A Study on Fiduciary Duty

－Focusing the State of Delaware－

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Contents

Ⅰ. Introduction

This article purports to be a brief and concise introduction into American law of Fiduciary duty in order to shed a light on the topic and its related areas for law students and scholars in foreign jurisdictions. Due to the dominance of Delaware state laws and cases, the emphasis is on those cases and rules stemming from the state of Delaware.

Corporate directors as managers of corporation are said to be fiduciaries who owe certain duties to the corporate shareholders. Fiduciary principles govern agency relationships where one (the principal) delegates authority to another person (the agent) to perform some service on the principal's behalf.[1] In our context the principal is a shareholder of a corporation and

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1) Easterbrook & Fischel, "Corporate Control Transactions", 91 *Yale L.J.* 698, 700 (1982).

the agent is the manager. There are two main streams of the fiduciary duties, i.e., the duty of care and the duty of loyalty. This bifurcated system has been changing into the three prong concept adding the duty of good faith recently.

With the growing popularity of non-corporate forms such as limited liability companies and partnerships, the issue become whether the fiduciary duties can be subject to a waiver in the company's operating agreement so that the fiduciary duties are completely avoided by these non-corporate entities.

Extending the fiduciary duties to officers of a corporation is a new trend in the fiduciary duty law. Recently the Delaware court held that corporate officers as well as directors owed the fiduciary duties to corporation and its shareholders.

Lastly, fiduciary duties and good faith are compared in the sense that they both are contractual gap fillers but a different generality. The former functions as untailored defaults that provide what most parties would have wanted in the fiduciary setting such as agency, trust or partnership. However, good faith fills the contractual gaps based on what the parties old have wanted for a specific case. This is a law and economics approach probing how the law can be structured and functioned to promote economic efficiency.

Ⅱ. Dominance of the State of Delaware

A peculiar aspect of the U.S. Corporate law is that corporations are allowed to choose their place of incorporation. Subsequently, the corporate affairs will be regulated and governed by the rules of the states which they chose to conduct the business in. The most dominant state in attracting such incorporation is the small state of Delaware.[2] Although Delaware is home to less than one third of a percent of the U.S. population,[3] it is the incorporation jurisdiction of half of the publicly traded companies in the U.S. and of an even greater fraction of the larger publicly traded companies.[4] Given the fact that the state Delaware has been the choice of incorporation of large publicly traded companies, the state has been producing a bulk of important case laws shaping the U.S. corporate law.[5]

Ⅲ. Definition of Fiduciary Duty

It is a long held view that corporate directors in the discharge of their duties stand in a fiduciary relationship to the corporation. It has sometimes been said that directors are trustees.[6] Further, the directors are bound by all those rules of conscientious fairness, morality, and honesty in purpose which the law imposes as the guides for those who are under the fiduciary

2) Lucian Arye Bebchuk & Assaf Hamdani, Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition over Corporate Charters ("Race"), Discussion Paper No. 376, Harvard Law School, John M. Olin Center for Law, Economic and Business (2002), p. 1.

3) Race, at 1, its footnote 2 states 'at the end of 1999, Delaware had a population of about 740,000, whereas the total population of the U.S. was about 270 million.'

4) Race, at 1, its footnote 3 states 'Delaware is the state of incorporation for 51% of U.S. public companies and for 63% of Fortune 500 companies.'

5) Generally refer: Andrew A. Lundgren, Sarbanes-Oxley, Then Disney: The Post-Scandal Corporate-Governance Plot Thickens, 8 Del. L. Rev. 195 (2006).

6) Litwin v. Allen, 25 N.Y.S. 2d 667, 677, citing Bosworth v. Allen, 168 N.Y. 157, 61 N.E. 163, 55 L.R.A. 751.

obligations and responsibilities. They are held, in official action, to the extreme measure of candor, unselfishness, and good faith. Those principles are rigid, essential, and salutary.[7] In other words, directors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment or for mistakes while acting with reasonable skill and prudence.[8]

Ⅳ. Types of Fiduciary Duties

Traditional Fiduciary Duties are duty of care and duty of loyalty with respect to corporate directors[9]. Corporate officers' liability under the fiduciary duty laws are more complex issue at this point. Alleged breaches of duty of care were protected by the business judgment rule and alleged breaches of the duty of loyalty were reviewed under the entire fairness test. Only violations of duty of loyalty were likely to lead to liability.[10]

1. Duty of Care

Under general corporate law, the business affairs are governed and managed by the corporation's board of directors. Under Delaware law, the business judgment rule is that the offspring of the fundamental principle

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7) Id. at 677, citing Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 193.

8) Id. at 678.

9) With respect to corporate officers, the historical view was that the law of fiduciary duties does not apply.

10) Julian Velasco, "How Many Fiduciary Duties Are There In Corporate Law?" 83 S. *Cal. L. Rev.* 1231, 1233 (2010) (hereinafter 'Many').

that the business and affairs of a Delaware corporation are managed by or under its board of directors.[11] This rule is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.[12] The burden of proof lies on the claimant that the board in fact made a decision on uninformed stage. Therefore, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.[13] The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves, prior to making a business decision, of all material information reasonably available to them.[14] In other words, under the business judgment rule, there is no protection for directors who have made an unintelligent or unadvised judgment.[15] Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty.[16] The standard of review under the business judgment rule is based upon concepts of gross negligence.[17] Curiously, therefore if a negligent director shall escape the liability under the rule while the only grossly negligent one will be liable. There is no

11) Smith v. Van Gorkom, 488 A.2d.858 (Del. 1985) at 872 citing Pogostin v. Rice, 480 A.2d 619, 624 (1984); Zapata Corp. v. Maldonado, Del.Supr., 430 A.2d 779, 782 (1981).

12) Aronson v. Lewis, Del.Supr., 473 A.2d 805, 812 (Del. 1984).

13) Smith, at 872.

14) Id. at 872, citing Kaplan v. Centex Corporation, Del.Ch., 284 A. 2d. 119, 124 (1971).

15) Id. at 872, citing Mitchell v. Highland-Western Glass, Del.Ch., 167 A. 831, 833 (1931).

16) Id. at 873, citing Allaun v. Consolidated Oil Co., Del.Ch., 147 A. 257 (1929).

17) Many, at 1239.

bright line test to determine a conduct of a director was only negligent or grossly negligent. The court will look closely to the facts presented in the case to evaluate if the conduct was in fact grossly negligent.

2. Duty of Loyalty

The second prong of the fiduciary duty is involved with the notion of duty of loyalty. The standard review under this rule is that a conduct by a director was tangled with self interest, i.e., conflicts of interests. While the business judgment rule generally presuppose the notion that directors can be trusted, thus they can be liable only when they are grossly negligent. In other words, if the key insight of the business judgment rule is that directors generally can be trusted, the key insight of the entire fairness test is that this is not always so.[18] Thus corporate directors are not permitted to use their position of trust and confidence to further their private interests.[19] The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[20] It is a long-established principle of Delaware corporate law that the fiduciary relationship between directors and the corporation imposes fundamental limitation on the extent to which a director may benefit from dealings with the corporation he serves.[21] Under the rule of per se voidability, self interested dealings by a director may be deemed "constructively fraudulent" in the absence of shareholder ratification, or statutory or bylaw authorization.[22]

18) Many, at 1240.

19) Many, at 1240.

20) Many, at 1240.

21) Marciano v. Nakash, 535 A.2d 400, 403 (Del. 1987) citing Guth v. Loft, Inc., 5 A.2d 503 (1939).

The principle of per se voidability for interested transactions, which is sometimes characterized as the common law rule, was significantly ameliorated by the enactment of Section 144 of the Delaware General Corporation Law.[23] Thus, if a transaction is sanitized by director or shareholder approval, it usually is found not to involve a conflict of interest and is reviewed under the business judgment rule. Otherwise, it is subject to scrutiny under the entire fairness test.[24] The entire fairness test contains two factors, i.e., a procedural and a substantive component. According to Weinberger v. UOP, Inc., the concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed transaction, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.[25]

This bifurcated system of fiduciary duty law has been changing recently. The Delaware courts have been active in redefining the realm of the law. In Smith v. Van Gorkom,[26] the court held the directors liable although many did not believe their conduct inappropriate.[27] Around the same time, the court began to announce a number of intermediate standards of review

22) See Guth v. Loft, Inc., 5 A.2d 503 (1939); see also Potter v. Sanitary Co., of America, Del.Ch., 194 A. 87 (1937).

23) Section 144 of Title 8 Del.C. (a) (1) (2) (3).

24) Many, at 1241, citing Marciano.

25) Many, at 1241, citing Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

26) 488 A.2d 858 (Del. 1985).

27) Many, at 1233, citing Smith v. Van Gorkom, 488 A.2d 858, 872-73, 893 (Del. 1985).

for situations in which neither the business judgment rule nor the entire fairness test seemed appropriate.[28] The Delaware Supreme Court announced that rather than being bifurcated, the law of fiduciary duties actually was divided into three branches, with good faith joining duty of care and loyalty in a triad of fiduciary duties. The court further ruled that enforcement of fiduciary duties would be subject to a unified test, with both the business judgment rule and a fairness inquiry having application in every case.[29] However in the subsequent case of Stone v. Ritter, the court returned to the notion of bifurcation of fiduciary duty declaring the duty of good faith was actually a component of the duty of loyalty.[30]

Ⅴ. Ascendency of non-Corporate Form

There are unincorporated business forms such as limited liability company and limited liability partnership in the U.S. The American limited liability company is like an uncorporated partnership.[31] The LLC allows private business owners to form a company that provides protection from personal

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28) Many, at 1233, citing Revlon, Inc. v. MacAndrews & Mesa Petroleum Co., 493 A.2d 946, 966.

29) Many, at 1233, citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del 1993).

30) Many, at 1233, citing Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).

31) Sandra K. Miller, What Fiduciary Duties Should Apply to the LLC Manager after More Than a Decade of Experimentation (“What Duties”) 32 J. Corp. L. 565, 566(2007); The generally accepted definition of a partnership is an association of two or more persons to carry on as co-owners of a business for profit. See uniform partnership act of 1977 §101.

liability for business debts, without incurring a second level of corporate federal income tax on the business entity's earnings.[32] Basically, the American tax codes allow non-corporations to enjoy pass-through tax treatment, avoiding tax at the entity level that would otherwise reduce the shareholders returns.[33] More importantly, non-corporations, such as limited liability companies and partnerships, however, also avoid the law of fiduciary duties.[34] It provides freedom from cumbersome corporate processes by offering unparalleled flexibility in management structure.[35] Although unburdened by an entity level corporate tax, the LLC can have centralized management similar to that of a corporation or create any other number of alternative modes of management.[36]

Beginning with Wyoming in 1977, states across the U.S. started embrace the concept of LLC.[37] In 1994 the National Conference of Commissioners on Uniform State Laws (NCCUSL) endorsed a uniform LLC statue called the Uniform Limited Liability Company Act (ULLCA) but a majority of the states opted to adopt their own self styled LLC statutes.[38] With regard to the standard of care applicable to LLC Managers, the duty of loyalty owed to the LLC and the extent to which remedies are available to address wrongful behavior between the manager and member, the treatments among the LLC statutes are strikingly different state to state.[39] Basically some states

32) What Duties, at 567.

33) Mohsen Manesh, Legal Asymmetry And The End of Corporate Law ("Legal"), 34 Del. J. Corp. L. 465 (2009).

34) Legal, at 465.

35) What Fiduciary Duties Should Apply to the LLC Manager after More Than a Decade of Experimentation ("What Duties") 32 J. Corp. L. 565, 567 (2007).

36) What Duties, at 566.

37) Id. at 567.

38) Id. at 568.

installed mandatory statutory standards of care while others chose to defer to the contractual provisions adopted by the LLC members.[40] The state of Delaware, the most important jurisdiction in developing business entity laws in the U.S., has taken the lead in permitting not merely the modification of default fiduciary duties, but their elimination by contract.[41] Delaware's non-corporate statutes permit non-corporate firms to opt out of the fiduciary regime by the elimination.

Upon the rise of popularity of choosing LLC in lieu of the reasons of saving taxes and shielding personal liability, the issues have become whether fiduciary duties should be even included and articulated in the LLC statute and whether the fiduciary duties could be subject to a waiver by and among members and managers in the LLC operating statement. Putting it simply, the issue is to what extent the fiduciary duties can be waived or modified by contract. Scholars have differed on the extent to which mandatory statutory provisions should be given to LLC participant.[42] There are two distinct legal views on the latter issue. The contractarian view envisions that investors in unincorporated entities such as LLC should be able to strike the bargain with managers in the LLC free from outside input. Thus, the theory put forward a view that statutory invasion into the relationship between the managers and investors should be kept to a minimum. Obviously this contractarian view presupposes that all participants' legal and business

39) Id.

40) Id. Its footnote indicates the states of Colorado, Delaware, Kentucky as the jurisdictions exalting freedom of contract and emphasizing deference to the LLC operating agreement; the state of Minnesota was named as the state emphasizing a statute reflecting mandatory corporate-like rules.

41) What Duties, at 568.

42) Id. at 569.

interests will be protected by their own legal experts. On the other hand, the concept mandatory fiduciary duties dictate that the fiduciary is required to act to protect the interest of the beneficiary and must refrain from transactions from which he/she might gain personally.[43] This concept is also known as the traditionalists view. In general, the contractarian camp seemed to win over the traditionalists in the battle as shown in its enactment of in the Uniform Limited Liability Company Act in 1993 which allowed parties to bargain over the boundary of the fiduciary duties. However, in Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., the Delaware court seemed to suggest that the fiduciary duties might not be completely eliminated by provisions in a limited liability company agreement.[44] Along the line, the Delaware legislature revised its Revised Uniform Limited Partnership Act and its Limited Liability Company Acts to permit parties to expand, restrict, or eliminate duties, including fiduciary duties at law or in equity, provided that they do not eliminate the implied covenant of good faith and fair dealing.[45] In a critical view onto this trend, the author proposed a compromise called the Mandatory Core Approach which codifies default statutory fiduciary duties as consisting of the duty to account, the duty to refrain from dealing with the LLC as or on behalf of a party having an adverse interest, and the duty to refrain from competing with the LLC.[46] He attacks the presumptions of contractarian paradigm such as the existence of a fair and level contractual playing field, a well-negotiated LLC agreement, and a legal community of practitioners and courts well-trained in fiduciary

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43) Id. at 570.

44) Id. at 578 citing Gotham Partners v. Hallwood Realty Partners, 817 A.2d 160 (Del. 2002).

45) Id. at 578, citing Del. Code Ann. Tit. 6, ss17-1101(d), 18-1101 (c) (2006).

46) Id. at 600.

duties.[47)]

The 2007 initial public offerings of the private equity firms like Blackstone Group, Fortress, and Och-Ziff challenged the generally accepted rules that publicly held firms like corporations are subject to the usual corporate regulations, checks, and balances of standard corporate law including the law of fiduciary duty. Thus, these offerings brought forth a curious asymmetry in the law, in both substantive and structural respects, public non-corporations can resemble their corporate counterparts, yet unlike corporations, non-corporations are able to avoid one of the basic precepts of corporate laws.[48)] Further the initial public offerings may mark the beginning of the end for corporate law and portend the ascendancy of the non-corporate form.[49)]

Ⅵ. Fiduciary Duties of Officers compared to Directors

In Gantler v. Stephens,[50)] the Delaware Supreme Court held that officers of Delaware corporations owe the same fiduciary duties of care and loyalty to the corporation and its shareholders as do directors.[51)] This was a new

47) Id. at 614.

48) Legal, at 465.

49) Id. at 514.

50) 965 A. 2d. 695 (Del. 2009), in this case, shareholders of a bank holding company sued several of its directors and a non-director officer, alleging among other things, the defendants violated their fiduciary duties by self-servingly sabotaging an opportunity to sell the company, id at 881.

51) Randall S. Thomas and Harwell Wells, "Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers Fiduciary Duties ("Officers")", 95 *Minn. L. Rev.* 846, 880-881 (2011).

development of the corporate law in a neglected area of officer's fiduciary duty law.[52] In the Gentler decision, the Delaware supreme court recognized that corporate officers have the same fiduciary duties as do directors.[53] Then the issue becomes why had the officer's fiduciary issue took such a long time to come before the court. Although a few court addressed the issue of the fiduciary duties issue, it was usually to make the cursory statement that 'directors and officers' owed the corporation fiduciary duties.[54] Some argue based on the Board Capture Theory[55] that even though boards of directors had legal power to manage the corporation, the CEO usually wielded the real power.[56] Then the subsequent question becomes what exactly are the fiduciary duties of officers. More specifically, how different are the fiduciary duties in between directors and officers and if so what are the differences.[57] Gentler basically held that officers have fiduciary duty of care and loyalty as same as those of directors.[58]

Ⅶ. Fiduciary Duties and Good Faith as Gap Fillers

Under the contractarian perspective, both good faith and fiduciary duties function as gap fillers in incomplete contracts.[59] The underlying premise

52) Officers, at 901.
53) Id. at 881.
54) Id. at 882.
55) Id. at 852, the theory generally states that directors at public companies are beholden to the firm's CEO and other top executives largely due to management's control over the director nomination process.
56) Id. at 882.
57) Id. at 884.
58) Id.

is that in our world of positive transaction costs and bounded rationality, parties cannot write complete contracts specifying a suitable provision for every possible state of the world and from a Coasean perspective, the law can help promote efficient outcomes by providing a default rules and the terms the parties would have contracted for in a world of zero transaction costs and unlimited foresight.[60] In this context, the notion of a hypothetical bargain emerges as the main framework for efficient gap filling.[61]

The conventional economic view is that good faith and fiduciary duties share the same function as contract gap fillers, but they lie at different points upon a continuum.[62] The doctrines of good faith and fiduciary duties both embody the notion of a hypothetical bargain, but at different levels of generality.[63] At one level, courts could endeavor to discover the terms for which the specific parties would have contracted and alternatively, courts could seek an untailored default that corresponds to the majoritarian term that most parties would have wanted.[64] While a tailored provision aims to supply precisely the terms for which the parties would have contracted, an untailored provision supplies the parties with a single off the rack standard that in some sense represents what the majority of contacting parties would

59) Mariana Pargendler, "Modes of Gap Filling: Good Faith and Fiduciary Duties reconsidered ("Gap Filling")", 82 *Tul. L. Rev.* 1315, 1318 (2008), citing Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J.L. & Econ. 425, 427 (1993).

60) Gap Filling, at 1318.

61) Id. at 1318.

62) Id. at 1319, citing, Easterboork & Fischel, at 427.

63) Gap Filling, at 1320.

64) Id. at 1320, citing Ian Ayres & Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules", 99 *Yale L. J.* 87 at 91–92 (1989).

want and thus good faith and fiduciary duties are tailored and untailored standards respectively.[65)]

Fiduciary duties impose higher standards of behavior on fiduciaries and these demanding standards contained in the notion of fiduciary duties are untailored defaults gap fillers in the sense that the fiduciary duties provide the rules and standards that most parties in the various fiduciary categories, such as trust, agency or partnership, would want.[66)] Thus, unless otherwise expressly excluded by agreements, this untailored fiduciary duties rule apply as discussed in Ascendency of Non-Corporate Form above.

Differing from fiduciary duties, good faith serves a doctrinal rubric for a tailored gap filling provision and the lack of a more precise definition for the duty of good faith provides the ideal framework for courts to fill the gaps with a case specific hypothetical bargain method.[67)]

(투고일 2011년 7월 23일, 심사일 2011년 8월 5일, 게재확정일 2011년 8월 23일)

Key Words : Fiduciary Duty, Duty of Care, Duty of Loyalty, Duty of Good Faith, Corporate Directors and Officers

65) Gap Filling, at 1320-1321.

66) Id. at 1325, the author suggests reading of Fiduciary Obligations and Joint Ventures: The Collaborative Fiduciary Relationship (1995) by Gerard M. D. Bean for a discussion on fiduciary duties.

67) Gap Filling, 1330-1331.

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[국문초록]

미국법상 신인의무에 관한 연구
-델라웨어주를 중심으로-

김 재 형*

이 논문은 미국법상 신인의무에 관한 최근 델라웨어주법과 판례의 동향을 소개하고자 함이다. 주식회사의 경영진으로서 이사는 회사의 주주들에 대하여 신인의무를 부담하고 있다고 일반적으로 인식된다. 신인의무의 원칙은 일방(the principal)이 타인(the agent)에게 자기를 대신하여 행위할 권한을 수여함으로써 발생하는 대리인관계(agency relationship)의 핵심이다. 회사라는 상황에서, the principal은 회사의 주주이며 the agent는 경영진이다. 신인의무는 크게 2가지로 나누어지는데, 주의의무(duty of care)의 영역과 충실의무(duty of loyalty)의 영역이다. 최근 여기에 신의성실의무(the duty of good faith)가 세 번째 요소로써 추가되었다.

유한책임회사(limited liability company)와 유한책임조합(limited liability partnership)과 같은 비법인의 증가와 더불어 최근의 쟁점은 신인의무가 그러한 조직의 운영규범에서 면제될 수 있는가 하는 점이며, 결국 그러한 결과는 이러한 비법인조직에서 신인의무가 완전히 회피되어짐을 의미하는 것이다.

한편 신인의무를 회사의 임원(officers)에게 확대하는 것은 신인의무의 영역에서 새로운 동향이다. 최근 델라웨어주 법원은, 회사의 이사뿐만 아니라 임원도 회사와 주주에 대하여 신인의무를 부담한다고 판결하

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였다.

결국 신인의무와 신의성실의무(fiduciary duties and good faith)는 모두 계약적인 흠결을 채우는 역할을 하지만 구체적으로는 다른 역할을 하게 된다. 전자는 대리인(agency), 신탁(trust) 혹은 조합(partnership)관계와 같은 신인관계 상황에서 불명확한 사항이 발생한 경우에 기능할 수 있는 기준의 역할을 하는 반면, 후자는 일반적으로 잘 정립된 계약관계의 집행에 있어서 흠결을 해결하는 기준으로서 기능하게 된다. 이것은 법경제학적 접근방법에서 비롯되는 것이며, 결국 경제적 효율성을 제고하기 위해서 법이 어떻게 정립되어야 하고 기능하여야 하는가 하는 측면을 다루는 것이다.

주제어 : 신인의무, 주의의무, 충실의무, 신의성실의무, 이사, 임원