**Fiduciary Disclosure and Informed Consent:**

**A Behavioural Law and Economics Approach**

Dr Remus Valsan

**Abstract**

This paper contributes to the existing law and economics literature of fiduciary duties in two ways. First, it brings clarity to the existing theoretical framework, by mapping out the current contractarian, anti-contractarian and behavioural strands of research. Second, the paper uses the behavioural law and economics framework to revisit the issue of risk allocation in a fiduciary relationship following disclosure of a conflict of interest. It emphasises the shortcomings of disclosure and informed consent in mitigating the additional risk of unreliable exercise of discretion, and makes the case for an enhanced duty of care post disclosure.

Fiduciary relationships arise when one party (the fiduciary, or the agent) acquires discretion or decision-making authority over the interests of another party (the beneficiary, or the principal). Due to this power imbalance, the law imposes on fiduciaries strict duties of loyalty, directing them to promote solely the beneficiaries’ best interests and proscribing conflicts of interest and unauthorised profits. Fiduciary duties are embedded in many legal and economic relationships, from agency contracts to trusts and corporations, to provision of specialist services (such as legal, financial, audit or medical services).

Despite the omnipresence and increased economic utility of the fiduciary relationship, its conceptual framework remains unsettled. Traditionally, law and economics has used agency theory (the principal-agent problem) as the main paradigm for conceptualising fiduciary relationships. The theoretical debates have engaged with this framework either positively (the contractarian theories, which view fiduciary duties as mere bargained-for contractual terms) or sceptically (the anti-contractarians, who argue that fiduciary duties reflect higher societal values and thus have a mandatory non-contractual core). Despite their divergences, the two sets of theories agree on two key features of fiduciary relationships: (i) the core problems are incentives misalignment and high monitoring costs; (ii) the main goal of fiduciary duties is deterrence of opportunism.

More recently, the agency framework has been challenged by a rapidly growing body of research on decision-making, coming from behavioural law and economics, behavioural ethics and other cognate fields. The emerging theory of fiduciary relationships relaxes the assumptions of rationality and utility maximisation embedded in the traditional agency theory. It focuses instead on the subtle processes, beyond conscious level, that render fiduciaries’ good faith exercise of judgment riskier or less reliable, when they have a personal interest in the outcome of their decision. The behavioural theory of fiduciary relationships replaces the ‘conflicting interests’ and ‘deterrence’ paradigms of the agency theory with ‘conflict between self-interest and judgment’ and ‘correction’. In other words, instead of focusing on deterring fiduciary’s temptation to act self-interestedly, the behavioural theory sees the main role of fiduciary duties as preventing or correcting unwanted influences that self-interest poses on fiduciary’s good faith exercise of decision-making authority. Misfeasance, nonfeasance or opportunism are acknowledged as important concerns in fiduciary relationships that are governed by a multitude of other institutions or mechanisms (including other legal doctrines such as contract interpretation, good faith, unconscionability, negligence, embezzlement or theft).

 The normative implications of the behavioural theory of fiduciary duties are yet to be fully grasped. The paper aims to fill this gap by analysing the consequences of disclosure and informed consent, from a behavioural law and economics perspective. The contractarian agency framework views fiduciary’s disclosure of self-interest and the beneficiary’s consent as an important ex post mechanism that allows the parties to fill in contractual gaps and align their interests. Drawing on recent behavioural studies on disclosure and consent, the paper highlights multiple shortcomings of this mechanism, on both on fiduciary’s and the beneficiary’s sides.

On the fiduciary’s side, one potential negative effect of disclosure is a false perception of eliminating the danger inherent in a conflict situation - a good faith fiduciary may believe that there is no longer anything reprehensible or to be vigilant about with regard to the conflict situation. However, given the insidious vitiating effect of self-interest on the exercise of discretion, and one’s tendency to over-estimate their ability to resist this distorting influence, the fiduciary’s judgment will continue to be less reliable post disclosure than it would have been outside a conflict situation. Another potential negative effect is the risk of strategic exaggeration (or the opposite, strategic restraint). When disclosure is made, a purely self-interested fiduciary might deliberately increase the weight she places on self-interest, in order to offset the anticipated discounting by the beneficiary. Moral licensing is yet another risk following disclosure. To the degree that disclosure is perceived to level the playing field between fiduciary and beneficiary, the former may feel ‘morally licensed’ to take into account her self-interest.

 On the beneficiary’s side, behavioural research shows that beneficiaries do not know how to respond to conflict of interest disclosures, or discount conflicted advice and decisions insufficiently or erratically. One reason why beneficiaries may not adjust their position adequately stems from the difficulty of assessing the actual impact that the conflict of interest has on the various stages of exercise of discretion by the fiduciary. Moreover, research on judgment suggests that beneficiaries are likely to anchor on the decision or advice they receive, and then adjust or discount insufficiently, even though they know the advice may be biased. Another possible reason for inefficient adjustment is, paradoxically, an increase of the beneficiary’s trust in the fiduciary. Insofar as disclosure is perceived as a sign of honesty, it could serve as an assurance of trustworthiness rather than serve as warning. Because people generally believe that the danger posed by a conflict of interest is corruption, disclosure may be seen as a sign of trustworthiness. This is linked with the phenomenon of insinuation anxiety. A disclosure of conflict of interest may increase the pressure on the beneficiary to accept the potentially biased decision or advice, for fear of having their rejection misinterpreted as a sign that they suspect that the fiduciary is corrupt.

These studies indicate that disclosure and informed consent do not ‘cure’ a conflict of interest, due to a residual risk on fiduciary’s judgment that persists after the conflict has been disclosed and approved, mirrored by inefficient adjustment on the beneficiary’s side. Consequently, the paper makes the case that, following disclosure of self-interest and informed consent, the fiduciary should automatically be bound by an enhanced duty of care, which raises the liability standard from reasonableness to entire fairness. The enhanced fiduciary duty of care is necessary in order to mitigate the risk of diminished objectivity caused by the potential of the disclosed interest to continue to affect the fiduciary’s decision-making process.