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A COGNITIVE THEORY OF FIDUCIARY RELATIONSHIPS

Gregory S. Alexander†

Is there anything special or distinctive about fiduciary relationships? Or is the term “fiduciary” nothing more than a label that obscures rather than clarifies? Recently, several law-and-economics scholars, building on the economic literature on agency costs,¹ have argued that nothing categorically distinguishes fiduciary from nonfiduciary legal relationships. So-called fiduciary relationships, they argue, are nothing more or less than contractual relationships. Judge Frank Easterbrook and Dean Daniel Fischel, for example, state that “[f]iduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings.”² While acknowledging that “[c]ases announcing fiduciary obligations teem with [moralizing] language”³ of the kind Cardozo employed in his famous opinion in *Meinhard v. Salmon*,⁴ Easterbrook and Fischel argue that, analytically, fiduciary relations are just contractual arrangements with unusually high transaction costs. This high-faluting rhetoric is just that—overblown rhetoric that obscures more than it illuminates.

The contractual approach to fiduciary relations makes a second, more important claim. The claim is behavioral rather than strictly analytical. Contractarians argue that however courts may *talk* about fiduciary relations, they do not *act* that way. Courts apply the same analysis to both fiduciary relationships and nonfiduciary contractual relationships. The moralizing rhetoric that characterizes judicial opinions involving alleged breaches of fiduciary duties has no substantive effect.

† Professor of Law, Cornell University. I am deeply grateful to my colleagues, Jeff Rachlinski and Bob Hillman, for their invaluable comments and suggestions on this Essay. In the interest of full disclosure, Rachlinski found more to agree with in this Essay than Hillman did. Neither should be blamed for the blunders that doubtless remain here.

¹ The seminal paper is, of course, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

² Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993).

³ *Id.* at 428 n.6.

⁴ 164 N.E. 545, 546 (N.Y. 1928) (“A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”).

Several scholars have attacked the contractual deconstruction of fiduciary relationships. At times employing economic analysis, they have offered various theories of what analytically distinguishes fiduciary relationships from mere contractual relationships.⁵ This Essay takes a different approach. Rather than challenging the analytical point, I focus on the behavioral claim. Applying concepts and insights from cognitive theory, which my colleagues Robert Hillman and Jeffrey Rachlinski prefer to call behavioral decision theory (BDT),⁶ I offer the following hypothesis: Cognitive factors lead courts to analyze fiduciary relationships, at least those that are property-based,⁷ differently than they evaluate contractual relationships.

In cases involving alleged breaches of fiduciary duties, courts tend to use a top-down mode of cognitive analysis; whereas in cases of alleged contractual breaches, they employ a bottom-up cognitive method. The difference between the two approaches is that top-down processes are theory-driven or image-driven, which implies that the analyst's own preconceived notions and expectations exert a heavy influence.⁸ Bottom-up processes, on the other hand, are data-driven and therefore remain free from the influence of a preconceived theory of the situation.⁹ The most important consequence of the difference between these two approaches is that courts are more likely to hold fiduciaries liable for losses to beneficiaries than they are to hold ordinary contracting parties liable for losses their counterparties may experience.

The judicial tendency to apply top-down cognitive processes in cases involving property fiduciaries stems principally from a cognitive phenomenon called the schema. Legal scholars, including those working in BDT, have thus far overlooked this phenomenon. A schema is a cognitive bias that the psychological literature defines as "a cognitive structure that represents knowledge about a concept or type of stimulus, including its attributes and the relations among

⁵ See, e.g., Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 55 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 *DUKE L.J.* 879; J.C. Shepherd, *Toward a Unified Concept of Fiduciary Relationships*, 97 *MOD. L. REV.* 51 (1981).

⁶ See Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 *CORNELL L. REV.* 717 (2000); Jeffrey J. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 *CORNELL L. REV.* 739 (2000).

⁷ I limit my claim to trustees and estate personal representatives—executors and administrators—for two reasons. First, these are the fiduciaries with whom I am most familiar. Second, the legal standards regulating these fiduciaries are more onerous than those that apply to other fiduciaries.

⁸ See SUSAN T. FISKE & SHELLEY E. TAYLOR, *SOCIAL COGNITION* 98 (2d ed. 1991).

⁹ See *id.*

those attributes."¹⁰ More simply, a schema is a fuzzy-edged, but still relatively clear, preconceived image that the observer has of a particular situation or person.

This Essay hypothesizes that courts possess a fairly well-developed schema of the fiduciary role, but have not developed a comparable schema for ordinary contracting parties. The fiduciary role-schema often makes courts more likely to over-interpret behavior of fiduciaries than in the case of conventional contracts. This attribution of qualities to fiduciaries strongly influences how judges analyze the causes of losses to beneficiaries. In some cases, the fiduciary schema alone produces this attribution effect. In others, additional cognitive biases that behavioral decision theorists have identified and analyzed reinforce the schema. In the final Part of this Essay, I will discuss how the fiduciary schema may work together with the well-known hindsight bias to expose fiduciaries to an unusually high risk of liability.

The hypothesis that I develop in this Essay is just that: an untested hypothesis. It requires empirical testing, of course, before warranting any strong claim of validity. But it seems to have sufficient plausibility to merit consideration and, to whatever extent possible, further investigation. Testing the hypothesis would require more than comparisons of outcomes in reported cases involving alleged breaches of fiduciary and nonfiduciary duties. Analysts would also need to compare settlement rates, levels of damages, and other factors. While such an extensive analysis is not impossible, it would be complex and expensive. Short of such comprehensive case testing, an experimental form of testing might assist scholars in evaluating the hypothesis's validity.

I have not engaged in either form of testing. In the final Part of this Essay, I will discuss, both for purposes of illustration and as modest evidence of the hypothesis's plausibility, some recent cases involving fiduciary liability. These cases illustrate the effects of the fiduciary schema in operation by itself and in tandem with other cognitive biases such as the hindsight bias. I fully recognize that the hypothesis's validity ultimately depends on far more empirical work. Nevertheless, introducing the hypothesis into the literature on fiduciary law, even in its current tentative and rudimentary form, seems worthwhile in order to encourage future testing.

I have also chosen to offer the hypothesis at this time to join my colleagues Robert Hillman and Jeffrey Rachlinski in the important debate concerning the value of cognitive theory to legal analysis. In discussing how the fiduciary concept operates as a cognitive schema, my aim is to illustrate how cognitive theory can contribute to the develop-

ment of a more complete positive theory of judicial behavior. In this respect, while I share Professor Hillman's concerns that scholars may be asking cognitive theory to do too much, I agree with Professor Rachlinski's observation that "[t]he new law and psychology has begun to blaze a new trail and to inspire unique questions about law that legal scholars would not otherwise have asked."¹¹ At a minimum, cognitive theory checks the excessively reductionist tendencies of many law-and-economics scholars, including those who reduce all fiduciary relationships to "mere" contracts. More fundamentally, cognitive theory offers the promise of a deeper, richer understanding of the behavior of legal actors. Such an understanding may have concrete consequences for legal reform; and even if it does not impact the reform movement, it will be an intrinsically worthwhile endeavor.

I

SCHEMAS AND CAUSAL ATTRIBUTION IN COGNITIVE THEORY

Recent work in cognitive theory has increasingly emphasized the extent to which schemas influence our inferences and causal explanations.¹² Schemas are knowledge structures that are comprised of assumptions, expectations, and generic prior understandings. We all carry such prior knowledge around with us. People literally could not function in society without ever relying on what they believe they already "know."

Where do schemas come from? Cognitive psychologists generally agree that "[s]chemas develop from encounters with instances or from abstracted communications of the schema's general characteristics."¹³ Concrete experiences are perhaps the most obvious way in which role schemas develop. A person's first encounter with a physician, for example, may generate a schema of doctors as caring and attentive people. However, experience is not the only source of schemas. What we learn or hear about particular roles or situations frequently leads us to create strong expectations of persons occupying those roles or participating in particular recurrent situations. For example, Americans learn at an early age that the first President, George Washington, was a strong military leader and a decisive and trustworthy President. This image has likely formed the basis for a "presidential schema" for many Americans who expect their leader to possess the positive qualities they associate with Washington.

¹¹ Rachlinski, *supra* note 6, at 766.

¹² See, e.g., KENNETH J. GERGEN & MARY M. GERGEN, *SOCIAL PSYCHOLOGY* 46-47, 50 (2d ed. 1986).

¹³ FISKE & TAYLOR, *supra* note 8, at 147.

Schema research has generated an extensive typology of schemas.¹⁴ Fortunately, the type that psychologists have studied most extensively—the so-called role schema—is the focus of my concern in this Essay. The psychological literature defines a role schema as “the cognitive structure that organizes one’s knowledge about . . . appropriate behaviors.”¹⁵ Some roles, such as gender, race, and age, are ascribed, while others are achieved. I will focus on the latter type of role schema here.

Schemas are neither inherently desirable nor undesirable; they simply are. People have different behavioral expectations of others depending on the others’ role. For example, we expect a doctor to behave in a warm yet professional way, while we expect a trial lawyer to behave in an aggressive fashion.¹⁶ Usually, our schemas serve us well. Generic knowledge, like the fact that a red traffic light means that it is not safe to cross the street, is generally reliable and very useful. Other schemas, however, may lead individuals to draw inaccurate or even insidious causal conclusions. For example, many police departments use racial profiles as the basis for whom to arrest.¹⁷

All schemas, but especially role schemas, influence the encoding of information. More importantly, they affect the inferences people draw when they lack information. In this sense, schemas serve as information gap-fillers and frequently provide important efficiencies to their users. At the same time, though, individuals are apt to overuse and misapply schemas.¹⁸ An increasing body of work in attribution theory has focused on the misuse of schemas. Lee Ross and Craig Anderson summarize attribution theory’s approach this way: “[I]n the perspective of attribution theory, people are intuitive psychologists who seek to explain behavior and to draw inferences about actors and about their social environments.”¹⁹ As Richard Nisbett and Lee Ross observe, “[t]he intuitive scientist [i.e., the ordinary person] is prone to several major sources of error in causal analysis, including . . . use

¹⁴ See generally *id.* at 117-21 (discussing person schemas, self-schemas, role schemas, event schemas, and content-free schemas).

¹⁵ *Id.* at 119. For example, a role schema organizes one’s knowledge about “behaviors expected of a person in a particular social position.” *Id.*

¹⁶ Role schemas are closely related to stereotypes. Indeed, as Fiske and Taylor noted, “[o]ne can think about stereotypes as a particular kind of role schema that organizes people’s expectations about other people who fall into certain social categories.” *Id.*

¹⁷ See Eric Lichtblau, *N.J. Agrees to End Race Profiling by Troopers*, L.A. TIMES, Dec. 23, 1999, at A1.

¹⁸ See RICHARD NISBETT & LEE ROSS, *HUMAN INFERENCE: STRATEGIES AND SHORTCOMINGS OF SOCIAL JUDGMENT* 38 (1980).

¹⁹ Lee Ross & Craig A. Anderson, *Shortcomings in the Attribution Process: On the Origins and Maintenance of Erroneous Social Assessments*, in *JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES* 129, 129 (Daniel Kahneman et al. eds., 1982).

of simplistic and 'overly parsimonious' criteria [e.g., schemas] for causal attribution."²⁰

Reliance on stereotypes in causal explanations provides many examples of how schemas lead to erroneous attributions and causal explanations. To pick just one example, many people continue to believe that the German people's innate aggressiveness *caused* World Wars I and II. An even more insidious illustration, according to a still-prevalent line of racist thought, is the notion that African Americans' aversion to work *causes* the higher ratio of poverty among African Americans compared with white Americans. More prosaically, many people believe that in a two-car accident, the driver of the larger or more expensive car was responsible.

This last example prompts another important point regarding reliance on schemas in seeking causal explanations. Considerable data indicate that social observers often go beyond constructing causal explanations and attribute blame to individuals.²¹ Pointing fingers is most likely to occur when an easily identified source—commonly a person—is readily available to blame.²² Moreover, as Susan Fiske and Shelley Taylor explain, "[a]n attribution of blameworthiness is typically reserved for cases in which a causal agent is regarded as subject to censure or punishment for a negative event."²³ Blame-attribution presupposes responsibility. When an agent who owes explicit duties to her principal is available as a responsible causal explanation, people tend to assign blame to the agent.

One might suppose that schemas that repeatedly lead to mistaken conclusions about cause and responsibility would gradually disappear through a process akin to natural selection. Under such a theory, experience would lead people to distinguish over time between "bad" and "good" schemas and abandon use of the former. In fact, cognitive research suggests otherwise. Researchers associate schemas with the cognitive bias known as the conservatism bias.²⁴ This link implies that schemas are strongly resistant to cognitive change. Indeed, the evidence indicates that as people employ schemas more frequently, they become more resilient to inconsistent evidence.²⁵ If I have been taught that priests are saintly men who do not indulge in the vices that plague the rest of us sinners, I am not apt to reject or even amend this prior knowledge when I encounter a priest who smokes, drinks alco-

²⁰ NISBETT & ROSS, *supra* note 18, at 114-15.

²¹ See FISKE & TAYLOR, *supra* note 8, at 83-86.

²² See *id.* at 83.

²³ *Id.* at 84.

²⁴ See Ward Edwards, *Conservatism in Human Information Processing*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES, *supra* note 19, at 359, 359 ("An abundance of research has shown that human beings are conservative processors of fallible information.")

²⁵ See NISBETT & ROSS, *supra* note 18, at 146-50.

hol, or tells off-color jokes. Rather, I am likely to regard this individual as a deviant from his role. Labeling him a deviant reinforces the underlying schema.

Experimental research indicates that ego-involvement is a principal source of the conservatism bias.²⁶ The ego, acting as an organizer of knowledge, encodes and manages information in a highly selective fashion that confirms what is already known. The ego acts to preserve itself by protecting the integrity of its existing organization of knowledge. The conservatism bias to which ego-involvement contributes is evident in a wide variety of common social practices, ranging from Americans' resistance to adopting the metric system to refusals to admit errors in one's memory. The effect of this bias is that once the ego has initially encoded and organized the knowledge, it tends to strongly resist change.

Legal analysis is particularly vulnerable to schemas and other cognitive biases and heuristics.²⁷ At first blush, this observation may seem counterintuitive. After all, in litigation, both sides must introduce nonintuitive, bottom-up evidence to support their causal accounts, and this evidence must meet particular standards of proof. Nevertheless, even these checking mechanisms are not sufficient to fully neutralize what Daniel Kahneman and Amos Tversky have called the "anchoring" effects of schemas.²⁸ That is, decision makers have difficulty overcoming their initial schema-based judgment about a problem, even in the face of analytical or evidentiary challenges.

Recent work in attribution theory²⁹ has emphasized the extent to which schemas influence how observers of events identify and explain the causes of those events.³⁰ As Fiske and Taylor explain, "there is now evidence that . . . when people are faced with a causally ambiguous situation . . . they think through what they know about the causes *in that specific domain*."³¹ People tend to rely on particular categorical schemas in making causal attributions rather than applying content-free attributional principles. This reliance on categories leads lay observers to overattribute characteristics and dispositions to actors who occupy those categorical positions. They draw particular inferences about the actors involved in the events that they are trying to explain.

²⁶ See Anthony G. Greenwald, *The Totalitarian Ego: Fabrication and Revision of Personal History*, 35 AM. PSYCHOLOGIST 603, 603 (1980).

²⁷ Here, I agree with Professor Hillman, whose paper makes this point effectively. See Hillman, *supra* note 6, at 735-36.

²⁸ Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1128 (1974) ("[D]ifferent starting points yield different estimates, which are biased toward the initial values. We call this phenomenon anchoring.")

²⁹ See Ross & Anderson, *supra* note 19, at 129, 130.

³⁰ See Amos Tversky & Daniel Kahneman, *Causal Schemas in Judgments Under Uncertainty*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES, *supra* note 19, at 117, 125.

³¹ FISKE & TAYLOR, *supra* note 8, at 60.

These inferences, in turn, affect their causal judgments. The ordinary observer is apt to draw different conclusions about actors' responsibility for events according to the categorical role that the actors occupy.

One of the most important dimensions of role categorization is the type of relationship between an actor and others with whom she interacts. More accurately, socially created knowledge structures *assign* a relational type to someone who occupies a particular role. This assignment strongly influences how lay analysts interpret that person's responsibility for events with which she is associated. Knowledge structures tend to assign relational roles according to hierarchical or nonhierarchical categories. For example, friends, business partners, and co-workers relate to each other nonhierarchically, which means that they hold positions of relative equality of power and knowledge. Doctor-patient, lawyer-client, and parent-child relationships, by contrast, tend to be hierarchically structured relationships in which one party occupies a role of dominance and responsibility for the other.

The fact that collective schemas assign responsibility to the dominant role-occupant in hierarchically structured relationships strongly influences how lay observers analyze questions of responsibility and blame for bad events that happen to the subordinate role-occupant. Lay observers are much more apt to assign blame to dominant role-occupants in hierarchical relationships than they are to either role-occupant in nonhierarchical relationships. Blaming the dominant role-occupant is the default norm for hierarchical relationships. No default norm exists for nonhierarchical relationships, so analysts resolve causation issues using data-driven, bottom-up analysis.

II

FIDUCIARY RELATIONSHIPS, ROLE-SCHEMAS, AND LIABILITY ATTRIBUTION

The cognitive theory of role schemas may help explain how fiduciaries differ from ordinary contracting parties. Legal cognition associates fiduciaries with a distinct role schema. Lawyers and judges explicitly learn to view the status of a fiduciary, especially a property fiduciary, as a distinctive legal role. As such, they subject the fiduciary relationship to more stringent legal norms than those they apply to nonfiduciary legal roles. This training forms the basis for a schema of fiduciaries that differs in important respects from schemas associated with nonfiduciary contracting parties.

Legal training is not the only source of the trustee schema. Trustees themselves play an important role in its development. Two-hundred years ago, trustees were individuals with whom the trustor had a

long-term personal relationship.³² Today, the vast majority of trusts are administered by large financial institutions, such as trust companies and trust developments of commercial banks. The shift from personal to institutional trustees created a need for literally trust-inducing mechanisms. To encourage trustors to repose their trust in large and impersonal institutions, the earliest trust companies began the now-universal marketing practices through which trust companies explicitly create a self-image of trustworthiness. These practices range from adopting names like "Old Fidelity Trust Company" to advertising strategies that emphasize the personal relationship between the company's trust officers and its clients. These practices bear a substantial responsibility for developing both the extraordinarily high expectations that the legal system has of trustees and the concomitant risk that those expectations will not be entirely fulfilled.

Legal doctrine reinforces those expectations. Conventional legal doctrine depicts the relationship between fiduciaries and their beneficiaries as vertical, with the fiduciary occupying a dominant position of power and responsibility. By contrast, traditional doctrine describes nonfiduciary contracting parties' relationships as horizontal, where all parties are equal and attend exclusively to their own interests. Admittedly, contract doctrine often distinguishes between different sorts of transactions,³³ but the paradigmatic image of contract is a horizontal relationship. Certainly, no one thinks that contract law *systemically* or *formally* assigns contracting parties to dominant and subordinate roles. Yet, that is precisely what fiduciary law does. Fiduciary law *always* defines the trustee or estate executor as the dominant party, who is systematically empowered over the subordinate beneficiary.

The difference between the horizontal and vertical relational character of fiduciary and nonfiduciary roles leads to substantial differences in the duties that the law assigns to those roles; it also leads to important differences in the ways in which courts determine whether parties have fulfilled or breached those duties. For example, no one talks about a duty of undivided loyalty between contracting parties. Certainly, the good-faith obligation exists, but that obligation is substantially weaker than and qualitatively different from fiduciary law's duty of loyalty. The typical judicial rhetoric explaining contract law's good-faith duty speaks of "refrain[ing] from arbitrary or unreasonable conduct"³⁴ and similar notions.³⁵ Indeed, courts do not universally

³² See generally *Peering into Trust Industry Archives*, 115 TR. & EST. 452 (1976) (reviewing the history of the modern trust business in the United States of the past 200 years).

³³ For example, it distinguishes between merchant and consumer contracts.

³⁴ *Wilgus v. Salt Pond Inv. Co.*, 498 A.2d 151, 159 (Del. Ch. 1985).

³⁵ See *Hais v. Smith*, 547 A.2d 986, 987 (D.C. 1988) ("This duty prevents a party from evading the spirit of the contract by willfully rendering imperfect performance or interfering with the other party's performance."); *Blank v. Chelmsford Ob/Gyn, P.C.*, 649 N.E.2d

recognize the implied duties of good faith and fair dealing. In Texas, for example, the courts refuse to imply covenants of good faith and fair dealing in most contracts.³⁶ In the contractual relationship, self-interest is the name of the game for both parties. Claiming that contract law requires that either party act out of undivided loyalty to the other party is laughable.

By contrast, fiduciary law's loyalty obligation requires that one party completely subordinate self-interest and act exclusively for the benefit of the other party. Unlike the contractual relationship, undivided loyalty is the heart of the fiduciary relationship, especially for property fiduciaries like trustees and estate executors. Joel Dobris and Stewart Sterk accurately express the legal profession's perception of fiduciary duties: "Lawyers tend to see the primary fiduciary duty as the duty of loyalty. A disloyal fiduciary is an anathema."³⁷ The picture that emerges from the case law is that in contractual relationships the duty is "don't screw the other side," but with regard to fiduciary relationships the demand to the fiduciary is "protect your beneficiary, not yourself."³⁸

Trust law has developed stringent rules to enforce the duty of loyalty. Perhaps most notably, the no-further-inquiry rule triggers strict liability in cases of trustee self-dealing.³⁹ Under this rule, a trustee is liable for all losses to the trust regardless of whether she acted reasonably or in good faith and regardless of whether her actions caused the losses. Although strict liability does not apply to instances of disloyalty other than self-dealing, judicial scrutiny is still intense. Courts may hold trustees liable for even the appearance of a conflict of interest.

The rationale for both the loyalty duty and the decidedly strict approach to enforcing that duty rests in the vertical character of the property fiduciary's relationship with the beneficiaries. The verticality

1102, 1105 (Mass. 1995) (stating that a covenant of good faith requires "that neither party shall do anything that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract" (quoting *Anthony's Pier Four, Inc. v. HBC Assocs.*, 583 N.E.2d 806 (Mass. 1991))); *Sterling Capital Advisors, Inc. v. Herzog*, 575 N.W.2d 121, 125 (Minn. Ct. App. 1998) ("Minnesota law does, however, impose an implied covenant of good faith and fair dealing into every non-sales contract to prevent one party from unjustifiably hindering the other party's performance of the contract.").

³⁶ See *English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983) ("To adopt the laudatory sounding theory of 'good faith and fair dealing' would place a party under the onerous threat of treble damages should he seek to compel his adversary to perform according to the contract terms as agreed upon by the parties.").

³⁷ JOEL C. DOBRIS & STEWART E. STERK, *RITCHIE, ALFORD & EFFLAND'S ESTATES AND TRUSTS: CASES AND MATERIALS* 942 (1998).

³⁸ I am indebted to my colleague, James Henderson, for sharing with me a collection of judicial statements that reflect this difference in outlook.

³⁹ See WAGGONER ET AL., *FAMILY PROPERTY LAW: CASES AND MATERIALS ON WILLS, TRUSTS, AND FUTURE INTERESTS* 1222-25 (2d ed. 1997).

of that relationship implies that a gross imbalance of power exists between the parties. One commentator expresses the conventional wisdom when he states that "the hallmark of a fiduciary relation is that the relative legal positions are such that one party is at the mercy of the other's discretion."⁴⁰ The legal literature consistently depicts trustees as occupying positions of superior power and beneficiaries as being vulnerable. This explains why judicial opinions in breach-of-trust cases are, as Dean Clark has pointed out, replete with moralizing rhetoric.⁴¹ Judge Easterbrook and Dean Fischel are correct in stating that moral rhetoric is "a proposition about judges rather than about rules,"⁴² but from a cognitive perspective it is judicial behavior that matters. Rhetoric matters, too, precisely because it affects behavior.

The characteristic moral tone of judicial opinions about fiduciaries reflects the influence of a distinctive role-schema that judges associate with fiduciaries. Judges analyze claims of fiduciary liability in a qualitatively different fashion than they analyze claims of contractual liability. While they are more apt to use data-driven methods to decide ordinary contractual disputes, judges tend to rely on a particular knowledge structure associated with the fiduciary role when dealing with claims of fiduciary misfeasance. The relational verticality of the fiduciary role strongly affects the content of that knowledge structure.

There are, of course, many vertical role relationships in society, but the two that we are most likely to associate with the trustee-beneficiary or executor-beneficiary relationship are those between master and servant⁴³ and between parent and child. Both the parent-child and master-servant relationships involve structural power imbalances that are directly analogous to trustee-beneficiary relationships. These power imbalances result from two factors. First, the party in the subordinate role tends to be passive and has only highly constrained exit options. The effect of the power imbalance is that the relationship is rife with opportunities for abuse by the dominant role. Masters and parents do not always abuse their charges, of course, but scholars widely recognize that the roles are fraught with this risk. Second, given the intimacy of the parent-child and master-servant relationships, abuses by the dominant role are difficult to detect. Courts' difficulty with discovering abuses highlights the need for more stringent

⁴⁰ Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 7 (1975).

⁴¹ See Clark, *supra* note 5, at 75-76.

⁴² Easterbrook & Fischel, *supra* note 2, at 434.

⁴³ Mere employer-employee relationships do not constitute master-servant relationships.

standards of liability to discourage those who might be tempted to abuse their greater power.⁴⁴

The structural similarity between the parent-child and master-servant relationships on the one hand and the fiduciary-beneficiary relationship on the other leads judges, as intuitive psychologists, to associate the latter with the former. That association in turn affects the inferences that judges draw about the fiduciary. Judges are not neutral about what they expect from fiduciaries. The fiduciary's (perceived) power superiority, combined with the difficulty of actually detecting abuses of power, leads judges to draw inferences against fiduciaries. Moreover, because fiduciaries, like parents and masters, are expected to protect their charges when beneficiaries experience losses, judges are apt to blame the responsible fiduciary. Consequently, judges will resolve questions of doubt against the fiduciary.

This mode of analysis differs substantially from courts' traditional approach to alleged breach-of-contract cases. Because the contracting parties' relationship is horizontal rather than vertical, they are normally assumed to be equally powerful and responsible only for themselves.⁴⁵ There is no a priori warrant for drawing inferences against one side or the other. Consequently, analysis of disputes between contracting parties must be more data-driven than in cases of beneficiary losses.

If my hypothesis regarding the influence of schemas in fiduciary cases is correct, then we should expect greater accuracy in determining liability in judicial decisions on contract claims than on breach-of-fiduciary-duty claims. This discrepancy results because courts employ a more data-driven mode of analysis in contract cases that is relatively uninfluenced by knowledge structures like role-schemas. That is, actual evidence more frequently tends to warrant attribution of liability in contract cases than in fiduciary cases.

III

TWO ILLUSTRATIVE CASES

A. The Fiduciary Schema in Operation: *In re Estate of Rothko*

In order to illustrate the influence of the distinctive fiduciary schema that I have described, I will briefly discuss a widely noted case

⁴⁴ For a similar argument, see Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1053-56, 1074 (1991).

⁴⁵ This statement needs to be qualified to acknowledge differences among various sorts of contracts. For example, courts are much more apt to treat merchant-merchant contracts as relationships between equals than when they encounter merchant-consumer contracts. Even in the case of merchant-consumer contracts, however, there is no systemic assumption that the consumer is vulnerable or unable to protect her own interests.

involving alleged breaches of the duty of loyalty. The case, *Rothko v. Reis (In re Estate of Rothko)*,⁴⁶ attracted considerable attention not only because it involved a famous artist's estate, but also because the three courts that heard the case treated the fiduciaries quite harshly.

Three months after Mark Rothko's tragic death by suicide in 1970, the three coexecutors of his estate entered into two contracts with a well-known art gallery, Marlborough, to deal with some 800 paintings remaining in the estate.⁴⁷ Rothko had personally selected all three coexecutors, and his will expressly conferred on them the power to sell his estate assets, including his paintings.⁴⁸ The first contract sold 100 paintings to the gallery for \$1.8 million.⁴⁹ The second contract consigned the remaining 700 paintings to the gallery, to be sold over twelve years at a fifty percent commission.⁵⁰

The trial court found that two of the executors, Bernard Reis and Theodoros Stamos, had breached their duty of loyalty by entering into these contracts.⁵¹ The conflict of interest arose because Reis and Stamos were involved with the gallery in relationships that, according to the court, benefitted them personally.⁵² Reis was an officer (but not owner) of Marlborough, while Stamos was a "not-too-successful artist" whose work Marlborough later handled.⁵³ The court found that the two men attempted to curry favor with the gallery by cutting deals that were unusually favorable to the gallery and allowed the gallery to earn substantial profits from resales of some of the paintings.⁵⁴ The court held that the third executor, Morton Levine, was not guilty of self-dealing, but acted negligently in failing to blow the whistle on his two disloyal coexecutors.⁵⁵

The court voided the two contracts, ordered return of the unsold paintings, and held the three coexecutors and the gallery jointly and severally liable for approximately \$6.5 million.⁵⁶ This amount represented the fair market value of the sold paintings at the time of sale.⁵⁷ In addition, the court held the two disloyal coexecutors and the gallery liable for an extra \$2.8 million as "appreciation damages."⁵⁸ This

⁴⁶ 372 N.E.2d 291 (N.Y. 1977).

⁴⁷ *See id.* at 293; *Estate of Rothko*, 379 N.Y.S.2d 923, 935 (Sur. Ct. 1975); Lee Seldes, *The Passion of Mark Rothko*, *ESQUIRE*, Nov. 1974, at 118, 122.

⁴⁸ *See* 372 N.E.2d at 293.

⁴⁹ *See id.*

⁵⁰ *See id.*

⁵¹ *See id.* at 294.

⁵² *See id.*

⁵³ *Id.* (quoting *Estate of Rothko*, 379 N.Y.S.2d at 941).

⁵⁴ *See id.*

⁵⁵ *See id.*

⁵⁶ *See id.* at 294-95.

⁵⁷ *See id.* at 295.

⁵⁸ *Id.*

represented the increase in the market value of the sold—and therefore unrecoverable—paintings between the time of sale and the time of trial. The two disloyal fiduciaries were therefore liable for some \$9.2 million.

Both the New York Appellate Division and the New York Court of Appeals affirmed the trial court's findings, including the amounts of liability.⁵⁹ Writing for the Court of Appeals, Judge Cooke stated that the court based its disloyalty findings on clear and strong evidence of actual disloyalty that directly caused substantial losses to the estate beneficiaries rather than on the strict liability no-further-inquiry rule.⁶⁰ As other commentators have noted,⁶¹ though, it is hard to square these conclusions with the facts. *Vis-à-vis* the gallery and the two disloyal coexecutors, the \$5.5 million award, which constituted the amount actually realized from the resale of paintings, is conceivably justifiable on restitutionary grounds as disgorgement of actual gain. However, it is impossible to justify that award as restitution against the third coexecutor, who was not disloyal and in no way stood to gain from the transactions with the gallery. In order to make sense of the award as against the third coexecutor, we must assume that the award represents causally connected compensatory damages. But that theory works only if the executors owed a legal duty to delay sales of the paintings. The trial court, however, made no finding that the timing of the sales was wrongful. More significantly, none of the three courts that heard the case asked how loyal and nonnegligent executors would have handled the estate under the circumstances. By framing the issue that way, the court would have invoked a bottom-up, data-driven mode of analysis.

Such an analysis would have disclosed several facts about which all three courts were totally silent. In response to the estate's expert witnesses, who contended that a more gradual plan of disposition was appropriate, one might have pointed out that a loyal and nonnegligent executor had to anticipate tax liabilities in addition to satisfying the decedent's cash bequests. Rothko's will made a cash bequest to his wife of \$250,000. The original estate tax return of the coexecutors conceded a liability of \$546,000; the IRS responded that the deficiency was \$4.6 million.⁶² On the other side of the ledger, the estate's cash position at death was limited. Rothko had \$330,000 in bank deposits and \$1.1 million in receivables.⁶³ These figures alone suggest

⁵⁹ See *id.* at 295, 300.

⁶⁰ See *id.* at 296.

⁶¹ See, e.g., Richard V. Wellman, *Punitive Surcharges Against Disloyal Fiduciaries—Is Rothko Right?*, 77 MICH. L. REV. 95, 100-01, 113-14, 117 (1978) (arguing that courts should limit recoveries against disloyal fiduciaries to restitution and not to appreciation damages).

⁶² See Franklin Feldman, Letter, ART NEWS, Mar. 1977, at 32.

⁶³ See Seldes, *supra* note 47, at 178.

that the coexecutors were probably justified in selling when they did in order to improve the estate's liquidity to a level necessary to both pay taxes and satisfy cash bequests.

Beyond that, a loyal and nonnegligent executor would have taken other factors into account. As Richard Wellman aptly remarks, these factors include

weigh[ing] the risks of retaining inventory in the hope that, because of the stature of the artist and the quality of the paintings, its worth would increase; consider[ing] whether cash or art best suited the originally stated purpose of the residuary foundation to support deserving artists pending market acceptance of their works; and remember[ing] the conventional wisdom of fiduciary administration that the fiduciary's first obligation is to conserve values which are certain and to avoid speculation.⁶⁴

Again, the three courts' opinions were completely silent about all of these considerations.

The trial court's opinion typified all three courts' mode of analysis. The trial judge, Surrogate Millard Midonick, attributed a number of personal characteristics to the three coexecutors and focused especially on Bernard Reis. Reis and the others, Midonick asserted, were predisposed to look for opportunities for personal gain. Since Reis already had amassed a huge fortune, his gain was not financial. Rather, Reis sought prestige or, as Midonick put it, "aggrandizement of status."⁶⁵ Reis's position as executor enabled him to act on his ambition by cutting deals with Marlborough on terms that favored the gallery at the expense of the estate.

Midonick's analysis was, in short, dispositional rather than situational. That is, his analysis reflected the belief that people like Reis are motivated by individual proclivity rather than by responding to situational circumstances that are pertinent to the actions they take at a given moment. As Midonick's opinion demonstrates, dispositional behavioral analysis encourages inferential leaps. Midonick reasoned that because Reis was predisposed to engage in opportunistic behavior, his motive for entering into the two contracts with Marlborough was strictly self-interested. Although Reis did not technically engage in self-dealing, Midonick viewed Reis's self-interest as so gross that he labeled Reis's breach of loyalty "the equivalent of self-dealing."⁶⁶ Midonick's attributional inferences effectively precluded him from conducting a detailed analysis of legitimate reasons that might have motivated Reis to act as he did. As a result of foregoing such an inquiry, Midonick magnified the degree of disloyalty and consequently

⁶⁴ Wellman, *supra* note 61, at 101 n.23.

⁶⁵ Estate of Rothko, 379 N.Y.S.2d 923, 940 (Sur. Ct. 1975).

⁶⁶ *Id.*

increased the size of the liability judgment. In sum, it seems that the fiduciary role-schema exerted a greater influence on Midonick than any comprehensive and neutral assessment of the immediate circumstances affecting the actor.

B. The Fiduciary Schema and the Hindsight Bias

In some instances the fiduciary schema operates alone, while in other situations it operates along with other cognitive phenomena. As Professors Hillman and Rachlinski have clearly articulated, cognitive psychologists have identified a wide array of cognitive errors that affect decisional processes.⁶⁷ Many of these errors are relevant to legal decision makers, including courts and juries.⁶⁸ With respect to decisions about fiduciary liability, hindsight bias is the most prominent cognitive error.

Numerous scholars have documented this bias and fully explained its relationship to law,⁶⁹ but I will nonetheless provide a brief description here. Cognitive psychologists have described the hindsight bias as individuals' tendency to consistently exaggerate what, in foresight, they could have anticipated. It is the persistent tendency of people to believe that what they know *ex post* was eminently knowable *ex ante*. Or, as one psychologist puts it, "[p]eople believe that others should have been able to anticipate events much better than was actually the case."⁷⁰

The hindsight bias has obvious implications for property fiduciaries, especially trustees. Trust law imposes a rigorous duty on trustees to behave "prudently" when investing trust assets.⁷¹ As prudent investors, trustees are "to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."⁷² Under this rule, courts are supposed to judge prudence *ex ante* as opposed to *ex post*. As Professor Rachlinski has articulated, however, the truth is that "[t]he law governing the liability of trustees for improperly investing trust assets is best described as an instance of

⁶⁷ See Hillman, *supra* note 6, at 719-25; Rachlinski, *supra* note 6, at 743, 748, 750-51.

⁶⁸ See Hillman, *supra* note 6, at 731-32, 735-36; Rachlinski, *supra* note 6, at 753-56.

⁶⁹ See, e.g., Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998).

⁷⁰ Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES, *supra* note 19, at 335, 341.

⁷¹ For an excellent overview and critique of the prudent man rule in trust law, see Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52, 57-62 (1987).

⁷² *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, 461 (1830).

courts falling prey to the hindsight bias."⁷³ Courts have a pronounced propensity to evaluate the prudence or imprudence of a trustee's investment decision on the basis of information that the trustee could not have known at the time she made the decision. In trust litigation, trustees who are sued because their investments turned sour and resulted in losses to the beneficiaries have the unenviable challenge of starting out at the bottom of a deep hole.⁷⁴

In trust litigation, the fiduciary schema often reinforces the hindsight bias. As I indicated earlier, the structural power imbalance in the trustee-beneficiary relationship, in which the trustee is perceived as inherently dominant, together with the difficulty of actually detecting abuses of power, leads judges to draw inferences against trustees in doubtful cases. That tendency strengthens the hindsight bias by prompting legal decision makers to conclude that information they gained *ex post* was readily available *ex ante*.

The effects of the hindsight bias in turn reinforce the fiduciary schema so that the two cognitive phenomena confirm each other. A recent case involving alleged trustee imprudence illustrates this mutually reinforcing operation. In *First Alabama Bank v. Martin*,⁷⁵ the court held that the trustee's sale of certain stocks from a large and diversified common trust fund was imprudent because he sold the stocks "at the bottom of the market."⁷⁶ The court initially acknowledged the potential hindsight problem, but then immediately drew an inference about the propriety of the sale's timing against the trustee. "It is true," the court stated, "that a trustee will not be held liable under ordinary circumstances for losses due to unforeseen depression or recession of the stock market."⁷⁷ In the next sentence, the court undermined its acknowledgment by implicitly relying on a presumption that the trustee had abused his position: "Yet, where the course of dealing of the trustee is such that it causes the loss, a trustee will be liable."⁷⁸ This statement is problematic because it assumes the answer to the very question before the court: Should the court attribute the cause of the loss to the trustee's decision? This causal attribution effectively means that in cases of doubt the court will draw an inference against the trustee. Information that the trustee did not have available *ex ante* but gained *ex post* supports the inference.

⁷³ Jeffrey J. Rachlinski, *Cognitive Biases and the Courts: Ignorance or Adaptation?* 16 (1999) (unpublished manuscript, on file with author).

⁷⁴ Professor John Langbein and Judge Richard Posner have made a similar assessment. See John H. Langbein & Richard A. Posner, *Market Funds and Trust Investment Law*, 1976 *AM. B. FOUND. RES. J.* 1, 6.

⁷⁵ 425 So. 2d 415 (Ala. 1982).

⁷⁶ *Id.* at 428.

⁷⁷ *Id.*

⁷⁸ *Id.* (citation omitted).

Some commentators have viewed *Martin* as an exceptional case of judicial "backwardness and irrationality" in the law of trust investments.⁷⁹ Admittedly, *Martin* is a particularly extreme instance of cognitive error affecting causal attribution, but it is not an isolated example of this problem. Other recent cases reflect the combined effect of the fiduciary role-schema's causal inference and the hindsight bias. In *Millikan v. Hughes (In re Estate of Collins)*,⁸⁰ for example, the appellate court reversed the trial court's finding that the trustees "exercised the judgment and care under the circumstances then prevailing expected of men of prudence."⁸¹ Here, the trustee imprudently loaned \$50,000 to a builder where the loan was secured by a second mortgage on a parcel of unimproved land.⁸² The investment soured when the builder went bankrupt and the holder of the first mortgage foreclosed.⁸³ The first mortgage was worth \$90,000, and two years prior to the trustees' investment the owners sold the property for \$107,000.⁸⁴ The appellate court concluded that the trustees had "left an inadequate margin of safety."⁸⁵ The court acknowledged that at the time the trustee made the loan, construction industry in the area was "enjoying boom times, although the bubble was to burst just a few months later."⁸⁶ While the trustees did not have the parcel appraised, they did obtain the opinions of two real estate brokers regarding real estate values in the vicinity. The brokers informed the trustees that property in that area was selling for between \$18,000 and \$20,000 per acre. At those prices, the parcel in question was worth between \$170,000 and \$187,000.⁸⁷

The court dismissed the evidence of valuation with the remark that "any assumption that the property was worth about \$185,000—and therefore the \$140,000 in loans were well-secured—would have been little more than a guess."⁸⁸ In reality, any method of valuing real estate other than actual sale involves some degree of guesswork. The trustees were acting on the basis of current information provided by professionals who were familiar with current land values in the relevant locality. They were hardly in a position to realize or anticipate what the court later knew—that the bottom was about to drop out of the real estate market. The influence of hindsight bias on the court is

79 BEVIS LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 18* (1986).

80 139 Cal. Rptr. 644 (Dist. Ct. App. 1977).

81 *Id.* at 649.

82 *See id.* at 647.

83 *See id.*

84 *See id.* at 649.

85 *Id.*

86 *Id.* at 647. (quoting the trial court).

87 *See id.*

88 *Id.* at 649.

clear. The fiduciary schema's influence on the court's causal attribution is also evident. The court gave no indication of how the trustees could have known at the time they acted that the margin of safety was "inadequate." In truth, the adequacy or inadequacy of the margin of safety, judged *ex ante*, is more a matter of judgment than of fact. Even though the trustees presented at least some evidence to sustain their judgment call, the court attributed them with the loss. In doing so, the court relied on a presumption of imposing causal responsibility on the fiduciary. The fact that the court employed such a presumption does not necessarily mean that the case was wrongly decided. Indeed, other factors in the case might make the court's decision understandable. The point is that a considerable part of the court's reasoning exemplifies what I have called top-down causal reasoning. That reasoning, together with the effect of the hindsight bias, placed the trustees in considerable jeopardy from the very outset.

The moral that courts seem to have gleaned from these cases is that "when in doubt, hold the trustees liable." The *knowledge* about fiduciaries that courts take with them as they approach an allegation of fiduciary misconduct, combined with the influence of post hoc information, exposes trustees to a high level of risk of liability. Trustees are probably not the only professionals in this unenviable position. Physicians, especially certain specialists, likely face the same problem for similar reasons. Future research applying cognitive theory to legal decision making will surely be needed to confirm or deny the ideas I have presented in this Essay.

CONCLUSION

My goal in this Essay has been to suggest a sense in which at least some types of fiduciary relationships differ from ordinary contracts. I do not argue that courts always hold trustees and executors liable for beneficiary losses. Not all courts fall prey to cognitive errors when dealing with claims against fiduciaries. Sometimes, the analysis is more data-driven and leads to accurate decisions. Yet, cognitive error likely creeps into judicial analysis in contract cases as well as fiduciary cases. Still, judicial behavior and reasoning are, under my hypothesis, characteristically different in the two contexts. While my hypothesis requires further empirical testing, I posit that distinctive role schemas and related aspects of knowledge structures are at work in fiduciary litigation and create a greater risk of judicial error in that context than in an ordinary contracting scenario.