have this transaction succeed. It will be more likely that another transaction will capture F's interest. Therefore, the smaller F's investment in its transaction with B, the greater F's conflict with B. In the case of F as exclusive seller of B's parcels, F has a conflict with B inherent in the structure of the transaction: F's investment is minimal. Its payments to B decrease as F's performance under the contract decreases. If the market puts pressure on F by reducing F's resale price, F may even have an incentive not to exert any effort in the resale of B's products, as compared with other, more remunerative activities.

In an ordinary, arm's length contract, where B sells to F at a fixed price, F may be in a position of power as a practical matter if, for example, it is B's sole customer. However, the conflict inherent in the structure is less than when F is the contractually constituted exclusive buyer. While we have noted that the garden variety F is definitionally a party to the transaction with B and, therefore, is in conflict with B to that extent, B has invested in the B-F transaction more heavily than the exclusive dealer F. In the garden variety purchase, F has invested the amount of the purchase price. F can minimize its risk (after having

97. See Lynne L. Dallas, The Control and Conflict of Interest Voting Systems, 71 N.C. L. Rev. 1, 73 (1992) (defining conflict of interest as existing when a "controlling person . . . is a party to the transaction . . . "). This means that, at least where F is in a position of power relative to B, F in my hypotheticals necessarily is in conflict with B. See also American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §§ 1.02, 1.23(b) and comments (Proposed Final Draft, 3/31/92).

98. See Dallas, supra note 97, at 74. Speaking of a controlling person whose "subject transaction" is its relationship with the corporation it controls, Professor Dallas says there is a "conflict of interest transaction if a director [or] controlling shareholder . . . is a party to the transaction [between the corporation and a third party], has a direct financial interest in the [third-party] transaction, or has a financial interest in the . . . [third] party to the transaction." Id. at 73. Because she is focusing on the third-party transaction (not on the "subject transaction"), she sees conflict for the controlling person relatively heavily invested in that third-party transaction. That is no different from claiming, as I do, that the controlling person has conflict when relatively lightly invested in a transaction with, in Professor Dallas's example, the controlled corporation.

99. I am focusing on F's investment alone, because B's investment is already considered in the calculation of F's power over B. When B agreed that F be its exclusive dealer, B allowed the structure of the transaction to vest significant relative power in F.
PERMITTED HARM

paid B the fixed purchase price) only by seeking to sell the parcels as profitably as possible; unlike the exclusive dealer, F cannot reduce its downside merely by refusing to expend additional resources. In that sense, F's investment in the garden variety transaction is greater and gives rise to less conflict than in the exclusive dealership. Thus, the continuum explains why it is appropriate for an exclusive dealer to be at least presumptively subject to a higher standard than is a garden-variety contract party: the exclusive F has both more power and greater conflict, and is therefore held to the "best efforts" standard of good faith. This is a standard that approaches the fiduciary duty of loyalty, limits the range of acts permitted of F, and therefore defines permitted harm more narrowly.

The same analysis applies if the parcels are goods. The U.C.C. has preempted the definition of good faith in the context of exclusive sales of goods, and its definition is similar to the common law definition. If F has the exclusive right to sell B's packages, the structure of the transaction again gives F power. The conflict remains stark in the exclusive dealing situation: the exclusive buyer for resale has a captive supply from B. Therefore, F will buy from B only as F finds purchasers. If the contract with B becomes unattractive, F's incentive is to divert efforts away from contract performance by purchasing less from B. B's compensation falls as F reduces its purchases from B. Because the standard imposed on F as actor increases as F's relative power and extent of conflict increase, F should not purchase competing products for resale unless it can be reasonably sure that this will not adversely affect its ability to sell B's goods. This result is compatible with the differing common law standards. Where there is exclusive dealing, the only opportunity for the party granting the exclusivity to obtain a return on investment occurs when the actor performs adequately. U.C.C. section 2-306(2) requires the

100. If F does not pay the price, it has breached and owes remedies. While a related issue, remedies are not the focus of this Article. See supra note 31 (on the adequacy of remedies).

101. As we will see in Part II.C, infra, F is again permitted to do less harm as its incentive to violate the spirit of the contract, and its power to do so, increases. From a review of cases dealing with good faith, it does seem that a cause of action requires some actual harm (as distinguished from a cause of action under the fiduciary duty of loyalty). See infra text accompanying note 109.

102. Compare Feld v. Henry S. Levy & Sons, Inc., 335 N.E.2d 320 (N.Y. 1975) (output sale of bread crumbs determined to be under the good faith standard of U.C.C. § 2-306(1) (1992)) with Bloor v. Falstaff Brewing Corp., 601 F.2d 609 (2d Cir. 1979) (target's explicit obligation under contract to use best efforts in sale of beer upheld; dicta to the effect that good faith would be the standard absent explicit requirement of best efforts is logical; although seller's aggregate price was determined in part by output of target, the contract provided for a substantial minimum price). Output and requirements contracts cannot for these purposes be viewed as also
"seller to use best efforts to supply the goods and . . . the buyer to use best efforts to promote their sale" if the contract is for exclusive dealing.\textsuperscript{103} The official comment to this subsection essentially redefines "best efforts" as "reasonable diligence as well as good faith,"\textsuperscript{104} thereby confirming the intuition that best efforts represents a higher standard than straight good faith. Therefore, both at common law and under the U.C.C., F, as the fiduciary-analogue on whom B relies for a return on investment, has a relatively high obligation of good faith; only modest harm is permitted.\textsuperscript{105}

But why does the continuum depend on both power and conflict? Is not power alone sufficient to raise the standard? The answer is that power alone is not sufficient, and should not be. The following example illustrates why. If, for example, F has the typical power of the exclusive purchaser, but has invested heavily in the transaction, F's conflict will be less. By analogy to the percentage lease, if F has paid B a substantial mandatory payment, F's performance standard is reduced to the threshold level of good faith.\textsuperscript{106} This makes sense on the continuum: F invested that payment, and F's incentive to recoup the payment will encourage its performance. Thus F's conflict decreases as its mandatory payment increases. Simultaneously, F's position of

\begin{itemize}
\item being exclusive dealing contracts. First, the structure of the section will not admit such an interpretation (U.C.C. § 2-306(1) being a separate subsection on output and requirements contracts).
\item Second, while the output seller and the requirements buyer could be seen as obligated to deal only with their contracting party, thereby putting the output seller or requirements buyer in the same position as a lessor under a percentage lease, the situation is so fundamentally different as to be almost the reverse. While the percentage of the lessor's return depends upon the lessee's effective use of the lessor's tangible or intangible assets, it is the output seller and the requirements buyer that are in the driver's seat. The good faith limitation does protect the output seller and requirements buyer by preventing the entire contract from being illusory and therefore unenforceable, but its primary purpose is to prevent abuse by the output seller or requirements buyer. See, e.g., U.C.C. § 2-306 cmts. 2 & 3 (1992). There is no major factual issue about the sufficiency of performance of the buyer from the output seller or the seller to the requirements buyer. In that sense, the output seller and requirements buyer are not at the mercy of their contracting parties. By contrast, in a classic exclusive dealing case, the percentage lessor, as the party limited by the exclusivity, is also the party whose success under the contract depends on the sufficiency of performance of the other party—a sufficiency that cannot be predicted by numbers established at formation of the contract.
\item At common law, a reduction in the fiduciary-analogue's power does reduce F's duty. If B as the beneficiary-analogue has any significant return on investment without F's performance, F's obligation is lessened, and a greater degree of harm is permitted. See Dickey v. Philadelphia Minit-Man Corp., 105 A.2d 580 (Pa. 1954) (lessened obligation if there is a substantial payment of rent under the lease); Bloor, 601 F.2d 609, 610 (a substantial minimum payment under an exclusive dealing contract). See also supra text accompanying note 96 (varying levels of good faith).
\item See, e.g., Dickey, 105 A.2d 580.
\end{itemize}
control inherent in the structure of the transaction may also decrease as the contractually mandated return to B increases. But even if F's power is unchanged, its standard of performance is only good faith because F has no incentive to use its power to harm B. The obligation of good faith, at whatever level applicable, would then be mandatory and unwaivable. ¹⁰⁷

2. Fiduciary Duty on the Continuum

Now let us approach the relationship between power and conflict on the one hand, and level of duty on the other, in the context of fiduciary duty as opposed to good faith. When discussing good faith, I started with the threshold level of contract law good faith, and worked up. For purposes of symmetry, when discussing fiduciary duty, I start at the most draconian, trust law extreme, and then work back toward the middle. Accordingly, just as the obligation of good faith rises as the fiduciary-analogue's power and conflict increase, the true fiduciary's duty is attenuated as the fiduciary's power and conflict lessen.

A fiduciary, who is a trustee in classic trust law, has the highest duty because it has the power to act, and it also has the conflict to act in its own self-interest. That the trustee has power is easy: it acts with respect to the corpus. ¹⁰⁸ That the trustee is in a position of great conflict is again a function of its relatively low personal investment as trustee. The trustee invests no assets, only time. Any fruits of the trustee's successful performance belong to the beneficiary, so the trustee does not expect a huge return. The trustee's substantial power and degree of conflict place it at the highest level on the continuum; the trustee is not permitted to inflict any harm on the beneficiary. That, indeed, is the result under traditional trust law. The trustee is not allowed to use its power for its own benefit: ¹⁰⁹ "The trustee is . . . to

¹⁰⁷. This is generally the case today. See, e.g., Restatement (Second) of Contracts § 205 (1979); U.C.C. §§ 1-205, 2-306(2) (1992). Even the lawyer-economists agree. See, e.g., Ribstein, supra note 40, at 55-56 (expressly recognizing good faith as inherent to contracts, and impliedly accepting that contractual good faith therefore applies to partnerships); Market St. Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (Posner, J.). See also Steven J. Burton, More on Good Faith Performance of a Contract: A Reply to Professor Summers, 69 Iowa L. Rev. 497, 499 (1984).

¹⁰⁸. Restatement (Second) of Trusts § 186 (1957).

¹⁰⁹. No harm at all is permitted, because no actual harm need be shown for a violation of the trustee's fiduciary duty to be proved or for penalties to be owed. This is true in traditional forms of fiduciary duty, such as in the agency context. See, e.g., Tarnowski v. Resop, 51 N.W.2d 801 (Minn. 1952). It is also true in other circumstances where the courts have found a common law fiduciary duty. See, e.g., Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) (new state law cause of action for breach of fiduciary duty; Chief Judge Fuld says that the breach of the fiduciary's duty to the corporation can occur without a finding that the corporation has been harmed).
administer the trust solely in the interest of the beneficiary."

As an offshoot of the law of trusts, agency theory imposes this same unrelentingly high duty on the agent as fiduciary. The agency relationship is important because it is a standard business form. Not only are a sole proprietor’s employees typically agents, but so are corporate officers. Within the scope of the agency, the agent’s power is great; the agent acts on behalf of the principal and binds the principal. Further, the agent’s investment in the agency relationship is only time, as is the case of the trustee. Therefore the agent’s position of conflict also is similar to that of the trustee. The continuum consequently imposes a high fiduciary duty on the agent.

Under traditional agency law, if B asks F to sell B’s parcels on B’s behalf, F is B’s agent. If F then sells parcels obtained from third parties to potential purchasers of B’s parcels, F is in breach of its fiduciary duty. In contrast, the person with only exclusive contract rights, like our buyer F when it had exclusive right to resell B’s parcels, will not be subject to fiduciary duty. F as exclusive dealer is obligated only under the standard of best efforts, still titularly within the rubric of good faith; F need not act solely in favor of the beneficiary-analogue. Under best efforts, F could resell a third party’s parcels if F could prove that F was still exercising best efforts in seeking to sell B’s parcels.

In partnership law the actor-partner has power. Even though some partners are relatively equal in power outside the partnership relationship, once in the partnership the person acting has all the power. A partner can bind the entire partnership by any act within the scope of the business, thereby creating personal liability for all partners. Further, there is some conflict inherent in the partnership structure. As is


111. Restatement (Second) of Agency §§ 387, 389, 393 (1957). For a discussion of agency as an offshoot of trust law, see, e.g., Scott, supra note 110, § 8.

112. See, e.g., Bloor v. Falstaff Brewing Corp., 601 F.2d 609, 614 (2d Cir. 1979) (even absent the express best efforts clause in the contract, the actor would have had an obligation of good faith, thereby implicitly accepting that the former standard is higher).

113. For example, the fiduciary-analogue’s “obligation to use ‘best efforts to promote and maintain a High [sic] volume of sales . . .’ (emphasis added) . . . did not require [the fiduciary-analogue] to spend itself into bankruptcy. . . .” Bloor, 601 F.2d at 613 (Friendly, J.).

114. Therefore, F is permitted to inflict more harm on B under the “best efforts” standard than pursuant to fiduciary duty, but less than under the lowest level of good faith.


116. UPA § 9; RUPA § 301.
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the case with any agent, in its capacity as an agent the actor-partner has a relatively low investment. However, in the partner's capacity as owner, the actor-partner typically has invested. Therefore, on the continuum, the partner's conflict as owner is less than that of a pure agent. F, as the actor-partner, should be held to the high standard of an agent when acting purely as an agent of the partnership principal, but should be allowed to consider F's own interests as owner when serving as a managing partner, i.e., as a manager-owner—at least so long as it does not affirmatively harm F's co-partners.

Traditional partnership law comes to similar conclusions, but without articulating the power and investment analysis. The kinds of acts that the Uniform Partnership Act condemns are those that can be accomplished because of the actor's position of relative power, not those acts that focus on the actor's preservation of its interests as an owner (when the actor is theoretically on par with the other owners). Thus, while relatively selfish acts are permitted of a partner, those acts could represent a breach if committed by a trustee or pure agent. The partner's interest as owner is recognized as almost inevitably in conflict with the partner's actions as manager of the entire partnership. The partner, in its capacity as owner, is therefore allowed to act in conflict with the other partners, so long as the partnership is not harmed. To the extent that the partner is doing more than acting as an owner (for example, if the partner is seeking to derive a benefit from the partnership as opposed to merely managing the partnership), the partner will be held to the normal fiduciary duty of an agent.

117. A partner is both manager, UPA §§ 9(1), 18(e), (h), and owner, UPA § 18(a).
118. The managing partner may, however, owe a heightened duty. See infra note 121.
119. See supra text at note 74 (discussion of Judge Cardozo's opinion in Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928)). Therefore, at some point on the continuum (perhaps partners acting as owners define that point) not only power and conflict must be shown, but also some degree of harm. The reason why some harm must be shown at that point and below is precisely because the combination of power and conflict are judged to be less compelling than in the traditional trust context.

Put differently, where harm is not required, conduct is prohibited if it merely can lead to harm to the beneficiary. For example, a partner that uses its power and succumbs to the conflict of interest, and thereby obtains profits, will owe all the profits to the partnership. The partner will owe those profits even if the partner can show that it has not harmed the partnership—for example, where the kickback received resulted in a below-market price for the partnership as buyer. See UPA § 21(1). Of course, the argument can always be made that the partnership was harmed by the lost opportunity to receive the kick back. After all, the partner who received those profits could have accepted a market price, or a price slightly above market, in order to have the kickback. It is the ease of engaging in faithless conduct (power), and the relatively low investment as agent (conflict), that eliminates the need for harm.

120. The UPA is explicit that a partner must account to the partnership for any benefit, and must hold as trustee any profits derived from the partnership without consent of the other partners, even if there is no proof that the partnership has been harmed. UPA § 21(1). Subject to the
B's partner, F, is acting as an agent if F is seeking to sell the parcels on behalf of the partnership.

On the other hand, if F is deciding as managing partner whether the partnership should enter into a long-term or short-term lease, the fact that F is younger than B and therefore has a personal interest in the business's long-term success does not automatically place F in breach of a fiduciary duty if it selects the longer lease. Traditional partnership law describes the partner as an agent or owner and then asserts conclusions. The continuum provides a less descriptive, more theoretical justification; as the partner's power or conflict rises, so does the standard of performance.

Once the extent of the duties has been established on the continuum, partners should not be able to opt out of fiduciary duties. The partnership form determines the nature of the relationship. If the parties are found to have satisfied the elements of partnership formation, including evidencing objective intent to exercise joint control and share profits, a partnership is formed; the relative rights of the parties are determined, regardless of the parties' subjective intent. The joint control creates the power of the actor-partner, and the profit-sharing is at the heart of the actor's conflict with the other partners as owners. The power and conflict, which are inherent to the partnership form, justify both a restriction on the harm permitted to be inflicted, as well as the mandatory nature of the fiduciary standard of performance. A mandatory fiduciary standard does not add new costs to society even under the assumptions of the law and economics school of thought; for the past eighty years, partnership law has imposed mandatory fiduciary duty. Instead, this proposal in support of mandatory duties represents an appreciation that it is precisely when the non-actor can least afford to have the standard lowered, that the actor-partner will seek to have its fiduciary duty reduced.

In corporate law, officers and directors, are not the only persons who can be found to owe, and to have breached, a duty of loyalty;
controlling shareholders also are potential fiduciaries. A common law concept has been developing to the effect that a controlling shareholder is not to appropriate corporate property for personal benefit. The extent of the duty not to appropriate corporate property for personal benefit remains unclear. However, because the duty is limited to shareholders who have a controlling interest, it is a duty that necessarily devolves only on persons with relative power. Shareholders are traditionally permitted to act selfishly despite obvious conflict. It is as the shareholder’s power increases that conflict becomes incompatible with their duty.

e.g., Bates v. Dresser, 251 U.S. 524, 530-31 (1920) (president-director, but not other directors, liable for misconduct of employee). However, officer-liability is a purely agency concept. Agents’ duties are still described by the Restatement (Second) of Agency §§ 387-89, 393 (1957). “Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.” Id. § 387. “Unless otherwise agreed, an agent is subject to a duty not to deal with his principal as an adverse party. . . .” Id. § 389. “Unless otherwise agreed, an agent is subject to a duty not to compete with the principal. . . .” Id. § 393. The ad hoc, case-by-case consent of the principal can therefore be obtained, as has traditionally been the case.

It is not clear that directors are agents; directors are more similar to a classic trustee who deals in property (in this case the corporation) on behalf of others, including the shareholders. See, e.g., People ex rel. Manice v. Powell, 94 N.E. 634, 637 (N.Y. 1911). Today, an interested director’s duty of loyalty can be terminated only after full disclosure by the fiduciary and consent by the corporation, and only if the transaction is inherently fair. See Talbot v. James, 190 S.E.2d 759 (1972); Globe Woolen Co. v. Utica Gas & Elect. Co., 121 N.E. 378 (N.Y. 1918) (dicta). The interested director allowed grossly inaccurate facts to be expressed in his presence, and the transaction was clearly unfair to the corporation. Id. at 378-81. Because of the purchaser’s sudden and drastic increase in requirements, Judge Cardozo could have invalidated the transaction based on the purchaser’s lack of good faith. DeMott, supra note 19, at 899.

A court has even asserted that, if the process by which the interested director transaction is approved is fair, then the underlying transaction is presumptively fair. See Gottlieb v. Heyden Chemical Corp., 90 A.2d 660 (1952). This rule was a product of the legal-process jurisprudential school. See generally Dickerson, supra note 17, at 127. Finally, state legislatures toward the middle of this century began to adopt statutes, e.g., CAL. CORP. CODE § 310 (West 1990) (originally enacted as 1947 Cal. Stat. 2322); DEL. CODE ANN. tit. 8, § 144 (1991) (originally enacted as 8 Del. Laws. c. 148 § 7 (1953)); N.Y. BUS. CORP. LAW § 713 (McKinney 1986) (originally enacted as New York L. 1961, c. 855; amended L. 1962, c. 834, § 52; L. 1965, c. 803, § 29; and repealed L. 1971, c. 768, § 3), that to differing degrees confirm the voidability of an interested-director transaction only if the disclosure is inadequate and the transaction inherently unfair. See generally Claire Moore Dickerson, Interested Directors of New York Corporations and the Burden of Proof, 88 COLUM. BUS. L. REV. 91, 101 (1988).


Consider the following example. B and F are shareholders in B-F Corporation. F is the controlling shareholder. A pre-existing shareholders' agreement provides that a shareholder who leaves the employ of B-F Corporation must sell back the shareholder's shares to the corporation or to the other shareholders at a fixed price. Again, the shareholders who have control are permitted to act in ways that inflict harm on the shareholders who do not have control, until the controlling shareholders' act is shown to be a product of their power and conflict. But the issue is this: at what point should society, through its legal system, step in to say that the harm inflicted, harm perceived by B, cannot be permitted?

F, as controlling shareholder, has power especially if F also serves as a senior executive. Further, F can be in a significant position of conflict with, for example, minority shareholders. F will indeed have made an investment in B-F Corporation in order to acquire its shares. However, that investment shrinks in significance when the corporate structure allows F to leverage on the backs of minority shareholders. This is precisely the result if F can engineer a cheap redemption of other shareholders' interests in the corporation; a redemption that the minority would have rejected if the minority had been aware of an impending better opportunity. Under the continuum, for example, if F knows of a possible merger of B-F Corporation that would allow F to benefit at B's expense if B triggers the repurchase of B's shares, F has an affirmative obligation to disclose the information to B.

The American legal system agrees. As the continuum mandates, the controlling shareholder must have a conflict, as well as the inevita-

128. The controlling shareholder or group typically holds a majority of the voting shares. See, e.g., Wilkes, 353 N.E.2d 657. However, the controlling shareholder can be a minority shareholder if functionally in control. For example, the structure can give the minority shareholder a veto, see, e.g., Smith v. Atlantic Properties, Inc., 422 N.E.2d 798 (Mass. App. Ct. 1981), or the rest of the shares can be so widely distributed in the public as to give the holder of a minority block practical control. See, e.g., Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962)(discussing minority control).

129. Shares, not parcels, are the subject matter in this example, so the board of directors and the directors' fiduciary duties need not be involved in the transaction. This would be the case if the transaction is exclusively between two shareholders. This should also be the case if the corporation is buying back the shares, so long as the corporation is doing so as required by contract; again, the board has no decision to make. See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (for an example of a case where the directors' duties arguably were relevant).

130. See, e.g., Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) (Fuld, C.J.) (shareholders at issue were the chairman of the board and the president, and were found liable under state law for having breached a fiduciary duty to the corporation by trading on inside information).

131. Accord Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), cert. dismissed, 485 U.S. 901 (1988). In fact, when the conflict and power are great, recovery may be allowed.
ble power, in order to be subject to fiduciary duties; a controlling shareholder is not automatically subject to fiduciary duties for all transactions. F would not be in a position of conflict with B if F had found a buyer for only its own shares. In that scenario, corporate assets are not involved, and whatever F’s power as controlling shareholder of the corporation, F is heavily invested in the shares it plans to sell. Therefore, F is not in a position of conflict and can act selfishly. Conversely, the duty of loyalty is heightened as the fiduciary’s conflict and power increase, when, for example, the fiduciary’s potential to do harm increases.

Once established, the duty is not variable; the continuum determines the standard. Doctrine is much less clear. While there are recent cases indicating that the controlling shareholder’s fiduciary duty is subject to a blanket waiver, some older cases suggest that the duty is waivable only upon an affirmative showing of a legitimate business purpose.

3. Good Faith and Fiduciary Duty on the Same Continuum

Does the lowest duty of loyalty, a modified trust law concept, approach the highest obligation of good faith, a descendant of the English law merchant? In other words, are good faith and fiduciary duties indeed on the opposite ends of a single continuum? The practical similarities have already been set out; in each case, the obligation rises as does the power and the conflict. There are apparent differences, too. For example, fiduciary duty can be waived down to the level of good faith, at least by ad hoc consent given after full disclo-

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1. See generally infra part III.B.
2. If the controlling shareholder is deemed to be benefiting from corporate assets, conflict is heightened: especially if the controlling shareholder is a minority shareholder, its investment in its relationship with its fellow shareholders is small compared to the aggregate investment in the corporation. That helps explain the result in Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955). See generally Jordan, supra note 95, at 519-22.
sure,\textsuperscript{137} while good faith itself cannot be waived.\textsuperscript{138} But even these differences may be more optical than real.\textsuperscript{139} As to the waivability of the standards, the parties' right to define precisely what acts will be deemed to comply with the standard of good faith performance can amount to waiver,\textsuperscript{140} although in both contract law as evidenced by the Restatement (Second) of Contracts,\textsuperscript{141} and in commercial law, by statute under the U.C.C.,\textsuperscript{142} good faith remains the mandatory

\begin{itemize}
\item \textsuperscript{137} See supra note 75.
\item \textsuperscript{138} Under fiduciary duty, no harm is permitted. Acts permitted by the good faith standard, including best efforts, can inflict harm, \textit{i.e.}, some harm is permitted. Good faith is mandatory and unwaivable both at common law and under the Uniform Commercial Code. See, \textit{e.g.}, \textsc{Restatement (Second) of Contracts} § 205 (1979); U.C.C. § 1-203 (1992).
\item \textsuperscript{139} The extent of permitted harm is itself on a continuum, in inverse proportion to the degree of F's power and conflict. Those who view courts as substantially result-oriented may argue that the judges' true rationale is the following: the greater the harm suffered by B, the less likely that the court will find the harm permitted and, therefore, the higher the standard that will be imposed on F. For example, if a court finds a sharing of profits by F and B, and significant harm inflicted, the court may struggle to find a partnership. In a different context (sharing of losses, not fiduciary duties), see, \textit{e.g.}, Lupien v. Malsbenden, 477 A.2d 746 (Me. 1984). This kind of analysis is, of course, possible only in a close case. Anyway, it is not the purpose of the permitted harm system; instead, its intent is to provide meaningful guidelines to the business community. See \textit{infra} part II.C.
\item \textsuperscript{140} A plain meaning analysis is expressly endorsed by U.C.C. § 1-102(3) (1992). The parties can decide what, \textit{inter alia}, the good faith standards are to be, so long as the "standards are not manifestly unreasonable." The difficult question is to determine when the definition of good faith proffered by the agreement is "manifestly unreasonable" for purposes of that section. For example, if the parties enter into a requirements contract without abuse at the time of making, and if, for example, the contract specifically and explicitly permits the buyer to purchase some portion of its requirements from someone other than the contract seller under particular circumstances, that provision is, in effect, an ad hoc waiver of the requirement buyer's obligation of good faith. Were that provision not in the contract, the buyer's failure to purchase all its requirements from the seller would have been a breach of the buyer's obligation of good faith under U.C.C. § 2-306 (1992).
\item A definition of good faith by the parties raises the issue of what standard to apply on formation of a contract. \textit{Both Restatement (Second) of Contracts} § 205 (1979), and U.C.C. § 1-203 (1992), require good faith only for performance and enforcement. One of the few cases arguably requiring good faith on formation is \textsc{Channel Home Ctrs., Div. of Grace Retail Corp. v. Grossman}, 795 F.2d 291 (3d Cir. 1986).
\item Otherwise, context governs. \textsc{Restatement (Second) of Contracts} § 205, cmt. a (1979): "The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context." For example, assuming that the contract is properly formed and that F does not have exclusive rights to B's products, the parties can expressly agree that F's performance satisfies good faith if F offers its own products to third parties before offering those of B. If F has exclusive rights, the problem is that the contract becomes illusory. \textit{Wood v. Lucy, Lady Duff-Gordon}, 118 N.E. 214 (N.Y. 1917) (Cardozo, J.).
\item \textsuperscript{141} \textsc{Restatement (Second) of Contracts} § 205 (1979) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.") (emphasis added).
\item \textsuperscript{142} U.C.C. § 1-203 (1992) ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.") (emphasis added).
\end{itemize}
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threshold.143

Tradition and formalism alone defend the current view that fiduciary duty and good faith are wholly separate concepts.144 The analysis of the continuum helps to visualize and understand the issues relating to good faith and fiduciary duty.145 For example, without doing violence to results under current doctrine, the continuum provides a fundamentally different method of analyzing whether parties should be able to opt out of fiduciary duties. The appropriate level of good faith is determined on the basis of the fiduciary-analogue's power and conflict, and (as we shall see below) on the basis of the permitted harm inflicted on the beneficiary-analogue. Once the level of the standard has been determined, it is mandatory. Because good faith is on the same continuum as fiduciary duties, once the level of the fiduciary duties has been determined by the same analysis, these duties, too, should be mandatory. Neither should be subject to waiver other than on a purely ad hoc basis. Otherwise, it is precisely when the weaker party needs the protection that the shield will be lost.

C. The Permitted Harm System as Predictive

As the examples in the next part will show, when attached to the concept of the continuum, the permitted harm model provides predictability. This combination, the permitted harm system, creates predictability for two reasons. It contains the normative guidelines that add the point of view of the victim to that of the actor, and these guidelines are in the form of standards. Let us consider first what the concept of permitted harm adds.

1. Permitted Harm as a Refinement to the Continuum

The continuum, together with the measure of harm it permits, provides business people with advance notice of the standards of performance to be applied to their transactions. The standards then encourage the actors to give adequate berth, meaning that the actors should be

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143. See Industrial & Gen. Trust v. Tod, 73 N.E. 7, 9-10 (N.Y. 1905) (concerning agreement of reorganization). See generally Summers, supra note 14; and Burton, supra note 40. See also Farnsworth, supra note 135, at 666.

144. Unconscionability is currently a means for the courts to raise the standard on the continuum when formalism places the transaction at a lower standard of performance. The unconscionability doctrine recognizes that power and conflict are not always manifested only by the structure of the relationship. Even in a straightforward arm's length contract it is possible for one party to exert so much power and have so significant a conflict that mere good faith is not the appropriate standard. However, as is discussed infra in part II.C, if the formalist structure is eliminated altogether, the goal of predictability is compromised.

145. See supra text accompanying note 87.
conservative when determining where on the continuum a particular transaction rests. Business people are familiar with this type of construct, colloquially referred to as a "smell test." For example, if an exclusive-dealing contract includes a price based on profit sharing, F knows that the standard of performance may be fiduciary duty, not mere best efforts, because the relationship may be a partnership. F would be wise to conform its behavior to the fiduciary standard.

Additional guidance is obtained by adding the concept of permitted harm to the continuum. Consider how a business person would determine the transaction's correct place on the continuum. Imagine, for instance, that F and B have entered into a contract that provides F with the right to share in the profits on resale of B's parcels. The initial analysis suggests that the transaction could be a garden variety contract, an exclusive-dealing arrangement, or even a partnership. While partnership law would determine whether a partnership exists, the intent of the parties can be gleaned in part by B's view of the harm B has, or, potentially could have, suffered at F's hands. That same analysis can help to determine whether the B-F contract is a garden variety agreement subject to a mere duty of good faith, or an exclusive-dealing contract giving rise to a duty to exert best efforts.

As this example reflects, some formalism must be respected; otherwise predictability will be compromised. Rather than being infinitely variable, placement on the continuum is by quantum leaps. In effect, there should be a presumption that, if the relationship is purely contractual, mere good faith is the standard imposed on F, unless B can show that the contract provides F with exclusive rights, in which case F's standard will be presumptively raised to best efforts. If B proves that the facts reveal a partnership instead of an exclusive dealing arrangement, then the standard is raised to a fiduciary level. It would be too difficult for F to assess initially whether the particular partnership relation was on the fiduciary or good faith end of the continuum; once there is a partnership, the duty is provisionally established.

The partnership is formed because the parties have satisfied the elements of a partnership, including having evidenced the objective in-

146. See, e.g., Kennedy, supra note 78, at 1773.
147. It may be a partnership by inadvertence, because the profit-sharing creates a presumption of partnership. See supra note 73.
148. See, e.g., UPA § 6(1).
149. This presumption can be rebutted if the minimum required payment by F negates the power and conflict provided by the exclusive rights. See supra text accompanying note 96.
150. This presumption cannot be rebutted, because the inherent power of a partner cannot be reduced. A partner's apparent authority to bind the partnership is hard to limit, and the conflict created by sharing of profits cannot be eliminated without eliminating the partnership form. See supra text accompanying note 123.
tent to have joint control over the business. In effect, it is by this finding that the presumption of mere good faith standard is overcome. Similarly, but more infrequently, even where the elements of partnership are not satisfied, unconscionability can overcome the presumption of mere good faith. F may have an affirmative obligation to disclose relevant information if F is shown to have sufficient power and conflict, especially if B claims significant harm. 151

Therefore, although the permitted harm analysis justifies the placement of a transaction on the continuum by consideration of F’s power and conflict, for reasons of predictability, the actual placement is effected in the first instance by identifying the nature of the particular transaction. Second, as a refinement designed to further maximize predictability, the placement of the transaction on the continuum is verified by analyzing the consequences of that placement: how much harm to B does the resulting standard permit and, given F’s power and conflict, is this standard appropriate? We look at the extent of permitted harm that results from treating a contract that calls for profit-sharing or resale as a mere contract. If subjecting F to the mere good faith standard permits extensive harm, perhaps F’s power and conflict are greater than first appeared. Perhaps the transaction is more like an exclusive dealership or even a partnership.

This is an analysis in which F and B can engage at any time during the transaction. Application of this two-step system is further described below in part III. But first: Why do we seek predictability, and what alternative structures offer predictability?

2. Why Is the Permitted Harm System’s Predictability Important?

That parties in the commercial arena seek predictability is a common refrain. 152 To put this into context, consider the parties to a non-

151. Not surprisingly, unconscionability is easier to find in the consumer context, as opposed to the purely commercial arena. One of the most famous cases is Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1966).

152. See, e.g., Robert S. Summers, The General Duty of Good Faith—Its Recognition and Conceptualization, 67 CORNELL L. REV. 810, 823 (1982) (when referring to Professor R. Braucher, first Reporter for the RESTATEMENT (SECOND) OF CONTRACTS: “Predictability and uniformity were high on his list of legal values.”); see also Burton, supra note 40, at 370 (effort to articulate and evaluate a concept of good faith performance). Good faith is economically sound because it simultaneously reduces transaction costs and uncertainty. Id. at 393. Sometimes the need for predictability is phrased in terms of tracking realities; if businesses behave in a specific way, then law should at least in part track those usages. See Russell J. Weintrob, A Survey of Contract Practice and Policy, 1992 WIS. L. REV. 1, 3. See also Kennedy, supra note 78, at 1688 (certainty as one of the two virtues of rules (the other is restraint of official arbitrariness)). With respect to standards, there is relative uncertainty. But it can be structured to increase the certainty that bad behavior can be avoided (the uncertainty of standards around their edges encour-
binding letter of intent preceding an acquisition. While the parties are prepared to spend for due diligence and lawyers' fees absent a binding agreement, the truly important issues and the significant funds are subjected to enforceable contracts. Not only is the actual obligation to pay the purchase price found in a final contract replete with protections for the buyer, but, even in an initial non-binding letter of intent, the prospective buyer typically has a binding obligation to preserve the confidentiality of proprietary information it learns about the target during due diligence. Therefore, as a practical matter, business people do seek out the predictability of the legal system. Despite the fundamental assumption that the parties should be free to bargain in order to promote economic efficiency, even so staunch a supporter of the law and economics perspective as Judge Posner approves of certain legal sanctions. He rejects the concept that contracting parties should be permitted to commit an opportunistic breach.

The fact that parties seek predictability through legal sanctions does not help us determine what those sanctions ought to be. A legal system could provide that might makes right. The law could create this type of predictability in contracts and in business organizations by mandating opportunistic behavior. If people behave opportunistically unless restrained, the legal system could render substantially the same

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154. See, e.g., Market St. Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (Posner, J.); Ribstein, supra note 40, at 55 (referring to contracts generally, although in the context of partnerships); see also Burton, supra note 107, at 499.

155. See Friedmann, supra note 52, at 4 (referring to the text now found at Posner, supra note 4, § 4.8, at 117-18); see, e.g., Frey, 941 F.2d at 594; Posner, supra note 4, § 4.8, at 117-18. An opportunistic act is one that takes advantage of the other person's vulnerability; see also Muris, supra note 52. "'[O]ppportunism . . . mean[s] self-interest seeking with guile. This includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating. Opportunism more often involves subtle forms of deceit. Both active and passive forms and both ex ante and ex post types are included.'" Williamson, supra note 52, at 47.

156. Scholars, having made empirical surveys, would attribute the predictable behavior in part to reputational and professional motivations. See, e.g., Macaulay, Non-Contractual, supra note 63; Macaulay, Empirical, supra note 63.
result by eliminating meaningful legal sanctions against purely opportunistic behavior.

Business people demonstrate a basically Hobbesian perception of human nature, and also demonstrate a desire for legal sanctions precisely to avoid systematically opportunistic behavior. At least with respect to long-term relationships, this fear of rampant opportunism may be exaggerated. Empiricists and modern relational-contract theorists, as well as game theorists, argue that there will not be purely opportunistic behavior if the relationship between two parties is of very long duration. But it is far from clear that this type of predictability is sufficient to create an atmosphere in which parties seeking protection from opportunistic behavior will comfortably transact business.

All that the modern relational-contract theorists tell us is that persons act in a certain way due to their typically long-term, repetitive relationships. Similarly, the non-opportunistic behavior predicted by the game theorists requires not only a long-term relationship, but also parties of relatively equal strength. The parties have to be pre-

157. "[D]uring the time men live without a common Power to keep them in awe, they are in that condition which is called Warre . . . . In such condition, . . . . the life of man [is] solitary, poore, nasty, brutish, and short." THOMAS HOBBES, LEVITAHAN 88-89 (Richard Tuck ed., Cambridge University Press 1991).

By responding that business operations would be "substantially and detrimentally" affected if there were no legal sanctions (65.8% of respondents to the relevant question so concluded), business people confirmed their view that legal sanctions are necessary for predictably non-opportunistic behavior to predominate. Weintraub, supra note 152, at 24.

158. Regarding empiricists, supra note 156. Modern theorists believe that parties in long-term relationships in fact act according to a higher degree of good faith than do those who are engaged in a single, discrete transaction. The person who first systematically articulated this view is Professor Ian Macneil. See IAN R. MACNIEL, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS (1980). See also Ian R. Macneil, Relational Contract: What We Do and Do Not Know, 85 Wis. L. REV. 483, 491, 495 (1985) (stating that the traditional approach to contract law is based on the discrete contract, that such a contract is a product of neoclassical microeconomics, but that most exchanges are in fact relational).

159. See, e.g., ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984). The focus is on a non-zero-sum game (one person's winnings do not equal the other's loss). The corporation is an example of an organization designed to promote frequent and durable interactions. Id. at 180. A long-term contract is another such non-zero-sum game. While envy is not the best strategy, participants should not be too "nice" either. Id. at 113 (citing Macaulay, Empirical, supra note 63). The limitations of this strategy are that many moves are required to create reciprocity; long and indeterminate future is necessary. Id. at 132, 179. A long-term contract would be another. See generally Jeffery L. Harrison, Strategy and Biology: the Continuing Interest in Self-Interest, 86 COLUM. L. REV. 213, 214-21 (1986) (review of, inter alia, AXELROD, supra).

160. See, e.g., Ian R. Macneil, Values in Contract: Internal and External, 78 NW. U. L. REV. 340, 402-04 (1983). He himself recognizes the limited positivism of relational theory. Id. at 408. When Professor Macneil speaks of laws supporting relational contract, he refers to those that permitted long-term relationships (property law, agency law, partnership law). Id. at 492. He claims that relational contracts have always been present. Id. at 493.
pared to retaliate in order for this game theory to predict the avoidance of purely opportunistic behavior;\textsuperscript{161} if one party is far weaker than the other, that party may not be prepared to retaliate.\textsuperscript{162} It is precisely when one party is at the mercy of the other that any prediction of non-opportunistic behavior by the stronger party breaks down. Therefore, in the absence of legal sanctions, each party will be permitted to inflict any degree of harm on the other. The stronger party could predictably be expected to inflict harm because that party’s perceived self-interest will then not normally act as a restraint.\textsuperscript{163}

Other schools of thought that have contemplated standards of performance, especially good faith, consider predictability only as a consequence of the legal system.\textsuperscript{164} The traditionalists, being essentially descriptive of doctrine, articulate what they understand to be the current state of the law.\textsuperscript{165} In circular fashion, because the conduct permitted is presumably the conduct that occurs most often, the extent of harm permitted is in essence also the harm that occurs in fact. A solid group of the modern moralists asserts that the values of the relevant community should be applied.\textsuperscript{166} While the moralists’ theory sounds more prescriptive, the theory is descriptive; what actually happens in the relevant community is applauded. Because there is, however, no method to identify the correct community, this analysis is doubly inadequate to help business people predict which standard will be applied.\textsuperscript{167}

\textsuperscript{161} Participants should not be too “nice.” \textsc{Axelrod, supra} note 159, at 113. It is important to be rapidly provokable to retaliation. \textit{Id.} at 185.

\textsuperscript{162} \textit{See, e.g.,} Jonathan R. Macey, \textit{Chicken Wars as Prisoner’s Dilemma: What’s in a Game?}, \textsc{64 Notre Dame L. Rev.} 447, 450 (1989) (book review regarding cooperation of, as opposed to retaliation by, a small country as motivated by fear of worse retaliation).

\textsuperscript{163} What would be unpredictable to the parties is exactly when the perception of self-interest would trigger restraint. A change in the second party’s behavior, or merely in the first party’s perception of the second party’s behavior, can change the first party’s strategy. That, in turn, can cause a change in the second party’s strategy. Therefore, a small change at any point can have a mushrooming effect. \textsc{Eric Rasmusen, Games and Information: An Introduction to Game Theory} 124 (2d ed. 1994). \textit{See also,} Ian Ayres, \textit{Playing Games With the Law}, \textsc{42 Stan. L. Rev.} 1291, 1314 (1990) (book review).

\textsuperscript{164} \textit{See, e.g.,} Summers, \textsc{supra} note 152, at 823.

\textsuperscript{165} \textsc{See supra} note 35. The traditionalists are also called neoclassicists. \textit{See, e.g.,} \textsc{Farnsworth, supra} note 34, § 1.8, at 28. For another effort to describe the law of good faith, see also Summers, \textsc{supra} note 14. Professor Summer defines good faith as an “excluder” (he excludes bad faith). Summers, \textsc{supra} note 14, at 201. A judge should first identify what is bad faith, and the rest is good faith. \textit{Id.} at 207. This is what Professor Summers recommended for the Uniform Commercial Code as well. \textit{See id.} at 215. If all of this seems circular, that is a result of a purely contextual definition. \textit{See generally supra} text accompanying note 95.

\textsuperscript{166} \textit{See, e.g.,} \textsc{Mary A. Glendon, Rights Talk: The Impoverishment of Political Discourse} 102 (1991) (problems arise where there is no community; as social norms weaken a moral vacuum develops). \textit{See generally Etzioni, supra} note 41, at 256 (written for a mass readership, this book is more exuberant than measured).

\textsuperscript{167} \textit{See, e.g.,} \textsc{Etzioni, supra} note 41, at 37 (trying to answer that question by asserting that,
The most predictive of the proposals currently in vogue is the proposal of the law and economics school. Because of the lawyer-economists' assumption that people are influenced in accordance with incentives and are therefore rational, they maintain that people do behave predictably in the laissez-faire environment their school espouses. Given that assumption and their goals of efficiency and wealth-maximization, the lawyer-economists provide a structure that will let parties know in advance how the parties' behavior will be viewed. They accept fiduciary duties as default provisions, apply a

if the local community has reprehensible values, we turn to "higher-order values"; he does not explain how we are to justify whatever definition of reprehensible is adopted).

There is an argument that, in the business context, the community is automatically defined as the business community. See Macneil, supra note 160, at 408-16; this relational theorist arguably comes to the same conclusion, as he emphasizes that the appropriate definition of values is contextual. However, we still do not know what standards to apply. Is the standard the "conduct permissible in a workaday world," or "the morals of the market place?" Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J.). For a discussion of the power of Judge Cardozo's language, see generally Marleen A. O'Connor, How Should We Talk About Fiduciary Duty? Directors' Conflict of Interest Transactions and the ALI's Principles of Corporate Governance, 61 GEO. WASH. L. REV. 954 (1993).

Professor John C. Coffee, Jr., a signatory of the communitarian platform, believes that fiduciary duties should apply presumptively to corporations. Coffee, supra note 17, at 1680. However, the duties should be optional in the corporate context because they are derived from trust law, and therefore apply only imperfectly to corporations. Id. at 1658-59. Trust law requires trustees to act selflessly; the purpose of the corporation is different from the capital preservation role of trusts. Id. at 1658-59.

As to good faith, Professor Coffee maintains that the obligation's contract law origin makes good faith mandatory for corporations, and that, especially if the standard rises slightly higher than the contract law standard, the standard serves to reduce abuse. Id. at 1656, 1659, 1664. Professor Coffee has commented that good faith contains an element of the fiduciary duties of loyalty and care. Id. at 1655. Good faith nevertheless allows persons to act selflessly; the purpose of the corporation is different from the capital preservation role of trusts. Id. at 1658.

Arguably, the fiduciary content of the good faith standard allows the standard to be higher than the contract-law threshold. See generally Dickerson, supra note 17, at 136.

Therefore, presumptive fiduciary duties and a relatively high standard of good faith describe the morality of what Professor Coffee sees as the relevant community. But it is still difficult to know why a particular definition of morality is correct. It seems more accurate that the values adopted have defined the community than the other way around. Consider, for example, one of the most famous securities cases to discuss obligations, admittedly under statutes and regulations, rather than common law. In SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), certain defendants, including one geologist named Darke, were found to have violated the federal insider trading statutes and regulations. At least Darke apparently saw no wrong, because his smiling picture is included in a contemporary issue of Life magazine, together with the following caption: "supervised first strike, now plays the market on his own." Billion-Dollar Plunge in the Bush, 56 LIFE May 15, 1964, at 38. That a scientist sees no problem does not mean that he reflects the morality of the business community, but his extraordinary insouciance in boasting of his winnings does seem to communicate that at least his circle of acquaintances saw no problem with his actions.


A person will demand more compensation to give up an asset already held, than that
heightened obligation of good faith, and are willing to impose legal sanctions at the outer edges. However, as we have seen, these lawyer-economists are also willing, in the name of wealth-maximizing efficiency, to allow significant harm to be inflicted systematically on the weaker party. This preference for wealth-maximization, and the resultant deference to stronger players, is not the only way to provide a predictably non-opportunistic business environment. This preference is, for example, inconsistent with business people's instincts, as reflected by empiricists and relational-contract theorists.

By recognizing how much harm would be permitted at each standard of performance, i.e., by acknowledging the victim's perspective, the continuum provides predictability in a more even-handed way. The harm claimed by the victim helps confirm the initial measure of power and conflict attributed to a particular actor. The examples below demonstrate that this balanced method is predictive.

III. PERMITTED HARM SYSTEM AND AREAS IN FLUX

Although the analysis is different, the results on application of the continuum framework suggest that the permitted harm system tracks current doctrine for established cases. The important question is whether an analysis attentive to the notion of permitted harm is predictive for issues in a state of flux. Will this perspective help us conclude whether, or to what extent, shareholders of a corporation or partners in a partnership should be able to opt out of fiduciary duties? Will it help us to identify a breach of good faith in the context of a commercial loan? In seeking answers, I will apply the permitted harm

person would be willing to pay to acquire the asset. See, e.g., Kelman, supra note 47, at 788-91, 694-95. Therefore, the lawyer-economists' willingness to leave fiduciary duties as a default provision does reduce the imbalance in favor of the stronger F. See, e.g., supra note 78; infra note 186 (for the text of RUPA §§ 103-404). However, this corrective element will have been less of an impact as F's power and conflict increase—precisely when it is most needed.


172. See, e.g., Macaulay, Non-Contractual, supra note 63, at 63 (on the power of non-legal sanctions including belonging to the same social clubs); Macneil, Relational Contract, supra note 158, at 503-04 (there is no such thing as an unpressured decision either after contract formation, or even outside the contract relation; the consequence is that the choice of wealth maximization must be an exaggeration); Macneil, Values, supra note 160, at 356 (law and economics scholars are wrong to claim the existence of freedom of contract). A specific example given by Professor Macaulay of a non-legal sanction is the reputational incentive highlighted by the chief executive who wants to spend the business's funds on the local orchestra or art museum. Macaulay, Non-Contractual, supra note 63, at 63. This describes wealth-maximization in the broadest sense, but there are potential conflicts with the owners who find greater value in funding employee education. See Posner, supra note 4, § 1.2, at 16.
system to a partner, to a controlling shareholder, and to the parties in loan transactions.173

A. Permitted Harm and Partners

By advocating a revision to the uniform statutory law of partnerships, the law and economics scholars are seeking to reverse the long-standing ascendancy of fiduciary duty in partnerships.174

A new uniform statute (Revised Uniform Partnership Act, RUPA) was adopted by the National Conference of Commissioners on Uniform State Laws in 1992, and subsequently amended in 1994.175 This draft statute is designed for adoption by the states as the first systematic overhaul of the eighty-year-old Uniform Partnership Act (UPA), and as of this writing has already been adopted by at least three states.176 Although the UPA does not expressly refer to the fiduciary duty of loyalty,177 the courts have found in the UPA’s language a broad-based fiduciary duty, including, in particular, a duty of loyalty.178 As we saw above, under the UPA this duty of loyalty is mandatory and can be waived only if the beneficiary knows all relevant facts about the fiduciary’s proposed act and consents to the waiver.179

173. Although I discussed F as an exclusive dealer in part II.B.1, supra, I am not including an exclusive-dealer hypothetical in part III because the law applicable to exclusive-dealer transactions does not appear unsettled.

174. See supra note 78.

175. The Revised Uniform Partnership Act was adopted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in August 1992. The RUPA Drafting Committee proposed additional changes that were approved at the NCCUSL meeting in August 1993. The text includes further revisions agreed to on January 13, 1994, by the drafting committee, and presented to the NCCUSL Executive Committee in 1994.


177. UPA § 21(1) deals most directly with the topic as indicated by the section’s title. But the wording of the provision is far more limited:

UPA § 21: PARTNER ACCOUNTABLE AS A FIDUCIARY
(1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

178. See DICKERSON, supra note 50, at 106 n.7; Jennison v. Bierer, 601 F. Supp. 1167, 1177 (D. Vi. 1984) (relations between partners highly fiduciary; trustees in all dealings with partnership property); Cude v. Couch, 588 S.W.2d 554, 555 (Tenn. 1979) (duty in all matters relating to partnership); see also Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (UPA had been enacted by New York State in 1919, three years before the acts challenged in the case, but Cardozo does not refer to the UPA; Cardozo’s omission may be because the relationship in question probably was neither a true joint venture nor a partnership). See generally BROMBERG & RINSTEIN, supra note 50, § 6.07, at 6.72; DICKERSON, supra note 50, at 427.

179. See supra note 75.
The fiduciary cannot obtain a blanket waiver for the future. Partn
ners are limited in the harm they are permitted to inflict. This is the
situation that RUPA section 404 is designed to modify.

Importantly, RUPA seeks to limit the harm partners are permitted
to inflict by creating an exclusive list of duties that defines a breach of
the duty of loyalty in the partnership context. A partner is expressly
prohibited from retaining benefits derived from the partnership, from
dealing in a manner adverse to the interests of the partnership, and
from competing with the partnership. Nothing else is defined as a
breach of the duty of loyalty. Arguably an exclusive list will necessar-
ily be narrower than the general standard currently in existence; how-
ever, RUPA section 404 also expressly accepts that a partner’s in-
terest as owner may be in conflict with the partner’s duty as manager,
and the section treats a partner who is lending to its partnership as
though the lender were a third party. RUPA section 103 provides a
means to limit further the scope of the duty of loyalty. While the duty
of loyalty cannot be eliminated, the partners can agree to exclude pro-
spectively from the reach of that duty entire categories of activities, so
long as the agreement is not “manifestly unreasonable.” Under
RUPA, if and to the extent that the duty of loyalty is trimmed, there
remains the safety net of good faith, which may be a higher level than
the purely contractual duty of good faith.

180. Id.
181. See supra note 78.
182. Id.
183. See Kennedy, supra note 78, at 1773 (standards must be given wide berth; rules can be
closely skirted).
184. See supra note 78.
185. Id.
186. RUPA § 404(d) states that “A partner shall discharge the duties to the partnership and
the other partners under this [Act] or under the partnership agreement and exercise any rights
consistently with the obligation of good faith and fair dealing.” RUPA § 404 cmt. 4 notes that
in some circumstances, affirmative disclosure will be necessary to satisfy this standard of good
faith. A lawyer-economist has complained that this language reintroduces a “fiduciary-like”
(i.e., heightened) duty by the back door. Ribstein, supra note 40, at 56.

RUPA § 404 clearly applies to the performance of the partnership agreement. Whether it also
applies to the formation of the partnership agreement that limits fiduciary duty under RUPA §
404, or defines good faith as permitted by RUPA § 103, is unclear. For RUPA § 404 to apply,
we must assume that such limitation or definition is part of a partner’s discharge of duties. This
assumes that a person is a partner before the partnership agreement is executed, a conclusion
possible because a partnership is created when the statutory elements exist; an agreement
would serve only as evidence of the elements. See UPA § 6; RUPA § 202; see generally Bromberg &
Ribstein, supra note 50, § 2.01, at 2:1; Dickerson, supra note 50, at 24-48. If a person is a
partner before the partnership agreement is executed, then the unreduced fiduciary duty would
apply at the time of formation of the partnership agreement. On the other hand, if the partner-
ship agreement creates the partnership, the relationship at that instant is purely contractual.
Thus, for formation of this partnership agreement, mere contract-level good faith would apply.
At least some law and economics scholars object to any raising of this threshold obligation of good faith as promoting inefficiency. If the focus is on maintaining freedom of contract, then the lawyer-economists' preference for optional fiduciary duties and a low level of good faith appears logical. The lawyer-economists respond to skepticism as to whether freedom of contract in fact exists by emphasizing that the playing field can be level. But what if the playing field is not level? What if the relationship between the parties is unequal despite the joint ownership, precisely because of the structural realities of partnership law? Of course, the playing field could also be unequal because of financial or psychological factors, but that is in addition to the inequality peculiar to any partnership arrangement, at least as between partners. Because a general partner is inevitably personally liable for partnership obligations, and because each partner is an agent with the power to bind the partnership within the context of the partnership's business, there is a substantial possibility of significant harm being inflicted by any partner ostensibly acting on behalf of the partnership. This reality applies to any partnership, even the most sophisticated one. The potential for harm is further heightened by the fact that a partnership can be created without a party having the subjective intent to create the partnership; all that is needed is objective intent in order to create a partnership by inadvertence. Therefore, a partner can inflict significant harm on another without the latter's expectation of being subject to such harm, especially since a waiver of

This fits by analogy with the concept that no fiduciary duty is owed to a former partner who has withdrawn from the partnership and has been converted to a creditor. See, e.g., Brown's Indus., Inc. v. Snow Mountain Pine Co., Civ. No. 87-1119-FR (D. Or. 1989).

Despite this analysis, it remains uncertain whether the new, exclusive language of RUPA § 404(b) would ever apply to partnership formation. It is not clear that entering into a partnership agreement is "dealing with the partnership in the conduct . . . of the partnership business," RUPA § 404(b)(2), or is "competing with the partnership in the conduct of the partnership business," RUPA § 404(b)(3).

187. See, e.g., Ribstein, supra note 40, at 55-57.

188. A prominent lawyer-economist objects to RUPA because the draft does not go far enough in maintaining freedom of contract. See id.

189. See, e.g., id. at 58-59 ("[P]arties to formal general and limited partnership agreements, . . . often negotiate in detail or are participating in sophisticated, idiosyncratic tax-motivated deals . . . ")(footnote omitted). In the context of non-corporate business organizations, this Article focuses only on general partnerships. See supra text accompanying note 16. See also Ribstein, supra note 40, at 60 n.110 (emphasizing "sophisticated investment partnerships" as well as "family grocery stores").


191. UPA § 9; RUPA § 301.

192. See, e.g., Bromberg & Ribstein, supra note 50, § 2.01, at 2:1; Dickerson, supra note 50, at 25. The result appears unchanged under RUPA § 202. See generally supra note 50 (regarding inadvertent partnerships).
the fiduciary duty can be found absent the parties' subjective intent to waive.\textsuperscript{193} In any event, even if there is the subjective intent to form a partnership, we have seen that the financially weaker party may lose the benefit of any non-mandatory fiduciary protection purely because of its weak position. This reduction in fiduciary protection gives the actor-partner extraordinary power. Whether the partnership is intentional or by inadvertence, the interesting question is then: should the harm be permitted?\textsuperscript{194} The harm will be permitted unless it is inflicted in violation of an obligation or duty.\textsuperscript{195}

The proposed direction of RUPA creates another problem, related generally to its increase of permitted harm. Although RUPA does not precisely define "good faith,"\textsuperscript{196} it is certainly not clear that RUPA's drafters intend the courts to apply a standard that rises in some proportion to the relative power of the actor. Therefore, even absent fiduciary duty, under RUPA a partner with relatively more power may not owe a higher duty of good faith; this would be at variance with both the continuum and tradition.\textsuperscript{197} In effect, by focusing on a level playing field, the law and economics scholars have created a system that can be entirely binary: a partner's conduct is not permitted if egregious (i.e., not in good faith); otherwise, it is permitted. The permitted harm system creates a more subtle and responsive structure. By acknowledging the victim's claim of potential or actual harm, the concept of permitted harm imposes on the actor-partner an obligation of good faith or a fiduciary duty at a level determined by the actor's ability and motive to inflict that harm. Once determined, that standard of performance is mandatory.

\textsuperscript{193} See generally supra text accompanying note 81 (the waiver is governed by contract law, which normally uses objective intent); Dickerson, supra note 17, at 149-51.

\textsuperscript{194} Or, if no harm is needed for the cause of action, whether the conduct could likely have harmed the beneficiary. See supra text accompanying note 70 (noting that partners, not acting purely as owners, can be liable for breach of fiduciary duty even if no harm has in fact been inflicted on the beneficiary). The only leavening aspect of partnership law as compared to trust law is that each partner simultaneously has a structural equality with each of the other partners because all partners are owners. As we have seen, that structural equality defines a fundamental difference between the partnership and the trust relationship.

\textsuperscript{195} Whether or not RUPA is modified to lower the good faith standard, the parties' partnership agreement limiting fiduciary duty may be tested on a good faith standard, not the higher fiduciary standard. See supra note 186. This interpretation increases the extent of permitted harm. To emphasize, this interpretation means not merely that the harm will not be fully compensated; it means that the harm will not be treated as an injury in either law or equity.

\textsuperscript{196} See RUPA § 404(d); RUPA § 404, cmt. 4 (adopted at NCCUSL's July 30-August 6, 1993 Annual Conference). See generally supra note 186 (concerning the potentially high level of RUPA good faith).

\textsuperscript{197} See supra part II.B.
B. Permitted Harm and the Controlling Shareholder

To what extent should the controlling shareholder be permitted to inflict harm on a minority shareholder? If the answer is that a great deal of harm may be inflicted, then the controlling shareholder either never owes a fiduciary duty, or can opt out of that duty. With the continuum, we can posit the principle that the controlling shareholder should be permitted to do less harm as that shareholder’s power and conflict increase. This principle means that a shareholder who, by a combination of structural, financial and psychological factors, dominates the minority shareholder, should therefore be treated as a fiduciary. That controlling shareholder should not be able to opt out of fiduciary duties.

Clearly a controlling shareholder can be subject to fiduciary duties. However, we have seen that Judge Posner, one of the most visible law and economics scholars, has challenged the mandatory nature of these duties, to the extent that his dissent in *Jordan v. Duff & Phelps, Inc.* can be viewed as his expression not only of a close corporation’s obligation, but also, by analogy, the obligation of a controlling shareholder. Judge Posner maintained that, because there

198. Structural factors include percentage of voting shares held (e.g., more than a majority of the voting stock, Del. Code Ann. tit. 8, § 216 (1953)). Structural factors would also include a shareholders’ agreement that allows a minority shareholder to be the controlling shareholder. See, e.g., Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 799 (Mass. App. Ct. 1981) (agreement included in articles of organization and bylaws: 80% of shares needed for any decision of shareholders). Financial factors include the situation where B does not have the resources to buy F’s acceptance of fiduciary duties. Psychological factors are relevant, as reflected by cases that technically are in contract, but sound like a classic fiduciary relationship. See, e.g., Young v. Kaye, 279 A.2d 759, 763 (Pa. 1971) (finding that tax consultant should have disclosed to octogenarian). For a comparison of unfairness in contract with fiduciary duty, see generally Farnsworth, *supra* note 34, §§ 4.11, at 404, § 4.27, at 490.


It is an exaggeration to maintain, as does Professor Mitchell, that a minority shareholder cannot win unless it can show that the controlling shareholder intended to harm. *See id.* at 1718. Instead, the minority wins unless the controlling shareholder carries the burden of showing its legitimate business purpose.

200. 815 F.2d 429, 444-52 (7th Cir. 1987) (Posner, J., dissenting). *See Smith*, 422 N.E.2d at 802-03. Judge Bellacosa of the New York Court of Appeals, a jurist not particularly aligned with law and economics, has arguably come to the same conclusion because he seems to say that a person who agrees to be an employee at will agrees to be fired arbitrarily. *See Ingle v. Glamore Motor Sales, Inc.*, 535 N.E.2d 1311, 1314 (N.Y. 1989). Judge Bellacosa’s decision can also be explained as one based on the principle of statutory preempted, since a statute existed under which the minority shareholder could have sued. *See id.* at 1314 (referring in dicta to a possible cause of action under N.Y. Bus. Corp. Law § 1104-a (McKinney 1986)).

201. Claire Hansen, the Chairman of Duff & Phelps, Inc., was the one who sought to obtain
was a contract, and because the contract did not refer to any fiduciary duty, the minority shareholder in a closely held corporation had waived the controlling shareholder's fiduciary duty and was not owed a disclosure of material information. Judge Easterbrook, another lawyer-economist, wrote for the majority in the same case. He found fiduciary duty despite the contract, because he believed that the parties would have expressly called for fiduciary duty if they had focused on the issue. Implicitly, the parties could have agreed to waive the controlling shareholder's fiduciary duty to the minority. How would a controlling shareholder in the future know how to act, when two of the most prominent members of the law and economics school cannot agree on the significance of the same set of facts? In , the controlling shareholder, who was chairman of the board and president, acted on behalf of the corporation in its dealings with the employee-plaintiff, and had all the material information about the marketability and potential sale of the corporation's shares. The employee-plaintiff was a subordinate of the person with whom he was negotiating, and was a minority shareholder. The chairman of the

the lucrative merger of the company, and who dealt directly with , the employee-plaintiff and minority shareholder (plaintiff purchased 188 shares, with an option to purchase 62 more out of 20,100 total). The corporation was a closely held. , was also the president and the largest shareholder. , Inc., 891 F.2d 1567, 1568 (11th Cir. 1990). Others have seen as a controlling shareholder case. See, e.g., , supra note 17, at 1680. Judge Posner is referring to an actual shareholders' agreement. , 815 F.2d at 444 (Posner, J., dissenting) (viewing the corporation as a "nexus of contracts"). Judge Posner is prepared to view "[t]he corporation as a standard contract." supra note 4, § 14.3, at 393. The law and economics scholars commonly describe a corporation as a "nexus of contracts." See, e.g., , The Corporate Contract, 89 COLUM. L. REV. 1416, 1426 (1989) (citing to Michael C. Jensen & William H. Meckling, , 3 J. FIN. ECON. 305, 310-11 (1976) (the phrases actually used were: "nexus for contracting relationships," "nexus of a set of contracting relationships," and "nexus for a set of contracting relationships;' these phrases seem more moderate than "nexus of contracts").

In effect, the shareholders' agreement serves as an amendment to the underlying corporate contract. See , 815 F.2d at 447. For a critique of the contractarian view of corporations as extreme, see, e.g., , Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 COLUM. L. REV. 1403, 1406 (1985).

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board and president was in fact the largest shareholder, and, in that capacity, was also the one with a direct interest in dissuading the employee from benefiting from the merger. Each dollar paid to that employee was a dollar less of value to be shared by the remaining shareholders.

Judge Easterbrook, for the majority, drew an analogy between this case and one where the controlling shareholder has abused information. The court held that the corporation owed a duty to disclose to the minority shareholder who was an employee because there was no waiver of the optional fiduciary duties. Judge Posner, in dissent, did not draw that analogy, but, rather, emphasized the employment relation between the corporation and the minority shareholder; he found the optional duty waived. This difference in perception may

208. Smith, 891 F.2d at 1568.

209. This point is made explicit by the court in an 11th Circuit case brought by another employee against Duff & Phelps, Inc. based on a similar failure to disclose that same merger opportunity. Smith, 891 F.2d at 1574. The corporation's value is reduced as the payment made to the employee increases, and therefore the price per share that a purchaser would pay to the remaining shareholders, including to the controlling shareholder, is reduced. As a function of the price, the corporation has to pay the minority shareholder-employees for the shares the corporation is redeeming. However, the price per share the corporation is paying upon redemption is by definition less than the per share price being offered by the potential merger partner (that is why the minority shareholder-employees are suing). Therefore, even if the price to be paid by the merger partner were reduced dollar-for-dollar by the amount paid by the corporation to the employees, the price per share to the remaining shareholders, including the controlling shareholder, would actually rise. Since the redeemed employee-shareholders will acquiesce to a redemption at a low price that enriches the remaining shareholders only if these employee-shareholders are ignorant of the merger opportunity, the controlling shareholder has a powerful selfish incentive not to disclose the potential merger.


211. Judge Easterbrook, the author of the majority opinion in Jordan, discussed the case without comment as to its applicability in the following context: a suit by a purchaser of shares, against the issuer, and a person who was both a manager and a substantial shareholder, although the relevant purchase had been from yet another manager and substantial shareholder. 815 F.2d 429. See Pommer v. Mediest Corp., 961 F.2d 620, 624, 626 (7th Cir. 1992).

212. Jordan, 815 F.2d at 446 (Posner, J., dissenting). See generally id. at 429-52. Judge Posner emphasized the employment relation as an "at will" arrangement. He also described the shareholder agreement as explicitly tied to employment, and "against a background of employment at will . . . ." Id. at 446. In effect, he says that the very low threshold of good faith obligation due to an employee at will has infected the shareholder agreement. Because the employer could have fired the employee at any time and thereby forced redemption, the employer owes no higher duty when the employee voluntarily leaves. While this is similar to a conclusion of the New York Court of Appeals in Ingle v. Glamore Motor Sales, 535 N.E.2d 1311 (N.Y. 1989), see supra note 200, it is in fact a non sequitur. The right to fire is to protect the employer. Subject to that right to fire, the employer has a fiduciary duty under the shareholder's agreement. In a case such as Jordan, where the employee left voluntarily, the issues are clearly separated. In a case such as Ingle, where the employee was fired, the issues are joined. The courts should then balance rights as the Jordan majority does, and not automatically eliminate those of one party as Judge Posner advocates.
explain the judges' opposing interpretations of the contract's silence concerning fiduciary duties. Under the permitted harm analysis, however, the difference in perspective would not provide inconsistent results. The facts reflect a combination of structural, financial and psychological dominance that places the controlling shareholder in a position to do harm. The harm in this case is caused by arrogating to himself the increased value of the corporation in which the minority shareholder was an owner, through failure to disclose the status of merger negotiations.

By definition, the controlling shareholder has power. Further, in part II.B.2, we saw that the controlling shareholder's investment in its relationship with the minority shareholder is low when compared to the controlling shareholder's potential return if the controlling shareholder fails to disclose the merger. The conflict is therefore inherent in the structure. The employee-minority shareholder claims that he has lost the opportunity to share in the merger due to the majority shareholder's exercise of power to the latter's benefit and in conflict with the minority shareholder's interest. Whether this case is substantially a controlling shareholder case or is more like an employment case, the amount of dominance over and conflict with the minority shareholder remains the same, and the transaction's initial placement on the continuum should also remain the same. But even if the relatively formalistic first cut places the transaction higher on the continuum as a controlling shareholder case than as an employment at-will case, the permitted harm analysis would correct the result. Because the harmed party's harm is the same regardless of the court's perspective, neither scenario can justify that greater harm be permitted. Indeed, the facts we are discussing demand fiduciary protection for the harmed party because the facts reveal substantial power and conflict

213. As opposed to the explanation given by two other lawyer-economists, see Butler & Ribstein, supra note 45, at 30-31 n.129 (Judge Easterbrook applied a hypothetical bargain; Judge Posner applied the contract literally; the latter is the better contractarian). The analysis of Professors Butler and Ribstein therefore approves of optional fiduciary duties and of the plain meaning interpretation of contract. See infra part III.C.

214. The playing field is not level, and the lack of independence is especially high when the person is not diversified. Managers are at a disadvantage if they have "substantial firm-specific human capital invested in the firm, ..." see Coffee, supra note 17, at 1661, 1680, or when there is a conflict of interest. See Melvin A. Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. 1461, 1476-80 (1989). While Professors Coffee and Eisenberg were focusing on managers of public corporations, this analysis also applies to typical shareholders of closely held corporations because such shareholders also are undiversified. See, e.g., Easterbrook & Fischel, supra note 76, at 271 n.3, 273. See generally Dickerson, supra note 17, at 138 n.150.

215. A loss that Judge Easterbrook, for the majority, calculates at approximately $623,000, as compared to the $23,225 the employee was paid. Jordan, 815 F.2d at 432, 442.
PERMITTED HARM

in the controlling shareholder, and substantial permitted harm to the victim absent such a high standard.

In effect, the duty of the controlling shareholder is the missing link in the continuum between good faith and fiduciary duty. Absent a showing that the conflicting shareholder’s standard of performance should be higher, this duty is almost a duty of good faith, while probably still more accurately characterized as fiduciary duty. The continuum implies that, for the minority shareholder to recover the shareholder will have to be able to show not only the controlling shareholder’s power and conflict, but also some degree of harm. Once the standard of performance is located on the continuum, the parties cannot opt out of the obligation.\(^2\)

C. Permitted Harm and Loans

This same analysis of permitted harm also helps us to adopt a direction for liability in the context of loan agreements. Typically, the lender is in a position of financial power over the borrower. There also is conflict: the lender’s interests are to maximize its aggregate profits by minimizing the risks from each transaction. The lender has, of course, invested the loan amount in the transaction. Especially where the loan is secured, however, the lender’s risk in the transaction is minimal, and its anticipated return is fixed. The lender’s investment is in any event not in the borrower, and therefore the lender’s incentive is to reduce its investment in any questionable loan as early as possible, even if that means cutting the borrower off from access to funds.\(^2\)

There has been a lack of consistency in the duty articulated by courts in the commercial loan context. Even where the lender has very substantial power over and conflict with the borrower, the courts will sometimes, but not always, follow the literal language of the contract.\(^2\) Merely applying the express terms of an agreement does not

\(^2\) See Coffee, supra note 17, at 1659 (calling for a functional compromise: fiduciary duties exist presumptively; if the shareholders do opt out, they are still subject to a high obligation of good faith). Under the permitted harm and continuum analysis, as the actor’s power and conflict are reduced, the transaction moves lower on the continuum.

\(^2\) The only time when the lender’s interest is to help the debtor is when the debtor is beyond redemption. At that point the lender’s advance has become a true investment in the borrower, and the lender’s conflict of interest with the borrower is reduced.

\(^2\) Compare K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (finding that the lender violated good faith) with Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) (finding that good faith was not breached).
avoid all opportunistic acts. However, the perspective of permitted harm provides guidance. Where the borrower claims harm due to the lending bank’s action, and where the lender itself has no commercial reason not to advance the funds, the lender’s refusal is a breach of the heightened obligation of good faith that results from a combination of the bank’s power over the borrower and the bank’s position in conflict with the borrower. The devastating harm that the lender would be permitted to inflict on the borrower under the lowest good faith standard confirms the application of a heightened standard.

Consider *K.M.C. Co. v. Irving Trust Co.* The court found that the bank-lender breached its duty to the borrower when it refused, without notice, to allow the borrower to draw on a line of credit, even though all amounts under the line of credit were payable on demand. The Sixth Circuit’s reasoning was based in substantial part on a separate agreement that forced the borrower to deposit all its receipts in a blocked account under the control of the lender. In other words, the lender was permitted to inflict only a lower level of harm because of its effective control over the borrower as its dominant creditor, and because of the lender’s obvious conflict in desiring repayment of the loan. Indeed, the conflict appears particularly substantial, given that the lender’s investment in the loan transaction was very low: the blocked account served as security for the borrower’s repayment obligation. The Sixth Circuit’s conclusion appears correct under the permitted harm analysis.

On the other hand, in cases where the borrower was required to

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219. Professor Ribstein has expressed approval of *Kham & Nate’s Shoes*, and objected to *K.M.C. Co.* Ribstein, supra note 40, at 54 n.66 (Professor Ribstein refers to fiduciary duty, though, and that may have influenced his conclusions; the cases in fact analyze good faith). As to the meaning of “opportunistic,” see supra note 155.

220. The borrower-victim’s claim at this stage in the case is being entertained only to determine if there is a cause of action. To recover, the borrower, as victim, will have to prove the amount of damages. See supra note 89.

221. In *K.M.C. Co.*, the bank advanced the funds three days after the initial refusal, thereby indicating that it had no reason to have refused the advance in the first place. 757 F.2d at 752. By then irreparable harm had been inflicted on the borrower. *Id.* at 762.

222. See *K.M.C. Co.*, 757 F.2d at 752. Much has been written on this case, and consequently many different points of view have been expressed. For example, in addition to the law-and-economics scholar’s response discussed in supra note 219, there has been a focus on language and plain meaning analysis. See, e.g., DENNIS M. PATTERSON, GOOD FAITH AND LENDER LIABILITY: TOWARD A UNIFIED THEORY 141-45 (1990) (discussing the meaning, in context, of “demand note”).

223. 757 F.2d at 752.

224. *Id.* at 759.

225. *Id.*
deposit receipts into a locked box, the courts did not find for the bor-
rower.\textsuperscript{226} The \textit{K.M.C.} result has been criticized by one lawyer-econo-
mist as encouraging opportunism on the part of the weaker party, the
borrower.\textsuperscript{227} It is not clear why opportunism by the stronger lender
should be feared less. A recent case decided by Judge Easterbrook
rejected the borrower’s claim that the lender breached an obligation
of good faith even in a context of bankruptcy, a circumstance that
emphasizes equity.\textsuperscript{228} In \textit{Kham & Nate’s Shoes No. 2, Inc. v. First
Bank},\textsuperscript{229} the lender-bank gave a debtor in bankruptcy notice of five
days as required by contract. But the notice was only in writing and
not by telephone as provided for in the contract.\textsuperscript{230} The court held
that, even though the contract in question had raised the lender from
unsecured to secured,\textsuperscript{231} and even though the lender had then
promptly terminated the loan,\textsuperscript{232} the borrower must lose because it
had accepted to pay on demand.\textsuperscript{233} By having the express term of “de-
mand” control, Judge Easterbrook in \textit{Kham & Nate’s Shoes} essen-
tially stated for the court that the express contractual language is the
parties’ definition of good faith, and that this definition controls. Al-
though this concept is compatible with U.C.C. section 1-102(3), which
allows the parties to agree on the standards of good faith so long as
the “standards are not manifestly unreasonable,”\textsuperscript{234} we are left with
uncertainty as to the extent of the good faith obligation in lender lia-
bility.

\footnotesize

\textsuperscript{226} See, e.g., Flagship Nat’l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336, 1341-42
(Fla. DCA 1986); Mid-State Fertilizer Co. v. Exchange Nat’l Bank of Chicago, 877 F.2d. 1333,
1337-39 (7th Cir. 1989) (Easterbrook, J.). For a summary of recent decisions, see generally A.
Brooke Overby, \textit{Bondage, Domination, and the Art of the Deal: An Assessment of Judicial
is generally in favor of plain meaning rule). But see cases that found for the borrower: \textit{K.M.C.

Professor Fischel’s principal objection may be that he sees no damages suffered by the borrower.
The latter did not receive the $800,000 requested from the lender, but the borrower also did not
become obligated in that amount. \textit{Id.} at 153-54.

\textsuperscript{228} Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir.

\textsuperscript{229} 908 F.2d 1351; \textit{In re Kham & Nate’s Shoes No. 2, Inc.}, 97 B.R. 420 (Bankr. N.D. Ill.
1989).

\textsuperscript{230} \textit{In re Kham & Nate’s Shoes}, 97 B.R. at 423.

\textsuperscript{231} \textit{Id.} at 422-23.

\textsuperscript{232} \textit{Id.}

\textsuperscript{233} \textit{Kham & Nate’s Shoes}, 908 F.2d at 1357-58 (analogizing a demand loan to employment
at will).

\textsuperscript{234} U.C.C. §1-102(3) (1992). \textit{See generally} Note, “Contracting Around” the Good Faith
When we apply the permitted harm system to this case, we note first that, if the borrower is not totally within the lender's power, and if the harm claimed by the borrower is lessened, the lender's obligation of good faith will be at the lower threshold. The decision in *Kham & Nate's Shoes*\(^{233}\) appears correct at first blush because the lender had not breached any duty. Because the borrower was in bankruptcy,\(^{236}\) it was not the party likely to suffer the most harm when the lender-bank changed from an unsecured to a secured position. Instead, it was the unsecured creditors, other than the lender-bank, that were most at risk.\(^{237}\) Further, because of bankruptcy protection, arguably the borrower was not at the mercy of the lender-bank (although the lender-bank, desiring immediate repayment of what had become a secured loan, was in conflict with the borrower). It was the bankruptcy court that approved the agreement with the lender-bank.\(^{238}\)

The facts in *Kham & Nate's Shoes*\(^{239}\) were substantially more involved than what I have described. The borrower, as debtor-in-possession under Chapter 11 of the Bankruptcy Code,\(^{240}\) was required to act compatibly with the interests of the unsecured creditors, not purely in its own interests.\(^{241}\) The bank, as lender, showed significant evidence both of exercise of power and of conflict. The lender-bank was the borrower's only non-trade creditor;\(^{242}\) originally, the lender had only an unsecured obligation directly to the borrower's trade creditors under letters of credit.\(^{243}\) Then, upon the approval of the bankruptcy court, the lender-bank extended a new line of credit to the borrower itself, and obtained a security interest in the borrower's post-petition assets for that new borrowing.\(^{244}\) In effect, the lender obtained a security interest in the borrower's inventory. The lender-bank then told the borrower not to pay the trade creditors; in consequence, the lender remained obligated to those trade creditors under its unsecured letters of credit, but did not advance funds under the secured line of credit.

\(^{235}\) 908 F.2d at 1351.


\(^{238}\) *In re Kham & Nate's Shoes*, 97 B.R. at 422.

\(^{239}\) 908 F.2d at 1351.


\(^{241}\) See, e.g., Fulton State Bank v. Schipper, 933 F.2d 513, 515 (7th Cir. 1991) (noting that debtor in possession owes a fiduciary duty to his creditors).

\(^{242}\) *First Bank of Whiting*, 104 B.R. at 910 (by implication: any non-trade creditor would normally have taken security, and then the debtor could not have promised all post-petition assets to the lender bank as security).

\(^{243}\) *In re Kham & Nate's Shoes*, 97 B.R. at 422.

\(^{244}\) *Id.*
Next, upon demand by the trade creditors, the lender, under the secured loan, advanced the borrower the funds necessary to pay off those creditors. The lender therefore was fully secured for these amounts, and its obligations under the unsecured letters of credit had been fully satisfied. With these transactions complete, the lender promptly terminated the secured line of credit, even though there had been no material change in circumstances.

Reality supports the conclusion that the borrower was in fact at the lender’s mercy when the secured line of credit was extended by the lender, and that the lender acted purely in its own interest. The bank’s conflict was confirmed when the bank reduced its investment in the loan transaction by converting itself to secured status. Finally, the same reality indicates that the borrower had been harmed in fact, because its assets remained encumbered in favor of the lender.

Judge Easterbrook, however, concluded, that a bank need not lend more money, or give more notice of termination than required expressly by the contract. He viewed the issue as one of statutory interpretation of good faith under the Uniform Commercial Code, because at issue is the appropriateness of the lender’s actions under a security agreement. A detailed analysis of his opinion has suggested that Judge Easterbrook’s interpretation in effect relies on plain meaning, when he states that concepts of good faith “do not block use of terms that actually appear in the contract.” But if this is true, per-

245. In re Kham & Nate’s Shoes, 97 B.R. at 422. See also Patterson, supra note 237, at 507.
246. 97 B.R. at 422.
247. Id. at 423.
248. The borrower needed the funds from the line of credit enough to agree to file for bankruptcy reorganization, a condition demanded by the lender, along with security. Id. at 422.
249. Compare Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1358 (7th Cir. 1990) (Easterbrook, J.) (“Although [lender’s] decision left [borrower] scratching for other sources of credit, [lender] did not create [borrower’s] need for funds. . . .”) with Patterson, supra note 237, at 508 (“Because its assets were encumbered by . . . [lender’s] security interest, . . . [borrower] was unable to obtain alternative financing.”).
250. 908 F.2d at 1358.
251. See section 510(c) of the Bankruptcy Reform Act of 1978 as amended, relating to equitable subordination. 11 U.S.C. § 510(c) (1988). See Kham & Nate’s Shoes, 908 F.2d at 1355. This statute was relevant because equitable subordination was the relief granted by the district court. First Bank of Whiting v. Kham & Nate’s Shoes No. 2, Inc., 104 B.R. 909, 915 (Bankr. N.D. Ill. 1989).
253. Kham & Nate’s Shoes, 908 F.2d at 1357. See Patterson, supra note 237, at 527. Judge Easterbrook seems a trifle uncertain of this conclusion since he also discusses the definition of good faith he considers applicable. For that purpose, he chooses U.C.C. § 1-201(19)’s “honesty in fact” definition, which is arguably the lowest available standard. 908 F.2d at 1357; see supra note 95.
formance in accordance with the express terms of a contract, no matter how egregious the terms, would never be a breach of good faith. But, contrary to that conclusion, we know that some terms are considered so outrageous that they even serve as proof of unconscionability.

Judge Easterbrook seems to commit to the view that two commercial parties entered into a contract, that they were free to do so, and that they will consequently be held to the terms of the contract. What the permitted-harm analysis adds to this picture is context. Precisely because the lender had extraordinary power over the borrower and also had motive to exercise that power, and because the power included the ability to inflict the significant harm described by the borrower, the lender will not be permitted to inflict that harm unless the lender can show that it has complied with a high degree of good faith.

Let us now turn the classic lender-borrower picture on its head. Will the result be conceptually different if, anomalously, it is the borrower who has power over the lender? Will the borrower then be held to a higher level of good faith, in proportion to the harm claimed by the lender as victim?

If the loan is in the form of bonds issued by a governmental subdivision, it is essentially a contractual relationship. The facts of a case before the Minnesota courts at the time of this writing put both the application and the measure of good faith in high relief. In re Hennepin County 1986 Recycling Bond Litigation concerns a contractual relationship between the county (including persons taking rights through the county) as issuer, and the bondholders as lenders. The

254. See Patterson, supra note 237, at 528.
255. See, e.g., Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965) (holding the contract unconscionable because it was extremely one-sided).
256. This illustration is chosen because it is stubbornly commercial. Bonds, and municipal bonds in particular, are essentially contractual in nature. See generally Robert B. Lamb, James Legland, & Stephen Rappaport, The Handbook of Municipal Bonds and Public Finance (New York Institute for Finance, Simon and Shuster 1993).
257. 517 N.W.2d 63 (Minn. Ct. App. 1994).
258. Brief for Respondent Bondholders at 3, In re Hennepin County, 517 N.W.2d 63 (“The Bond Contract expressly spelled out the rights between the parties concerning rates of interest, maturity dates, calamity calls that might result in early prepayment, and also the issuer’s right to redeem Bonds early.”); Brief for Appellant County of Hennepin at 4, In re Hennepin County, 517 N.W.2d 63 (“The Bonds, the Indenture and the Loan Agreement are central to Respondents’ [Bondholders’] claims . . . .”).
259. The bonds were issued by Hennepin County [hereinafter “county”]; when “purchased” by the bondholders, the latter transferred money to the county, which, under the terms of the bond documents, agreed to pay interest to the bondholders, and, at maturity of the bonds, to “repurchase” the bonds at face value. Thus came about the “purchase” by the bondholders (actually, by an underwriting syndicate that subsequently offered the bonds to the public. The
contract documents provided that the bonds be backed, that is, in effect guaranteed, by a standby letter of credit issued by two major banks. The reason for the letter of credit was to enhance the credit rating of the bonds; given market realities, this would permit the bonds to be issued at lower interest rate, a result desired by the county as borrower. The continuation of the letter of credit would be important to the bondholders who, as lenders, would have demanded a higher interest rate on the bonds absent access to the banks' financial security.

The problem that led to litigation arose because the bonds, by their terms, matured from 1995 to 2010, and, by law, the banks could not issue a letter of credit for the more than twenty years until maturity. Therefore, as is typical of letter-of-credit-backed bonds, the letters were issued by the banks for only six years, until 1992. Between the time of the issuance of the bonds in 1986 and the time when the initial letter of credit expired in 1992, interest rates in the market place fell. If the county as borrower could call the bonds in 1992, that is, pay off the principal amounts to the bondholders, and then issue new county then lent the "proceeds" from the sale of the bonds (the proceeds from the loan by the bondholders) to Hennepin Energy Resource Co., Ltd. Partnership [hereinafter HERC], pursuant to a loan agreement. In re Hennepin County 1986 Recycling Bond Litigation, File No. CT 92-22272 (4th Dist. Minn. Oct. 15, 1993) at 4. Thus, the "purchase" of the bonds is a loan to the county, and the county's "repurchase" at maturity is a repayment of principal to the lenders.

The purpose was to raise funds to build a waste recycling facility. Id. An advantage to the county in borrowing in this way is that, as a tax-exempt governmental subdivision for federal tax purposes, interest payments received by the bondholders are tax exempt. Complaint, File No. CT 92-22272 at 7 (confirming the tax-exempt status of the bonds). Typically, in such a situation, because they are tax exempt, the bondholders will accept a lower interest rate than if the interest were taxable to them; consequently, the county benefits from paying less, and can charge HERC a relatively low interest rate when the latter borrows the bond proceeds from the county. Therefore, an entity in HERC's position can build the recycling center more inexpensively because its financing charges are relatively low, despite the fact that it is not itself an entity that could issue tax-exempt bonds.

See, e.g., In Re Hennepin County, File No. CT 92-22272 at 4 (letter of credit is issued by Banque Indosuez and Credit Lyonnais).

See, e.g., the bondholders' contention to this effect in Brief for Respondent Bondholders, 517 N.W.2d 63 (Minn. Ct. App. 1994).

Affidavit for Robert B. Lamb, In Re Hennepin County, File No. CT 92-22272 at 8 [hereinafter Lamb Affidavit]. The bonds also were, by their contractual terms, expressly callable by the borrower after 1995, upon payment of a premium to the bondholders. Id. Professor Lamb served as expert witness for the bondholders and his affidavit was filed on behalf of the bondholders. Id. at 1.

Id. at 9.

Id.


bonds at the new, lower market rate, the county's aggregate obligation would be reduced.\textsuperscript{267} The contract documents expressly provided that, should the letter of credit not be renewed or replaced, the bonds would mandatorily be redeemed.\textsuperscript{268} Otherwise, the county would have to wait until 1996 to complete the redemption, and it could do so only with a prepayment penalty.\textsuperscript{269} The county was the party that refused in 1992 to renew the letter of credit; the banks were apparently ready to renew.\textsuperscript{270} The county as borrower then called for the mandatory redemption of the bonds.\textsuperscript{271}

When the bondholders sued to prevent the redemption of their above-market bonds, the trial court rejected the county's motion for dismissal, although it did conclude that there was no breach by the county of any express obligation under the contract.\textsuperscript{272} In order to focus on good faith, I am accepting this conclusion for purposes of discussion.\textsuperscript{273}

The argument advanced by the bondholders was that,\textsuperscript{274} even if the county did not breach an express contractual provision, there was am-

\textsuperscript{267} According to the bondholders, this was precisely the recommendation delivered to the county by a financial adviser. \textit{Id.} See also Complaint, File No. CT-92-22272 at 15.
\textsuperscript{268} See, \textit{e.g.}, \textit{In re Hennepin County}, File No. CT-92-22272 at 13.
\textsuperscript{269} See Brief for Respondent Bondholders at 16, \textit{In re Hennepin County}, 517 N.W.2d 63.
\textsuperscript{270} \textit{Id.} at 9.
\textsuperscript{271} \textit{Id.}
\textsuperscript{272} \textit{In re Hennepin County}, File No. CT 92-22272 at 18.
\textsuperscript{273} On appeal, the Minnesota Court of Appeals reversed the trial court's dismissal of the contract cause of action. \textit{In re Hennepin County 1986 Recycling Bond Litigation}, 517 N.W.2d 63, 66 (Minn. Ct. App. 1994).
\textsuperscript{274} The other obvious and more direct argument for the bondholders is that, even though there was no breach of any express contractual term, there is a breach of the obligation of good faith and fair dealing found in every contract. The county referred to this possibility in its brief on appeal, but noted that bondholders have not in fact made such a claim, at least not directly. \textit{See Brief for Appellant Issuer at 2, In re Hennepin County 1986 Recycling Bond Litigation}, 517 N.W.2d 63 (Minn. Ct. App. 1994). The argument is not made in this case, because it is not supported by local law. The district court accepted only that the obligation of good faith and fair dealing does apply to a contract in Minnesota. \textit{See In re Hennepin County}, File No. CT 92-22272 at 21. The appellant's (issuer's) brief emphasizes this point. \textit{See supra} note 259, at 16-17. Further, that argument would represent a bold expansion of law. Such an expansion can be found upon aggressive interpretation of the insurance and employment cases in California. With respect to insurers, see, \textit{e.g.}, Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1037 (Cal. 1973). As to employers, see, \textit{e.g.}, Foley v. Interactive Data Corp., 765 P.2d 373 (Cal. 1988). \textit{See generally} Diamond, \textit{supra} note 31. The analysis of what is good faith remains in the contract realm; it is the remedies that go off in the direction of tort law. In the context of both insurers and employers, there has been consideration of a tort, but the discussion has included a purer consideration of good faith itself as an implied contractual term. Can this implied term override express contractual language? The issue of tort relief is important because the notorious inability of contract damages to make the non-breaching party whole includes implicit "permitted" harm. In effect, the breaching party suffers no net adverse conse-
bigness in the contract because the language that literally mandated redemption of the bonds if the letter of credit was not renewed or replaced, was intended only for the protection of the bondholders.\textsuperscript{275} Therefore, because of the ambiguity, the bondholders could introduce extrinsic evidence in the form of custom\textsuperscript{276} to show that the parties truly intended the mandatory redemption clause to be for the benefit of, and exercisable only by, the bondholders. By violating that intention, the bondholders claim that the county breached its obligation of good faith.\textsuperscript{277}

How to get out of this morass? The bondholders and county both cite a Delaware case that equates a breach of good faith with a performance in violation of the intention of the parties as of formation.\textsuperscript{278} This view can be looked upon with favor by the lawyer-economists; it is an application of the hypothetical bargain.\textsuperscript{279} But on

\textsuperscript{275} Brief for Respondent Bondholders at 17, \textit{In re} Hennepin County 1986 Recycling Bond Litigation, 517 N.W.2d 63 (Minn. Ct. App. 1994) (mandatory redemption upon non-renewal or substitution of the letter of credit is for the bondholders’ protection); Brief for Appellant Issuer at 13, \textit{In re} Hennepin County, 517 N.W.2d 63 (arguing that bondholders are manufacturing the alleged ambiguity).

\textsuperscript{276} That is, essentially, the role of the Lamb Affidavit, \textit{In re} Hennepin County, File No. CT-92-22272. See, e.g., Brief for Respondent Bondholders at 23-24, \textit{In re} Hennepin County, 517 N.W.2d 63.

\textsuperscript{277} The county disputed any ambiguity, and therefore the appropriateness under Minnesota law of considering extrinsic evidence. Brief for Appellant Issuer at 14, \textit{In re} Hennepin County, 517 N.W.2d 63.

\textsuperscript{278} The case is \textit{Katz} v. Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986). Brief for Respondent Bondholders at 29-30, \textit{In re} Hennepin County, 517 N.W.2d 63 (emphasizing the expectations of the parties; what they would have agreed to had they thought to negotiate a particular topic (\textit{Katz}, 508 A.2d at 880)); Brief for Appellant Issuer at 17-18, \textit{In re} Hennepin County, 517 N.W.2d 63 (emphasizing that good faith is violated if there is violation of “the intendment of any of the express contractual provisions considered....” (\textit{Katz}, 508 A.2d at 881) (emphasis supplied by Issuer)). The \textit{Katz} court did not find that the obligation of good faith had been violated by the issuer of the debentures. \textit{Id.} at 882.

\textsuperscript{279} See, e.g., \textit{Jordan} v. Duff & Phelps, Inc., 815 F.2d 429, 438 (7th Cir. 1987) (Easterbrook, J.);

The silence of the parties may make it necessary to imply other terms—those we are confident the parties would have bargained for if they had signed a written agreement. One term implied in every written contract and therefore, we suppose, every unwritten one, is that neither party will try to take opportunistic advantage of the other. Dissenting, Judge Posner believed that there was no relevant silence (see \textit{supra} note 79; \textit{Jordan}, 815 F.2d at 449); therefore, he is in the same position as the county in the principal case. Another legal economist refers to \textit{Katz} as confirming that good faith means acting as would a "reasonable contracting party." Ribstein, \textit{supra} note 40, at 55. That may be too broad—the hypothetical bargain refers to the particular parties in question, although the relevant intent is the standard objective intent of contract law. \textit{Jordan}, 815 F.2d at 438; \textit{Katz}, 508 A.2d at 880. See \textit{supra} note 81.
what basis should law and economics scholars decide that there is a hypothetical bargain and what it should be?\textsuperscript{280} We have seen that they view opportunistic acts as breaches of good faith.\textsuperscript{281} But how do we know if an act is opportunistic?

The perspective offered by the permitted harm system, including its focus on the extent to which harm should be permitted, does offer guidance. The county is in a position of practical power because its quasi-beneficiaries are holders of widely distributed bonds. Before the bondholders instituted a class action, they had no procedure to organize among themselves to reintroduce some balance of power. If that provides the opportunity to the county, this borrower has motive too. The county’s conflict is evident: from the beginning, its intent had been not to risk its own credit.\textsuperscript{282} Further, even though it was paying the debt only out of revenues from that transaction, the county’s self-interest is to reduce its debt service.\textsuperscript{283} In short, the county’s investment is limited, since it is not personally at risk. Nevertheless, the county must pay its debt service and therefore, the county wants to redeem the bonds at the earliest possible moment, preferably without penalty, in order to reissue bonds at the new, lower rates. The only part of the analysis that leans toward a low standard of performance for the county is that the harm to be inflicted on the bondholders is the weakest kind of harm; they claim only the loss of an opportunity, and that is the only kind of potentially permitted harm the lender can create here.\textsuperscript{284}

While this analysis therefore on balance tends to support a high standard for and liability of the county, it is not the entire argument. Focusing on the language of the contract and not only on the reality of the transaction, we see that the county has in fact violated the intent of the parties since, as the bondholders claim, the redemption right belonged only to the bondholders. Alternatively, the county has acted in accordance with an express provision of the contract that does allow the county to call for redemption. In the first alternative,

\textsuperscript{280} That was the problem in \textit{Jordan}, 815 F.2d at 429.
\textsuperscript{281} See supra text accompanying note 155.
\textsuperscript{283} Id. at 22.
\textsuperscript{284} The most wrongful act the county can take in context is to fail to repay the loan. That would clearly be a breach, and therefore would be compensable. It would not be harm, let alone permitted harm. See supra part II.A. As to the loss of interest income, see, e.g., Kelman, supra note 47, at 688-89 (suggesting that people care less about the loss of opportunity income (such as the loss represented by the bondholders’ failure to receive interest from the County) than they do about a loss of received income). This wrong to the bondholders can be argued to be relatively mild.
the question answers itself; the county has by definition breached the obligation of good faith. In the second alternative, the contract has accorded to the county extraordinary power over the bondholders; the county's ability to inflict harm is concomitantly great, and, especially because of the county's obvious conflict of interest, its obligation of good faith is therefore heightened. This analysis militates in favor of the bondholders, especially since loss of opportunity is at least a form of harm.

The permitted harm analysis—the view from behind the mirror—therefore does suggest that the county cannot, on these facts, redeem the bonds without breaching its obligation of good faith. To decide otherwise would permit the county, despite its power and conflict, to inflict harm on the bondholders by a unilateral act in satisfaction of the county's own self-interest, and for its sole benefit.285

IV. Conclusion

Both jurisprudential and doctrinal analysis of good faith and fiduciary duty have focused on the active party to any transaction. To do so is to ignore the perspective of the other party to the transaction, the person who feels the impact of the active party's actions. The challenge is to respect the victim's perspective without skewing the system against the active party, and while maintaining predictability for all participants. The permitted harm system conforms to business realities; it is compatible with observed behavior. It does articulate what is the appropriate standard of performance in a particular context, and therefore informs the participants how to behave prospectively. By expressing presumptive standards based on the nature of the transaction, the permitted harm system does provide predictability. The refinements then applied by a consideration of the parties' relative power and conflict do not appreciably weaken predictability given that standards are by definition not bright lines. However, the refinements do increase the responsiveness of the system to the particular facts. They recognize that some partners may exercise scarcely more control, and be subject to less conflict, than certain parties to a contract. Finally, the last step is to check the result from the perspective of the victim. This represents no more than a recognition that each participant in a transaction has a valid point of view, and an under-

285. Minnesota's Court of Appeals noted that the bondholders can, under Minnesota law, maintain a cause of action under an implied covenant to supplement a breach of contract claim. *In re Hennepin County 1986 Recycling Bond Litigation*, 517 N.W.2d 63, 68 (Minn. Ct. App. 1994).
standing of the duties owed between participants requires an appreciation of the entire picture.

The permitted harm system also makes sense on a more theoretical level. That is why it is helpful in determining the proper standard of performance for partners, controlling shareholders, and parties to a loan transaction when traditional doctrine and scholarship provide no clear guidance. As the permitted harm system shows, given that good faith and fiduciary duty can be seen as part of a single continuum, the differences between them are differences of degree. And the differences of degree are measured primarily by differences in power and conflict. The greater the power and the greater the conflict, the closer to fiduciary duty the appropriate standard is. Conversely, as an active party’s power over and conflict with the other party diminishes, the standard of performance moves toward good faith. Because the purpose of the standard of performance is to avoid having society permit the infliction of harm deemed unacceptable by society, and because the victim’s understanding of the harm it has suffered is crucial to an assessment of the extent of the harm suffered, the perception of the victim is the final check.