Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)

*By Richard A. Booth**

SUMMARY OF ARGUMENT

The most basic question in corporation law is: To whom does management owe its fiduciary duty and what does that duty entail? The traditional wisdom is that management should serve the interests of the corporation and the stockholders who own it by maximizing stockholder wealth. But a significant number of legal scholars argue that management's fiduciary duty should be more broadly construed to include other constituencies ("stakeholders") such as employees, creditors, customers, suppliers, and the community at large. The distinction makes a difference. The broader view of management duty means that management has more discretion and that stockholders will seldom have recourse if management fails to maximize profits. Nevertheless, many states have adopted so-called "other-constituency" statutes permitting—and in some cases arguably requiring—management to consider such other interests.

The difference between the two views of management duty depends on how one defines a reasonable stockholder. If management duty is measured by the interests of a diversified stockholder, management duty is to

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maximize profits even at the risk of bankrupting the firm. A diversified stockholder cares little about firm-specific risk so long as return is adequate. A diversified stockholder cares only about the overall risk in his or her portfolio. Stakeholders, thus, cannot depend on the implicit protection of stockholder self-interest. On the other hand, if management duty is measured by the interests of an undiversified stockholder, the duty is to maximize profits *and* to minimize risk. An undiversified stockholder will likely prefer a merely adequate return to a high return with high risk. Such an investor cares very much about the survival of the firm. Thus, stakeholder interests are implicitly protected if fiduciary duty is seen as owed to an undiversified stockholder or, more simply, to the corporation itself.

Rational investors diversify. Thus, most commentators have naturally assumed that fiduciary duty should be construed as if owed to a diversified stockholder. The thesis here, however, is that (i) it is impractical to measure fiduciary duty by reference to diversified stockholders and (ii) diversified stockholders will, in any event, prefer management to behave as if it owes its duty to undiversified stockholders. Thus, in practice, management duty should be seen as owed to the corporation but not necessarily to the stockholders.

Ironically, management is the one constituency which identifies most with the fortunes of the corporation as an entity. A diversified stockholder can afford to win some and lose some. Management cannot. Management stands to lose the most if the corporation fails. Thus, management is not likely to pursue high-risk, high-return strategies even in the absence of an other-constituency statute. After all, if such strategies lead to the ruin of the company, it is management that is left holding the bag.

INTRODUCTION

Most scholars of corporation law seem to agree that a corporation's directors and officers (management) owe a fiduciary duty to the corporation and, because the stockholders own the corporation, that duty should be seen as a duty to maximize stockholder wealth.[1] The basic reason for

1. *See* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, 1 A.L.I. § 2.01 (1992) [hereinafter PRINCIPLES]; Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1282-84 (1991) (collecting numerous secondary authorities) [hereinafter Hu, *New Financial Products*]. *See generally* Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277 (1990) [hereinafter Hu, *Risk, Time, and Fiduciary Principles*]. *See also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 25-30 (1991); ALFRED RAPPAPORT, CREATING SHAREHOLDER VALUE: THE NEW STANDARD FOR BUSINESS PERFORMANCE (1986); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1192 (1981) [hereinafter Easterbrook & Fischel, *The Proper Role*]; Milton Friedman, *The Social*

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the duty-to-stockholders view is that the stockholders are the owners of the company. They get paid only if all other claimants are paid. Thus, they take the most risk and they have the ultimate voting power to hire and fire the managers.[2] Moreover, if management owes enforceable duties to a wider range of constituencies—to more than a single master—the potential for conflicting duties arises. Indeed, management may be able to avoid accountability altogether, conveniently justifying any decision which one group may protest by pointing to its duty to another group.[3]

Responsibility of Business Is to Increase Its Profits, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 22. It is unclear, however, that any court has ever held management liable for its failure to maximize stockholder wealth or gain other than in the context of a takeover. Moreover, it is not entirely clear what it means to maximize stockholder wealth. Among other things, some shareholders may prefer high risk and high return while others prefer low risk and low return. If both alternatives are equal to the market rate of return for the given level of risk, which maximizes stockholder wealth? Moreover, it is entirely possible that the stock market focuses on incorrect or flawed indicia of firm performance or views certain firm-level business strategies as good for trading purposes (whether systematically or because of a temporary fad) even though such strategies may be bad for business. Thus, maximizing share value may be different from maximizing firm value. For a more complete explanation of some of these phenomena, see Hu, *New Financial Products*, *supra*, at 1288-1300.

2. *See* MODEL BUS. CORP. ACT § 8.08 (discussing removal of directors), § 8.43 (discussing removal of officers) (1984 & 1993 Supp.). *See generally* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

3. *See* Committee on Corp. Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2269-70 (1990); James J. Hanks, Jr., *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Have Come*, 3 INSIGHTS 12, Dec. 1989, at 24-25; Hu, *New Financial Products*, *supra* note 1, at 1281-82; *see also* Easterbrook & Fischel, *The Proper Role*, *supra* note 1, at 1192 ("A manager responsible to two conflicting interests is in fact answerable to neither."). *See generally* Marleen A. O'Connor, *Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 3 (1991).

This argument assumes, of course, that management owes a duty to someone. Although no one seems to have suggested that management owes no duty at all to any constituency, the author suggests that management duty may best be conceptualized as owed to management itself. In any event, the duty of care that is owed to stockholders is so seldom enforced that one might validly ask whether there can be a duty that is unenforceable.

Of course, in some circumstances management does in fact owe a fiduciary duty, or something close to it, to creditors. If the corporation becomes bankrupt, creditors can, through the trustee, pursue claims that the corporation would have had so as to maximize the assets which will be available to pay creditor claims. Many courts even lapse into saying that management in such circumstances owes a fiduciary duty to creditors. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 311 (1939); Costello v. Fazio, 256 F.2d 903, 909 (9th Cir. 1958).

On the one hand, one might argue that in bankruptcy creditors have become the residual claimants on the firm and, therefore, should be entitled to the protections of fiduciary duty. The problem is that if fiduciary duty is interpreted as a duty to maximize the value of the firm, management may be led to assume risks that creditors would prefer for it to avoid in the interest of conserving the assets in hand. Moreover, creditors might enjoy the windfall of gaining standing to sue management for acts of mismanagement that in fact creditors would have opposed *ex ante*. Thus, in addressing any claim made by a corporation in bankruptcy (and, presumably, at the behest of creditors), it is important not to allow the corporation to assert claims which are in the nature of claims that only stockholders should be

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Despite the force and elegance of the arguments for management duty solely to the stockholders, there is significant sentiment in favor of a broader concept of management duty. This sentiment is based in part on the perception that enhanced stockholder returns often come at the expense of other constituencies (or "stakeholders") such as creditors and employees, especially in the context of mergers and other fundamental transactions.[4] Thus, some argue that management *may* consider the interests of other constituencies while others argue that management *must* consider the interests of other constituencies.[5] Although many states have

able to make. *But cf.* Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co., 417 U.S. 703 (1974) (dismissing suit by successor corporation because it could not have been maintained as a derivative suit). Nevertheless, in some jurisdictions such as California, creditors may maintain derivative suits in their own name when the corporation is insolvent.

On the other hand, if fiduciary duty is properly interpreted as a duty-to-firm rather than duty-to-stockholders, then in fact there is no conflict. If fiduciary duty does not in fact entail a duty to maximize and is instead more in the nature of a duty to survive, it is quite consistent with creditor interests, and saying that it extends to creditors is neither misleading nor confusing. *See generally* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485 (1993).

4. *See* Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 418 (1986); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988) [hereinafter McDaniel, *Bondholders*]; Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121, 123 (1991). For a case in which bondholders sued on such a theory (and lost), see *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1526 (S.D.N.Y. 1989), *vacated*, 906 F.2d 884 (2d Cir. 1990). For a collection of numerous authorities relating to the lack of wealth-maximization rights of debtholders (and of preferred stockholders), see Hu, *New Financial Products*, *supra* note 1, at 1288-92.

Whether bondholders are owed a fiduciary duty has implications for whether they are protected by other rules as well. For example, some theories of insider trading depend on whether the trader owed a "fiduciary or similar duty" to the stockholders with whom the trader traded. *See* Chiarella v. United States, 445 U.S. 222 (1980); Dirks v. SEC, 463 U.S. 646 (1983). Similarly, fiduciary duty is the key to the availability of Rule 10b-5 generally in connection with other sorts of frauds. *See, e.g.*, Pittsburgh Terminal Corp. v. Baltimore & Ohio. R.R., 680 F.2d 933, 940-42 (3d Cir. 1982).

Moreover, because federal tender offer law applies only to equity securities, numerous practices that are prohibited in tender offers for stock remain permissible in tender offers for bonds. *See generally* Andrew Laurance Bab, *Debt Tender Offer Techniques and the Problem of Coercion*, 91 COLUM. L. REV. 846 (1991); John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207 (1991); Lewis S. Peterson, *Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers*, 103 YALE L.J. 505 (1993).

5. For an argument that there should be a duty to bondholders, see Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821 (1992); David M.W. Harvey, *Bondholders' Rights and the Case for a Fiduciary Duty*, 65 ST. JOHN'S L. REV. 1023 (1991); McDaniel, *Bondholders*, *supra* note 4. For a broader vision of such a duty, see David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies in* PROGRESSIVE CORPORATE LAW 1-33 (Lawrence E. Mitchell ed., 1995); Alexander C. Gavis, *A Framework for Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. PA. L. REV. 1451 (1990) (questioning case made for public law approach to fiduciary duty); David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991); Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L.

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enacted other-constituency statutes which allow management to consider other interests, it remains unclear whether management has any duty to consider the interests of other constituencies.[6] Nevertheless, a broader definition of management discretion or duty spawns a broader array of justifications for management behavior and thus may alter the scope of potential management liability.[7]

The thesis here is that both sides of the debate have it wrong. The central flaw in both arguments is the assumption that a duty to the corporation is the same thing as a duty to the stockholders. This distinction may once have made little difference. In earlier times, when stockholders

REV. 1263 (1992); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992); Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U.L. REV. 1165 (1990); Marleen A. O'Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements in* PROGRESSIVE CORPORATE LAW 219-46 (Lawrence E. Mitchell ed., 1995); 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 (1991); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992); *see also* William W. Bratton, *Confronting the Ethical Case Against the Ethical Case for Constituency Rights*, 50 WASH. & LEE L. REV. 1449 (1993) (same); Michael E. Debow & Dwight R. Lee, *Shareholders, Nonshareholders, and Corporate Law: Communitarianism and Resource Allocation*, 18 DEL. J. CORP. L. 393 (1993) (same).

The *Principles of Corporate Governance* takes the position that such interests may be considered so long as to do so would not significantly disfavor the long-term interests of shareholders. *See* PRINCIPLES, *supra* note 1, § 6.02(b)(2). That is essentially the rule set forth in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). Needless to say, the ability to consider non-stockholder interests is not the same as a duty to do so.

Although some commentators seem to suggest that there should be a duty of care owed to other constituencies such as debtholders, no one seems to suggest that there should be a duty of loyalty to such other constituencies. If in fact the duty of care is unenforceable anyway, then the lack of a duty of loyalty would be the same thing as management owing its duty only to the stockholders.

6. According to the ALI, most such statutes can be interpreted as consistent with long-term stockholder interests. *See* PRINCIPLES, *supra* note 1, § 6.02, cmt. (a). The Indiana statute, however, appears to allow for consideration of stockholder interests more broadly. *See* IND. CODE ANN. § 23-1-35-1(f) (1995). And the Connecticut statute makes consideration of employee interests mandatory in the context of hostile takeovers. *See* CONN. GEN. STAT. ANN. § 33-756(d)(3) (1997).

7. Some states have also enacted statutes that absolve management from liability for simple negligence. *See* PRINCIPLES, *supra* note 1, Part IV, Intro. note, at 134 (stating that as of 1992 more than 33 states had such provisions). The primary example of such a statute is DEL. GEN. CORP. LAW § 102(b)(7) (1996). To be sure, such statutes were not inspired by the same considerations that led to the enactment of other constituency statutes. The Delaware statute was prompted by the holding in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), in which a board of directors was held liable for failure to bargain vigorously in connection with a buyout offer. Other-constituency statutes, on the other hand, were prompted for the most part by management demand for more authority to resist takeovers. Nevertheless, these two types of statutes clearly interact with each other in that the definition of management duty will determine what constitutes negligence (or a violation of any other standard of care for that matter).

tended to invest in one or a few carefully chosen stocks and were largely undiversified, the interests of the corporation and those of the stockholders were congruent. Thus, it is the undiversified stockholder—an investor who is focused on the fortunes of a single company—who is the traditional model for the hypothetical reasonable stockholder to whom management duty is owed. But in a world of both traditional and highly diversified investors (such as institutional investors), to say that management owes its duty to the stockholders leaves important questions unanswered. Which stockholders? It is unclear exactly what constitutes a reasonable stockholder. Does management owe its duty to an undiversified stockholder who has all of his or her eggs in one basket? Or does management owe its duty to a diversified stockholder who thinks of any given firm as merely part of a grander investment strategy involving a portfolio of ten or twenty or 100 or more different stocks?[8]

The distinction matters. The interests of diversified investors may often conflict with those of undiversified investors. A diversified investor will prefer that individual companies pursue high-return strategies even if they entail high risk (because with diversification you win some and you lose some, but only the average matters). An undiversified investor, on the other hand, will be strongly opposed to firm-level business strategies which increase the risk of loss.[9]

Which model of the stockholder is the correct model? Most scholars who favor stockholder wealth as the measure of management duty have quite naturally assumed that management should manage with the interests of diversified stockholders in mind because rational investors diversify.[10] Although one might think that it makes sense to base management duty on the behavior of rational investors, the argument here is that the classical formulation of management duty is in fact the correct view. Management duty should be thought of as owed to an undiversified stockholder

8. The issue of divergent stockholder interests has been addressed in several recent articles. *See, e.g.*, Daniel J. H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996); Hu, *New Financial Products*, *supra* note 1; Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443 (1996); D. Kyle Sampson, *The Fiduciary Duties of Corporate Directors to "Phantom" Stockholders*, 62 U. CHI. L. REV. 1275 (1995). Similar issues have long been recognized with regard to subscribers, optionholders, and holders of various securities convertible into stock. To put the point quite simply, there are many different types of shares, but only one duty.

9. On the other hand, a diversified investor may not be willing to wait for a bird-in-the-bush innovation, while an undiversified stockholder may be quite willing to suffer less than maximum current return in exchange for a shot at the jackpot down the road. Thus, an undiversified investor may have either an increased or a decreased taste for risk, depending on its nature, but it is fairly clear that the undiversified investor will have a different taste for risk from the diversified investor.

10. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 1, at 25-30, 339-40; RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW, 370-71, 380, 407-11, 417, 420, 549 (3d ed. 1986); Hu, *New Financial Products*, *supra* note 1; Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 1.

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and thus owed to the corporation. It is here that this Article parts company with those few other works of legal scholarship which have addressed the implications of diversification on management duty.

Although there are scattered examples of cases in which the courts have applied the diversified stockholder model, the courts adhere almost exclusively to the traditional model.[11] And with good reason. A well-developed idea of diversification is relatively new. Indeed, there has been very little attention to diversification in the legal literature.[12] Moreover, and more important, defining management duty with reference to the interests of diversified stockholders is unworkable.

First, practically speaking, managers cannot be expected to make business decisions on the basis of what a diversified investor would prefer. For all management knows, there are many different kinds of diversified investors out there following very different models in making their investment decisions. What one investor might prefer management to do (in light of that investor's particular portfolio) might differ radically from what another investor might like to see.

Second, several market phenomena seem to suggest that investors prefer managers who do their jobs single-mindedly and without attempting to anticipate preferences which individual investors have for company-level strategies designed to replicate similar strategies that investors can pursue more cheaply. For example, investors seem clearly to prefer that management refrain from conglomerate diversification over various lines of busi-

11. *See, e.g.*, TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438 (1976) (defining a material fact as one that would be important to a reasonable stockholder in deciding how to act). One of the most striking examples of this issue coming to the fore is *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), in which Justice Blackmun, writing for the majority and upholding the fraud-on-the-market theory, in essence held that investors are entitled to rely on market prices as being fairly set (thus, implicitly endorsing the view that investors may rely on the collective action of other presumably diversified investors). *Id.* at 246. Justice White, in his dissent, emphasized that the basic idea behind federal securities law is that investors should be able to inform themselves individually. For an example of a case in which a court considered the effect of diversification on stockholder interests, see *Joy v. North*, 692 F.2d 880 (2d Cir. 1982). *See generally* Lyman Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215 (1992). A recent search of LEXIS revealed that the overwhelming majority of cases that include the phrase "reasonable stockholder" or "reasonable shareholder" do so in the context of discussing *TSC* or *Basic* and the fairly narrow issue of materiality under federal securities law. Thus, it seems fair to say that there is relatively little discussion in the cases about just who a reasonable stockholder is and even less about how the two different models may affect the scope of fiduciary duty.

12. A recent search of the LEXIS LAWREV file turned up only one article related to corporation law or corporate finance with any variant of the word "diversification" in the title. *See generally* Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994). A search of the LGLIND file (which contains abstracts of law review articles as well as numerous more popular legal publications) turned up just 18 non-tax references (since 1982). Of those, nine related to diversification rules for trustees under the common law or ERISA. It bears noting that of the 176 total items retrieved, the vast majority related to firm-level diversification strategies.

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ness as a way of smoothing out income, presumably because investors themselves can diversify their holdings virtually costlessly. The proof is that the stocks of conglomerate companies tend to trade at a discount from asset value, making such companies attractive takeover targets because the pieces can be sold off at a gain by the acquirer.

Third, because many stockholders also own bonds (at least at some time in their investing lives), and because all investors value predictability, investors in general will opt for a rule which prevents the intentional diversion of returns from one class of investment to another.

Ironically, the interests of undiversified stockholders—for example, stockholders in a close corporation—may be more akin to the interests of bondholders and employees than they are to diversified stockholders because such stockholders may well prefer that the corporation simply chug along generating an adequate return. Thus, viewing management duty as a duty to undiversified stockholders or the corporation itself, rather than to diversified stockholders, has the effect of incorporating a duty to other constituencies.[13]

Perhaps even more ironically, the prime example of an undiversified (but nonetheless rational) investor is management itself. Even if management does not own a large percentage of the stock of its company, it is likely to have a disproportionate percentage of its own wealth tied up in company stock in the form of incentive stock options or similar stock-price-based rewards. Accordingly, managers are much more risk-averse than diversified stockholders. Thus, when forced to choose, management is likely to opt for strategies which will assure the survival of the corporation over those that maximize returns. This suggests that management is more likely to act in the interests of other constituencies such as creditors, employees, and others. In other words, management may already consider interests which diverge from those of most (diversified) stockholders and which closely resemble those of many other constituencies. As a result, it may be that other constituency statutes are merely descriptive of how management behaves anyway. That, in turn, may explain why such statutes do not seem to affect stockholder wealth significantly.[14]

The fact that management duty should be derived by reference to an

13. Indeed, a number of business scholars writing in the 1960s suggested that management may be more motivated to maximize borrowing potential than to maximize profits.

14. For a thorough examination of the conflicting interests of managers and stockholders in the context primarily of management buyouts, see John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986); *see also* Richard A. Booth, *The Other Side of the Management Compensation Controversy*, 22 SEC. REG. L.J. 22 (1994). For another view of how the managerial perspective may differ from that of investors, see WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES (6th ed. 1996). Regarding the point that other-constituency

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undiversified stockholder does not necessarily mean that we should ignore investor diversification for all purposes. Indeed, for purposes of determining stockholder *rights* it is vital to consider diversification. For example, if one assumes that stockholders are undiversified it might make sense to provide appraisal rights in the event of a sale of the company because such stockholders will care very much about the price they receive for their one and only investment. On the other hand, if stockholders are diversified, they will reason that sometimes they will receive a bit less and sometimes a bit more than their individual reservation price, but that returns will be fair on the average. Thus, a diversified stockholder will not care about appraisal rights and indeed will be strongly opposed to them for other investors (including undiversified investors) because appraisal rights will give individuals the right to hold up profitable transactions which diversified investors will prefer to see proceed.[15]

The same reasoning applies in connection with a stockholder's right to sue for mismanagement. Simply put, because stockholders can diversify away company-specific risk, they should not be able to recover for managerial negligence or any other managerial misdeeds which fall short of intentional infliction of loss. By diversifying, stockholders have already hedged their bets and would be overcompensated by any additional award of damages. Thus, it should be quite rare for a stockholder to recover for a simple breach of the duty of care. And indeed it is.[16] Intentional harms are different. Diversification cannot protect against intentional harms be-

statutes do not seem to have caused losses in the market value of stocks, see Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843 (1993).

15. *See generally* Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79 (1995).

16. Again, if fiduciary duty is measured by the interests of an undiversified stockholder, and management is itself the best example of an undiversified stockholder, then management may be seen as owing its fiduciary duty primarily to itself, and breaches should, therefore, be rare. Indeed, why would anyone ever breach a duty to himself? It should thus come as no surprise that there is no well-developed law of the duty of care in partnership. It may even be that there really is no duty of care that extends beyond the duty of loyalty. That is, if it takes an irrational business decision to make out a breach of the duty of care, it may almost always be that there is some unidentified personal benefit lurking in the background. Why else, after all, would a manager intentionally enter into a losing business deal? *See infra* text accompanying notes 73-74 (discussing the requirement of intent to cause loss). In other words, irrationality may be a surrogate for duty of loyalty analysis. It bears noting, too, that it does not necessarily follow from the idea that management owes its fiduciary duty primarily to itself or someone like itself that the duty of loyalty should be measured in the same way. As will be seen, diversification does not protect against intentional infliction of loss. Because a breach of the duty of loyalty necessarily involves a transaction that is unfair to the corporation, it necessarily involves a loss that may be presumed to be intentionally inflicted. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991). It might also be argued that the duty of loyalty serves to protect rationally undiversified stockholders *inter se*.

cause the win-some lose-some' logic of diversification does not apply. Whereas good faith business judgments sometimes lead to gains and sometimes lead to losses, actions designed to inflict harm always lead to losses when they succeed and rarely if ever lead to gains when they fail.

It is particularly appropriate to take a new look at the management duty now. Major reforms in the federal securities laws have recently been enacted that are designed to curb the ability of stockholders to bring suit and to assure that relatively large and presumably well-diversified stockholders will be in charge of such lawsuits as the lead plaintiff when they are brought.[17] To be sure, management duty is a matter of state law, but ultimately it is from state law that the federal duty to disclose is derived.[18] Thus, for reform in one area to be effective, reform in the other area may also be necessary. Therefore, it seems quite pertinent to consider (or reconsider) the extent of management duty and the extent of stockholder rights to sue for breach.

HISTORICAL CONTEXT

The question of to whom management owes its duty has been hotly debated since the 1930s when Merrick Dodd proposed that publicly held corporations were quasi-public entities and that management should serve a broad range of constituencies, including stockholders, debtholders, employees, suppliers, customers, and the community at large.[19] Adolf Berle and Gardiner Means countered (in their classic work, *The Modern Corporation and Private Property*) with the argument that as a result of the divorce of ownership and control, corporations were essentially run for the benefit of management; adherents of that view became known as the "managerialist school."[20] Berle and Means concluded that management should be held more accountable to stockholders.[21]

Until the 1980s, the answer to the question of to whom management owes its duty hardly ever mattered. It was almost always arguable that any decision made by management, even if it appeared to visit harm on the stockholders in the present, could serve some long-term stockholder interest. After all, under the business judgment rule, management decisions are

17. The Private Securities Litigation Reform Act of 1995 (PSLRA), which became law in late 1995, creates significant new requirements for class action and derivative suits under federal securities law. *See* 15 U.S.C. § 77z-1 (1994 & Supp. I 1995).

18. *See* Chiarella v. United States, 445 U.S. 222, 227 (1980).

19. *See* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1156 (1932). *See generally* A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

20. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 300-02 (1932); *see also* KLEIN & COFFEE, *supra* note 14, at 172-73, 357-60.

21. BERLE & MEANS, *supra* note 20, at 300-02.

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protected from legal challenge, provided they are merely rational.[22] Prior to 1980, there were no more than a handful of cases in which management had been held liable to the stockholders simply for a breach of the duty of care.[23] Thus, practically speaking, management was free to consider a broad range of interests.[24]

With the advent of an active market for corporate control, beginning in the late 1960s and reaching its peak in the 1980s, the question of to whom management owes its duty became more relevant. Target management often argued that the interests of other-constituencies justified resistance to takeover. Sometimes, the courts agreed.[25] But the vigor of the takeover market rendered the question somewhat academic. Target managers who failed to get top dollar for their stockholders—for whatever reason—were usually ousted somehow. Potential target managers continued, however, to engage in defensive tactics, including convincing many state legislatures to enact other-constituency statutes.[26]

Again, the primary argument against expanding fiduciary duty is that the interests of other-constituencies may, and often do, conflict with those of stockholders. Under an expanded notion of fiduciary duty, when a conflict arises, the board is in a position to choose whose interest to serve and is effectively insulated from challenge. When someone complains, the board can always say that in its judgment the interests of some other constituency takes precedence. In effect fiduciary duty is eviscerated. It is true that before the advent of other-constituency statutes, the duty of care operated as a check on management discretion only in the most extreme circumstances.[27] But under an other-constituency statute it serves as no check at all.

Some scholars have seized on the development of other-constituency statutes to argue for a very different point. Although most observers would likely agree that other-constituency statutes were enacted as a defensive measure to protect potential target companies from takeover, this group of scholars prefers to view such statutes as recognizing a broader idea of managerial duty.[28] Still, it is only a small step from *recognizing* the legitimacy of other interests to *requiring* that they should be served, and even if it is unworkable, the broader view of management duty may be correct.

22. *See* PRINCIPLES, *supra* note 1, § 4.01(c)(3).

23. *See id.* § 4.01(a), Reporter's Note 17 at 155. *See generally* Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968).

24. *See* PRINCIPLES, *supra* note 1, § 6.02(b)(2).

25. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

26. *See* Romano, *supra* note 14.

27. Admittedly, it is at least conceivable that the rule was so clear and worked so well that management almost always knew its duty and there were very few violations.

28. *See supra* note 5.

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Although reports that the hostile takeover is dead may be somewhat exaggerated, scholars of corporation law have gone back to asking the basic question: Who will hold management accountable? Who will do something when a company underperforms, or when management pays itself too much, or when management persists in investing in projects that do not hold out the prospect of a sufficiently attractive return given the risk involved? So long as there is an active market for corporate control, there is little reason to worry about such issues. Any company that fails to operate efficiently will be attacked by a hostile raider. But with the (tentative) demise of the takeover as a disciplinary force, the question again arises: Who will keep management in line?

One possible answer, as many commentators have noted, is institutional investors.[29] Institutional investors (such as mutual funds, pension plans, and insurance companies) have stockholdings large enough to make it worth their while to monitor management behavior. Even though others may free-ride on their efforts, the payoff in terms of enhanced return may still be large enough to outweigh the costs. Moreover, institutional investors already own their stock. Thus, they are potentially even more efficient monitors than the market for control, which depends on raiders to seek out and pay a premium for their targets. In contrast, an institutional investor can keep all of the gain attributable to any improvement in management that it may induce.

The last few years have seen an increase in institutional stockholder activism as well as regulatory changes designed to allow institutional in-

29. *See generally* Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135 (1991); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); *see also* Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).

One variation on the theme of monitoring by institutional investors is the idea of relational investing. Legal scholars have recently begun to explore the possibility that relatively large stockholders might serve as a disciplinary force on management. *See generally* Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033 (1994); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994); Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994).

Aside from such famous examples of relational investors as Warren Buffet, Pierre DuPont, and CalPers, it bears noting that in the leading case of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the plaintiff, Alden Smith, was a substantial stockholder in the Trans Union, the company that the court found may have been sold for too little as a result of the board's failure to bargain hard over price with the buyer. Although the case, which at the time came as a shocking result given the business judgment rule, may be seen as perhaps the first example of what came to be called the intermediate standard for sale-of-control cases, it may also be that the court was impressed by the fact that the plaintiff had substantial holdings, paid his own legal fees, and could not in any way be seen as a strike suitor.

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vestors to exercise greater control over management. The recent amendments to the U.S. Securities and Exchange Commission's (SEC's) proxy rules are a good example.[30] Institutional investors may now communicate with each other much more freely without running afoul of the need to register proxy materials.[31] Moreover, under the Private Securities Litigation Reform Act of 1995,[32] there is a presumption that the largest stockholder should be the lead plaintiff in any stockholder action involving claims arising under the federal securities laws.[33]

Nevertheless, several scholars have expressed doubts about the willingness or ability of institutional investors to act as a check on management discretion.[34] And some scholars—those associated with the broad view of directorial duty—would likely argue that institutional investors are the problem, not the solution.[35] After all, institutional investors have been most vociferous that the board of directors owes its duty to the stockholders and the stockholders alone.[36] Thus, it was institutional investors who were most opposed to takeover defenses and state takeover statutes, including other-constituency statutes, because institutional investors stood to gain the most from an active market for corporate control.[37]

Admittedly, if other-constituency statutes are designed to protect bondholder interests, then institutional stockholders who also own bonds stand to benefit. But the worry over the influence of institutional investors extends beyond the mere fact that they may speak, perhaps too effectively, for stockholder interests. As diversified investors, they care little about the fortunes of individual companies. Indeed, a diversified investor may favor risky business strategies—even if such strategies entail the possible ruin of the company—provided the expected return (the weighted average of the possible outcomes) is great enough to justify the risk.[38] Again, only the

30. *See SEC Adopts Proxy Reform Package After Long Study and Intense Debate*, 24 Sec. Reg. & L. Rep. (BNA) No. 41, at 1603 (Oct. 16, 1992).

31. *See* Rule 14a-2(b), 17 C.F.R. § 240.14a-2 (1997).

32. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C).

33. *See* 15 U.S.C. § 77z-1 (a)(3)(B)(iii)(I)(bb) (Supp. I 1995).

34. *See* Coffee, *supra* note 29; Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994). *See generally* Allen D. Boyer, *Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons from the Robber Barons*, 50 WASH. & LEE L. REV. 977 (1993); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445 (1991).

35. I am indebted to Eldridge Cleaver for this construction.

36. *See* Coffee, *supra* note 29.

37. *See* Rock, *supra* note 34; *see also* Coffee, *supra* note 14; Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and Corporate Law*, 70 N.C.L. REV. 137, 183-84 (1991). *See generally* Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective*, 1992 COLUM. BUS. L. REV. 223.

38. *See* KLEIN & COFFEE, *supra* note 14, at 354-55. For a case in which stockholder preference for the highest risk-adjusted return appears to have played a significant role in a court's analysis, see *Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

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average matters. In the context of takeovers, this attitude no doubt translates into a preference for a freewheeling market for corporate control among well-diversified investors. Thus, the real worry over the influence of institutional investors is that they may somehow encourage more takeovers than would otherwise arise. To be sure, bidders, who are not well-diversified investors, may act as a check on this process. Why, after all, would a bidder assume the risk for the benefit of target stockholders? But, then again, if the bidder can quickly dismantle the company, possibly even pursuant to pre-existing arrangements with buyers for the pieces, the risk of temporary ownership may be minimal.[39]

What one thinks of this state of affairs depends on where one sees the greater danger. Those who see managerialism as the greater threat will likely prefer a strict duty to maximize stockholder wealth. Those who see other value (or values) at risk may not be as concerned about the loss of a clear duty of care. Instead they will likely prefer a duty of care which allows boards of directors to take into account the interests of other constituencies (such as workers who may lose their jobs), even if it means that management may use such excuses as a cover for preserving their own positions of influence.

THE LOGIC OF DIVERSIFICATION

The traditional model of management duty, which equates stockholders with the corporation, depends on a notion of a reasonable stockholder that is quite at odds with current reality. Rational investors diversify. Through diversification an investor can eliminate the firm-specific risk which goes with picking individual stocks. As a result, a diversified investor is risk-neutral.[40] This is not to say that a diversified investor is indifferent to risk. Rather, a diversified investor will prefer that management of any individual company pursue the highest risk-adjusted return even at the risk of the ruin of the company.[41] In contrast, an undiversified investor—one with all of his or her eggs in one basket—will care very much whether that one company survives. In short, an undiversified stockholder is risk-averse.

Which type of stockholder is the proverbial reasonable stockholder? To which type of stockholder does management owe its duty? The two different formulations of management duty will often lead to very different outcomes in particular cases. Whereas a diversified investor will prefer that management maximize gains, an undiversified investor may prefer that management minimize losses. In short, the conventional single-master notion of fiduciary duty, for all its seeming rigor, is ambiguous as to what kind of stockholder management should seek to serve.

39. Given the increasingly common practice of prepackaged bankruptcy, it should hardly be surprising that takeover firms also plan ahead for disposal of assets.

40. *See* EASTERBROOK & FISCHEL, *supra* note 1, at 29-30.

41. *See supra* note 38.

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In order to understand how diversification affects stockholder preferences, it is useful to consider a simple example. Suppose that Acme Industries (ACME) has been generating modest returns of 5% per year for its stockholders (including both dividends and capital gains). Acme researchers have developed a new manufacturing process which will allow the company to cut costs dramatically and to increase stockholder returns to 20%. There is a 40% chance, however, that the new process may entail delays in delivery and may compromise the quality of Acme's product such that a number of customers may be lost in the short term and, thus, which Acme will be forced into bankruptcy if the new process is adopted. On the other hand, there is a 60% chance of a 20% return, which means that the expected return from adopting the new process (as adjusted for risk) is 12%.

Will Acme stockholders prefer that management adopt the new process or stick with the old? The answer depends on whether Acme stockholders are diversified or undiversified. The new process is clearly worth more even if one considers the 40% risk of bankruptcy. Twelve percent is more than 5%. Yet an undiversified stockholder who has no other assets or other sources of income may not want the company to take the risk. After all, Acme currently pays a 5% return; thus, although the stockholder cannot be held liable for additional losses suffered by Acme, he or she does stand to lose the modest returns which are currently being paid. A diversified stockholder, on the other hand, will not hesitate to have the company opt for the new process. If the diversified stockholder holds stock in, say, ten different companies facing similar choices, and all opt for the riskier alternative, the chances are that six will succeed and four will fail. The six that succeed will pay 20% returns for a portfolio-wide average of 12% even though four companies will end up in bankruptcy.[42]

In the real world, of course, it is possible that all ten companies might suffer worst-case outcomes, although it is also possible that all ten might enjoy best-case outcomes. Thus, it might seem that there is some residual risk. Indeed there is. But with a bit more diversification, virtually all such risk having to do with the fortunes of individual companies can be eliminated. Studies indicate that with a portfolio of as few as twenty stocks

42. Such bankruptcies may also lead to additional gains for surviving companies to the extent that competition is reduced, but the preference of diversified stockholders for firm-level strategies to maximize value regardless of risk does not depend on such gains.

Although one might think that risk neutrality is an outgrowth of the limited liability, and although limited liability may make diversified stockholders somehow more oblivious to risk than they already are, in fact limited liability is pretty much irrelevant. Even if stockholders were personally liable for excess losses of the corporation, diversification would eliminate the risk so long as business in the aggregate made more money than it lost, which it almost necessarily must. Consider also the situation of debtholders who also have limited liability. Debtholders, nonetheless, are risk-averse with regard to their preferences for firm-level strategies. Thus, it would seem that limited liability has little to do with investor attitudes toward risk.

more than 99% of company-specific risk can be eliminated, and with 200 to 300 stocks all company-specific risk is gone.[43]

To say that it makes sense for an investor to diversify is to understate the case. Investors do not really have the option not to diversify. Although it might at first seem as if only the very wealthy could afford to hold as many as 200 or 300 stocks, in fact a high level of diversification is available very cheaply through mutual funds for investors with as little as $1000 to invest.[44] It is so cheap and easy for investors to diversify that it is simply unnecessary for investors to take company-specific risk. But the fact that company-specific risk can be avoided means that the market sets the price of individual securities as if no such risk exists.[45] If market prices reflected company-specific risk, then portfolio investors would buy up securities—which would be underpriced from their point of view because of the extra risk implicit in the pricing—and hold them in portfolios which eliminated such risk, thus, driving up the price and eliminating any return attributable to company-specific risk. Similarly, an investor who buys a single security as a stand-alone investment takes more risk (or enjoys less return for the same risk) than is necessary. Because the goal of investing is to generate the greatest possible return at the lowest possible risk, it seems fair to presume that rational investors *must* diversify.[46]

43. *See* JAMES H. LORIE ET AL., THE STOCK MARKET: THEORIES AND EVIDENCE 21-24 (2d ed. 1985).

44. *See* ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS § 15.2 (1998).

45. *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 193-209 (4th ed. 1985).

46. It is arguable that the foregoing argument for diversification proves too much. Although it is widely agreed that the market sets prices of securities as if they are part of a diversified portfolio, it is also widely agreed that securities are priced according to the systematic (market) risk they carry. These ideas are arguably inconsistent with each other. Why would the market ignore company-specific risk on the one hand and take into account the market risk associated with individual stocks on the other? If diversification can eliminate company-specific risk altogether, why are not all companies priced at the same multiple of earnings? Would not portfolio investors do just as well to buy stocks at random, and would that not lead to prices that are more or less uniform for all stocks? Indeed, it is fairly common practice among portfolio managers to purchase combinations of stocks with widely varying risk and return combinations so as to achieve a blended (or synthetic) risk and return combination somewhere in between. The practice is itself paradoxical. It suggests that the risk and return combinations of all stocks should collapse into a single combination for all stocks.

There is no clear answer as to why individual stocks display differing risk and return combinations, but there are several possibilities, all of which may contain some truth. First, portfolio investors may still make judgments as to whether individual stocks are properly priced. It cannot hurt to check up on the value of individual stocks even if one is protected by diversification—a sort of belt-and-suspenders approach to investing. The problem with this explanation is that it takes time and money to do redundant research, and returns are, therefore, somewhat depressed. Nevertheless, it appears that institutional investors do in fact spend significant amounts of money on research (possibly to protect against the so-called efficiency paradox—that is, the chance that other investors have stopped doing research

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Although it is clear that diversified stockholders are indifferent to company-specific risk, provided it is justified by the potential for return,

because they believe the market is efficient). As the author has argued elsewhere, such hedging—and, indeed, the efficiency paradox itself—is a perfectly normal market dynamic. *See* Richard A. Booth, *The Efficient Market, Portfolio Theory, and the Downward Sloping Demand Hypothesis*, 68 N.Y.U. L. REV. 1187, 1195-97 (1993) [hereinafter Booth, *The Efficient Market*].

Second, a little diversification goes a long way. In view of the powerful arguments in favor of diversification, many have argued that more diversification is always better and that a rational investor should buy a portfolio of 200 to 300 stocks that replicates the market. *See, e.g.*, POSNER, *supra* note 10, at 405-10; John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1, 6-13 (1975). If one must buy the market (and indeed buy stocks in proportion to their total market value) to be adequately diversified, then there is likely to be relatively little variation in the portfolios of rational investors. It turns out, however, that a little diversification is good enough. An investor can eliminate virtually all company-specific risk with a portfolio of about twenty stocks. MALKIEL, *supra* note 45, at 185-209. The fewer the number of different stocks one must hold to be fully diversified, the greater the possibility of engaging in some degree of stock-picking. After all, the logic of diversification works both ways: even though one cannot beat the market, neither can the market beat the investor. So there is no harm done in picking stocks based on pet theories or even whims, hunches, or fads. The fact that it is good enough to diversify over a relatively small number of stocks has not been lost on professional money managers either. At least one large manager of mutual funds, T. Rowe Price, has recently announced that it would offer a series of funds containing 50 to 60 stocks in order to minimize transaction costs (such as commissions), follow companies more closely, and take advantage of company-specific opportunities. Similar thinking may be behind the idea of relational investing. *See supra* note 29. In any event, the fewer the number of different stocks one must buy, the more stock-picking can be expected. Moreover, and perhaps more important, with smaller portfolios there are many more efficient combinations available. Thus, it stands to reason that pricing discrepancies in individual stocks will arise as a result of various investors pursuing various models to determine which stocks to place in their portfolios.

Third, and closely related to the foregoing argument, investors have differing tastes for risk. Investors who want a safer portfolio buy a selection of safer stocks, driving up the price of safer stocks and driving down the price of riskier stocks. The prevailing model of the market, the Capital Asset Pricing Model (CAPM) suggests that investors who prefer differing levels of risk should buy the market portfolio in combination with borrowing or lending at the prevailing riskless rate, that is, the prevailing rate on government securities. Although it is certainly possible to achieve lower levels of risk with superior rates of return by buying a mixture of the market portfolio and government securities, it is not clear that investors can often borrow at the riskless rate to buy stocks on margin. Thus, even under the CAPM investors who want higher rates of return will often need to buy a portfolio of riskier stocks directly. Moreover, even if one is completely convinced that CAPM describes how market prices are determined, it is not at all clear exactly what portfolio is optimum. Therefore, even if everyone agrees that there is such a portfolio, they may still compete to figure out which stocks should be in it, which will lead, of course, to pricing discrepancies in individual stocks (particularly if portfolios of 20 or so stocks are sufficient for diversification). Indeed, just measuring risk and return in order to determine which stocks are which is likely to give rise to significant differences of opinion and thus, pricing discrepancies that may be even more significant than those that arise as a result of differences in portfolio design. *See generally* Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976). *See also* MALKIEL, *supra* note 45, at 216-18 (reviewing studies indicating that returns on riskier stocks are lower than they should be). To be sure, this argument from differing tastes for risk depends on the fact that different stocks do in fact

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the same is not true of investors in securities other than stock. Bondholders and preferred stockholders (as well as other constituencies such as

have different risk-and-return combinations. The argument is, therefore, circular. Nevertheless, if risk-and-return combinations do differ from stock to stock, investors will certainly take advantage of them even if they do not know why the discrepancy exists. Thus, investor taste for risk may have the effect of magnifying the variations as investors seek out even minute discrepancies on which to base investment decisions. It may even be that, because of fiduciary duty and similar concepts, investment managers need to be able to justify their investment decisions by reference to some rational decision-making process. *See* Franklin Sav. Bank v. Levy, 551 F.2d 521 (2d Cir. 1977) (discussing the requirement of reasonable basis for broker recommendations); Hanly v. S.E.C., 415 F.2d 589, 595-96 (2d Cir. 1969) (same); Buttrey v. Merrill Lynch, 410 F.2d 135 (7th Cir. 1969) (imposing liability for violation of NASD suitability rule); Lange v. H. Hentz & Co., 418 F. Supp. 1376 (N.D. Tex. 1976) (discussing suitability rule as evidence of broker-dealer duty); Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222 (1968) (imposing liability for violation of suitability rule under state law). *See generally* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987).

Finally, it may be that stock-picking investors, speculators, potential acquirers, arbitragers, or indeed even inside traders take advantage of market "noise" or of the tendency of the market to gravitate to uniform pricing. *See generally* Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988). In a similar vein, as the author argues elsewhere, portfolio-based trading strategies (e.g., program trading) may affect the price of individual stocks out of proportion with their individual value, creating opportunities for trading in individual stocks. *See* Richard A. Booth, *The Uncertain Case for Regulating Program Trading*, 1994 COLUM. BUS. L. REV. 1, 54-55. On a more pedestrian level, the price of individual stocks may be affected by tax-motivated trading (as where an investor matches sales of gainers and losers periodically or at year's end in order to net out capital gains). Similarly, managers who have received stock options as part of their compensation may periodically sell some of their stock in order to increase diversification. In both cases, imbalances may be created that force the price away from some ideal. All of these explanations suggest that the market price for each individual stock may be the product of several forces rather than simply a consistent search across investors for stocks whose fundamental value differs from market price. Thus, the evolving arbitrage pricing theory or some form of chaos theory may turn out to be a more accurate description of the way the market works than classical theory or even the CAPM. *See* MALKIEL, *supra* note 45, at 229-32; Hazen, *supra* note 37.

As the author has argued elsewhere, the interplay of these forces may result in a market for stocks that (like other markets) displays downward-sloping demand. *See generally* Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CALIF. L. REV. 1053 (1991) [hereinafter Booth, *Discounts*]; Booth, *The Efficient Market*, *supra*, at 1187, 1197-1208 & nn. 33-34. Professor Stout has written extensively on the same theme, though she tends to reach the conclusion that rational differences of opinion among investors (heterogeneous expectations, the HE model, as she calls it) imply that policies designed to foster market efficiency are a waste of resources. *See* Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1294-95 (1990). *See generally* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988). The author sees nothing inconsistent between rational differences of opinion and a well-functioning and efficient market. If anything, rational differences of opinion (which the author dubs the downward-sloping demand hypothesis or DSDH), imply that we should take extra care to insure that policies allow for full and free competition among the various actors in the financial markets.

Finally, it is also possible that there are significant numbers of investors out there who have not heard about the CAPM or simply do not believe it.

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employees, suppliers, customers, and the community), whose returns are generally fixed, do not stand to gain from the undertaking of risky projects.[47] In other words, no portion of the additional profits from a successful project will go to such investors, but such investors may well suffer if the project fails. Although fixed-return investors and other constituencies may see some slight benefit in the form of reduced risk of default or even voluntary profit-sharing when such projects succeed, from their point of view it is clearly preferable that the company be managed so as to minimize the possibility of default.

Management, however, is in a different position. If management is compensated with stock to any significant extent—and typically it is—management will gain if the process succeeds and will lose—perhaps even to the extent of losing their jobs—if the process fails. In short, management is in the same boat as an undiversified stockholder.

DERIVING THE STANDARD OF CARE

Based on the fair presumption that investors are diversified, it would seem sensible to construct rules governing management duty that comport with the preferences of diversified stockholders. There are, however, several compelling reasons not to do so. Specifically, to do so would require management to identify a single clientele of investors whose interests should be served, would often lead management to undertake strategies which were redundant of cheaper stockholder strategies, and would sometimes compel management to divert returns which would ordinarily flow to other constituencies.

The Clientele Problem

To derive the rules of management duty from the interests of diversified shareholders would be quite impractical. It would require management to consider the effect of its decisions on the value of its stock in the context of a portfolio. That is, management would need to consider the wealth effect of business decisions in terms of their fit with all other stocks in the portfolio. And quite aside from the burden involved in doing so, the stock in question may be held in many different portfolios with many different goals. Which portfolio strategy should be favored? Judging management decisions by reference to a diversified stockholder imports potentially conflicting duties similar to those which arise under other-constituency statutes. On the other hand, even if investors hold differing portfolios reflecting differing strategies, they all still have the common goal of eliminating

47. *See* KLEIN & COFFEE, *supra* note 14, at 354-57. *See generally* David R. Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098 (1962).

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company-specific risk. Thus, even if some decisions would favor certain portfolios over others, management could nonetheless pursue the highest possible risk-adjusted return.

One way to test the accuracy of the duty-to-firm model (in which duty is constructed based on the interests of undiversified stockholders) is to think about what fiduciary duty would look like if it were in fact construed as a duty to a diversified owner. There are some decisions which diversified stockholders might prefer that may nevertheless be unreasonable to expect management to pursue. The acid test would seem to be a situation in which a diversified stockholder might prefer that management simply liquidate the firm. For example, if to reduce the number of companies in a given line of business would lead to a net gain in the portfolio owned by the stockholder, the stockholder would presumably prefer that the least profitable firm in the line simply dissolve.[48] Do we really expect managers to make such decisions? Clearly we do not recognize a cause of action for breach of fiduciary duty in such cases (although it is at least conceivable that there are some duties for which there is no remedy in the event of breach).

If investors tend to invest in portfolios smaller than the whole of the market and at various levels of risk, as seems to be the case, they will presumably prefer that the companies in their portfolio not switch to business strategies which involve dramatically different levels of risk. Even if an investor buys a combination of risky stocks and safe stocks to achieve a hybrid return somewhere in the middle (also a common practice), such an investor will still prefer that the company stick to its original plan.[49] In

48. *See* Hu, *New Financial Products*, *supra* note 1, at 1281-82. One is reminded of the scene in the movie *It's a Wonderful Life* in which old-man Potter, the evil commercial banker who sits on the board of the Bailey Building & Loan (BBL), proposes that BBL dissolve and distribute the proceeds to its shareholders. Potter's argument is that the town is too small for two banks and that investors would gain from eliminating the competition between the two. The board of BBL, of course, rejects the idea, and vows to continue to compete with Potter's bank.

Although it is arguable that diversified investors might sometimes prefer that a marginal company liquidate (especially investors in so-called sector funds), it is also arguable that the decision not to dissolve is ultimately in the interest of diversified investors in that only with competition will management seek out ways to maximize stockholder value. In any event, management can always make such an argument. Thus, there may be few real world examples of such controversies. After all, who (other than a competitor) is going to buy a company solely for the purpose of liquidating it? It may be, then, that the most powerful argument for a limited idea of the duty of care is that any broader notion of the duty is simply unenforceable.

49. Indeed it is a known practice among sophisticated traders and portfolio designers to invest in two stocks of varying risk in order to achieve a blended (or synthetic) risk-return combination, a strategy sometimes called a "bone."

Diversified investors are risk-neutral, but they are not indifferent to risk. They still care about market risk that cannot be diversified away. Moreover, even fully diversified portfolios can have different levels of risk. Thus, a diversified investor may care if a safe company

short, a company may develop a clientele of stockholders and indeed other investors.[50] At the same time, however, management cannot be certain of its stockholders' preferences because those preferences may be skewed by idiosyncratic investment strategies.

Recent developments in investing lend credence to this view. Even with regard to an investment in a single firm, it is possible for an investor to concoct a wide variety of investments of which management itself may not even be aware. Imagine a company with a single class of bonds and a single class of common stock outstanding. Some of the bonds might be held as a whole by some investors while others might have been stripped and sold as interest-only or principal-only investments. As for the stock, some might be held intact by investors as a long-term investment. Some of those investors may own their stock outright, some may have bought on margin, some may have sold options as a way of enhancing return, and still others may have bought only the options. Thus, in this simple example the company may be seen as having seven different kinds of securities linked to it even though it has only issued two.[51]

pursues risky strategies. Should such an investor have a cause of action against a company that assumes a different level of risk and upsets the investor's portfolio? Probably not. It is, after all, possible to diversify away the risk of a company's changing its plans as it is with other company-specific risks. Moreover, the investor's complaint is akin to the kind of complaint that an undiversified investor might voice, so it is difficult to see how a standard of care derived from a reasonable undiversified investor could be problematic.

Although stockholders should not have standing to challenge firm-level decisions that have the effect of changing the riskiness of a stock, mutual fund investors and the SEC have expressed concern about funds that fail to stick to their descriptions or that offer only equivocal descriptions of target risk levels. Although it is a common practice for mutual fund investors to diversify across funds, it should not be necessary to do so if the fund itself is adequately diversified. On the other hand, an investor can use diversification to protect against the possibility that funds will not achieve the risk-return combination desired by the investor. On balance, however, where an investor has bought a fund in reliance on a stated target risk level, the argument from diversification against stockholder standing to sue individual companies has little if any force where an investor seeks to challenge a fund. Moreover, investors often do recover from their brokers on the grounds that the broker advised the investor to assume more risk than is suitable—even as to individual stocks. *See infra* note 74.

50. This possibility is, of course, closely related to the idea of a clientele effect regarding payment of dividends, which some commentators have suggested explains the apparently irrational preference of stockholder for dividends (which is contrary to the famous Miller-Modigliani Irrelevance Proposition). That is, it has been argued that investors tend to gravitate to companies that do or do not pay dividends depending on investor preference for income or growth and that a change in policy may have the effect of causing investors to sell, making it appear that investors prefer dividends in the case of companies that begin to omit them. *See generally* Richard A. Booth, *Junk Bonds, the Relevance of Dividends and the Limits of Managerial Discretion*, 1987 COLUM. BUS. L. REV. 553.

51. *See* Hu, *New Financial Products*, *supra* note 1 at 1297-1300. Of course, for the most part, the owners of derivative securities such as options have no standing at all to sue the company that issued the underlying security. Still, trading in derivative securities can affect the price of the underlying security and thus, may be a source of worry for management.

It is little wonder that burned-out physicists and mathematicians often retire to Wall Street,

In addition, more than thirteen percent of trading in New York Stock Exchange (NYSE) stocks is officially attributable to program trading involving strategies based on models of how a group of stocks behaves vis-á-vis another financial instrument (such as a stock-index future) or even another group of stocks.[52] Individual stocks may be included in such program-trading strategies for reasons which have little or nothing to do with the company's prospects. And to complicate matters still further, traditional, value-oriented investors may avail themselves of trading opportunities created by the program trading of other investors.[53]

The point is that portfolio investing, derivative instruments, and program trading have the effect of at least partially disconnecting a stock's price from the fortunes of the issuing company. How should management respond? Although one certainly cannot fault management for attempting to keep up with such developments, neither can one say that it is unreasonable for management to ignore much of what goes on in the market as noise, and stick to running the business as if it were a stand-alone investment.[54]

frustrated by the seemingly endless stream of smaller and smaller particles, to slice and dice securities. Why not apply the same techniques to making money? Why do you think they call them rocket scientists anyway?

52. NEW YORK STOCK EXCHANGE, FACT BOOK FOR THE YEAR 1996 (1997). Only trades involving 15 or more stocks and worth $1 million or more are required to be reported to the exchange. *Id.* Thus, there may well be much more trading based on theories, models, strategies, hunches, or whims involving groups of stocks.

53. *See* Hu, *New Financial Products, supra* note 1 at 1285-86 (discussing the notion of a "blissful" shareholder wealth maximization model); Michael S.H. Shih, *Conglomerate Mergers and Under-Performance Risk: A Note,* 35 Q. REV. ECON. & FIN. 225 (1995); Robert Stephan Cohen & Arthur H. Rosenbloom, *The Whole May Be Worth Less Than the Sum of Its Parts,* N.Y.L.J., Dec. 18, 1995, Outside Counsel at 1; Vineeta Anand, *More Companies Are Spinning Off Unwanted Assets,* INVESTOR'S BUS. DAILY, Jan. 8, 1992, Executive Update, Finance at 10; Vineeta Anand, *Split-Off Can Ease Conglomerate's Ills,* Dec. 26, 1990, Executive Update, Strategy at 6.

54. *See* Note, *Firm Versus Shareholder Diversification, in* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 317-20 (2d ed. 1995); LOUIS LOWENSTEIN, SENSE AND NONSENSE IN CORPORATE FINANCE 161-66 (1991); *see also* Don O. May, *Do Managerial Motives Influence Firm Risk Reduction Strategies?*, 50 J. FIN. 1291 (1995) (suggesting that focus on earnings may be due to compensation based on earnings). *See generally* Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach,* 88 YALE L.J. 1238 (1979); Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s,* SCIENCE, Aug. 17, 1990, at 745; Geoffrey Owen, *How the Conglomerate Concept Went Out of Fashion,* FIN. TIMES (London), Jan. 18, 1985, § I at 16; Malcolm S. Salter & Wolf A. Weinhold, *Diversification via Acquisition: Creating Value,* HARV. BUS. REV., July/Aug. 1978, at 166; *see* Michael J. Brennan, *Corporate Finance Over the Past 25 Years,* 24 FIN. MGMT. 9 (1995). Another reason why conglomerate firms may tend to be undervalued is that analysts who follow them do not understand all the unrelated businesses as well as others.

There is, however, at least one good recent example of an attempt to bring management incentives into line with the interests of diversified investors, namely the golden parachute. Golden parachutes are, in essence, employment contract terms providing for large payments to key managers in the event of a takeover of the employer company. Although many com-

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The Redundancy Problem

Stockholders appear to have a strong preference for management which focuses on the task at hand. Numerous market phenomena suggest that shareholders dislike company-level strategies designed to substitute for strategies which investors can pursue just as easily on their own. For example, the stocks of diversified conglomerate companies tend to trade at a discount from the stocks of more focused companies.[55] Ironically, one of the original ideas behind the conglomerate-merger movement was to assemble a collection of companies whose varying financial performances would tend to offset each other, smoothing out the income stream of the whole, and thus creating an aggregate entity the value of which would be greater than the sum of the parts because of reduced risk. Or so the thinking went.[56] But the fact that stocks of conglomerate companies tend to sell at lower rather than higher prices strongly suggests that investors would prefer to do their own diversifying. The reason is fairly simple. A diversified firm offers a fixed array of component companies. But even an

mentators saw golden parachutes as just another reprehensible defensive tactic, such payments did not, in most cases, have the effect of raising the cost of a takeover significantly. Thus, other commentators argued that golden parachutes could be used to eliminate disincentives for management to negotiate. In other words, the argument was that golden parachutes were more in the nature of a specialized stock option designed to eliminate the natural reluctance of management to sell the company to a buyer who might replace the current management or sell off pieces of the company and eliminate management jobs altogether. Despite the apparent sense of such an arrangement from the point of view of stockholders (who generally had a strong preference for takeovers), the market generally reacted negatively to the granting of golden parachutes. No doubt, golden parachutes may have been abused. They may have been so attractive as to induce management to seek out takeovers even at prices below what the stockholders might expect. Nevertheless, it is also possible that the market perceived that a golden parachute also had the tendency to make management too passive in a situation where aggressive negotiation—such as that in which an undiversified stockholder would be expected to engage—would be preferable.

55. *See, e.g.*, Gary T. Haight, *The Portfolio Merger: Finding the Company That Can Stabilize Your Earnings*, 16 MERGERS & ACQUISITIONS 33-34 (Summer 1981); Milton L. Rock, *Is Diversification Doomed?*, 16 MERGERS & ACQUISITIONS 4 (Winter 1982); *Roundtable: Diversification and Divestiture*, 17 MERGERS & ACQUISITIONS 26 (Winter 1983).

56. *See* Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745 (1990). A similar phenomenon has been noted in connection with closed-end mutual funds. *See* Booth, *Discounts*, *supra* note 46, at 1081-87 & n.88; Booth, *The Efficient Market*, *supra* note 46, at 1197-1208 & nn.33-34. Because such funds offer pre-packaged diversification, they only appeal at full price to the limited number of investors who would construct the same portfolio for themselves. Such funds may be likened to a supermarket produce package containing celery and carrot sticks. Although the combination may be sufficiently convenient for enough customers to justify preparing some number of such packages, it will be useless to a customer who needs only carrots or only celery or some combination in a different proportion. For that reason, closed-end funds tend to trade only at prices equal to or lower than net asset value, though there are exceptions. The more familiar open-end fund, which can be redeemed at any time at net asset value, is always worth net asset value, not because the selection of underlying stocks is any more appealing but because by law or agreement fund shares can always be sold back to the issuer at net asset value.

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individual investor of modest means can achieve the same effect by buying the stocks of similar but independent companies. Moreover, the investor can add and subtract component parts virtually at will. A conglomerate firm, on the other hand, can only make new investments, or divest itself of old ones, at great expense. Thus, it is easy to see why investors might prefer the stocks of companies which stick to one line of business. And it is easy to see why many conglomerates have been broken up and the pieces sold, first by means of the bust-up takeover and now by means of the spin-off.[57]

The fact that stockholders dislike company-level diversification does not necessarily mean that they dislike all company-level risk-management strategies. Indeed, stockholders often seem to like company-level borrowing (even in the form of junk bonds). Witness the number of companies that, in the 1980s, were either sold to junk-bond-financed bidders or that leveraged themselves in response to the threat of a takeover.[58] Although stockholders may "roll their own" leverage by margin-borrowing (just as they may construct a diversified portfolio on their own), they may prefer company-level leverage if companies can borrow at lower interest rates than can stockholders themselves. Moreover, under Federal Reserve Board regulations, stockholders only borrow fifty percent of the purchase price of stock.[59] Thus, if stockholders prefer more leverage than that, it must be created by company-level borrowing.

The difference between company-level diversification and company-level leverage seems to be a matter of who can perform the function more cheaply (or indeed at all). To the extent that stockholders are able to manage risk on their own, they will not want management to engage in redundant efforts to manage risk. Such efforts add no value, and indeed detract from value to the extent of their cost. Moreover, such efforts may have the effect of making it more difficult for stockholders to assess or monitor company-level risk. Presumably even risk-neutral diversified stockholders prefer certainty in the sense that they want to know how much risk they are taking.[60]

57. *See generally* Booth, *supra* note 50. The increase in corporate debt financing may be seen as a direct reflection of stockholder taste for risk and thus, as a striking example of how a market driven by diversified stockholders may induce issuing companies to pursue riskier strategies than management might prefer on its own.

58. Other examples of risk-management strategies that may only be undertaken at the company level include the acquisition of privately held companies and investment in customized OTC derivative instruments.

59. 12 C.F.R. §§ 220.12 (1998).

60. If in fact stockholders dislike management efforts to cater to stockholder tastes in areas in which stockholders are able to do the job equally well, how can management know which efforts will please the market and which will not? The simple answer is that management should focus on company-only opportunities. But the answer may be too simple. Even though company-level investment opportunities are clearly company-only opportunities that cannot be pursued by investors, there may be some such opportunities that are tempting not solely because of their intrinsic worth but rather because of their likely appeal to stockholders

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Whatever the reason for stockholder dislike of company-level risk management, it appears that diversified stockholders, who are supposedly risk-neutral, prefer management to behave as if they were not risk-neutral. The best explanation for this apparent paradox may be that a second-best solution to management performance is the best that stockholders can hope for. There is probably no better way to induce management to serve stockholder interests than to pay a substantial portion of compensation in the form of stock options.[61] Yet, stock options necessarily require management to forgo diversification at least to some extent. Although it would certainly be possible to set up a stock option plan that would pay management in shares of a diversified mutual fund, such a plan would

because of their high-return. For example, it may be that two very different investments have identical expected returns even though one is much riskier than the other. It is unclear that management should attempt to satisfy stockholder preferences even in these circumstances. Stockholders can often leverage up or down the returns of alternative investments through margin borrowing or lending so as to replicate alternative risk and return combinations. Thus, even efforts to manage risk that involve company-only investment opportunities may invade areas in which stockholders can fend for themselves and may have the effect of creating additional uncertainty at the stockholder level, the net effect of which may be negative even though (conceivably) the company-level opportunity may have the highest expected value of the alternatives available to management.

To be sure, there may be dramatically more profitable opportunities that are worth pursuing despite the creation of stockholder uncertainty (though stockholders will presumably be quite dubious, as they are about claims, that the payment of greenmail is designed to preserve unspecified long-term benefits). But even as to such opportunities, pursuit of the highest return may have costs in terms of management performance in other areas that are difficult to measure. For example, stress created by a bet-the-farm investment may make such investments unlikely to succeed, just as stress over defending too many lawsuits is said to distract management from the job at hand. Moreover, dramatically more profitable opportunities are probably quite rare, and shareholders are likely to be quite skeptical of any management claim to have found one. Thus, as a rule of thumb, management may not pursue opportunities with significant risk of positive loss as opposed to merely lesser return. In other words, it may be that when in doubt management should manage as if the stockholders were not there. That is, management should do what is good for the corporation without thinking much, if at all, about what the stockholders would like. *See* Hu, *New Financial Products*, *supra* note 1, at 1285-86.

61. The real question is why do managers want a piece of the action? It is well understood why stockholders like to compensate managers with options, but it also seems intuitive that managers want them too. The obvious explanation is that managers expect to make more money with options. Thus, it should not be surprising that options are often very lucrative. Indeed, they must be sufficiently lucrative to overcome added risk from the inability to diversify, which also suggests that much of the outrage over high pay is misplaced and probably reflects ex post perspective. Managers may also be trading on inside information in a sense when they agree to accept options. They know their own talents, ideas, resources, and so forth, and may not perceive the risks of stock ownership as quite as high as outside, passive investors. After all, managers do not really face agency costs. They know they will always agree with their own decisions. For an excellent example of a court seeking to discover how the parties would have contracted as to disclosure to option-holding employees of information about a planned merger, as well as a discussion of the utility of off-the-rack rules, see *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987).

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do very little to induce management to do a good job at its own company. The cost, however, is that stock options also increase the tendency of management to view decisions as an undiversified investor would.[62]

It may be that stockholders expect management to manage as an undiversified stockholder would manage. Studies indicate that the market overreacts to bad news; that is, market prices tend to fall by more than they should when a company announces losses.[63] Why? If diversified stockholders are in fact risk-neutral, there should be no excess market loss from bad news. That there is suggests that investors care more about risk than they should, even if they are undiversified. It could be that the market overreacts to bad news not because the market itself cares, but rather because it is a signal that management has failed to serve its own interests as effectively as one would hope. If management cannot manage to avoid losses for its own sake, how can it be expected to do a good job for the stockholders?[64]

In the end, it is at least possible that diversified stockholders prefer management to manage as if for the benefit of undiversified owners simply because such a system of incentives is the best that can be devised. And when management behaves inconsistently with the incentives which are in place, the market reacts negatively even though a particular decision may in fact serve the interests of diversified stockholders.[65]

The Diversion Problem

Many investors own both stocks and bonds. There is, after all, no reason why a portfolio must contain only stocks or only bonds. And even if an investor currently prefers stocks, over time the same investor may see his or her taste evolve to bonds.

What model of management duty would a diversified investor who owns a mixture of securities prefer? Again, because of the wide variety of portfolios which investors can construct, management should not be expected

62. *See generally* Booth, *supra* note 14; Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 TEMP. L.Q. 47 (1987).

63. *See* Michael G. Ferri & Chung-Ki Min, *Evidence That the Stock Market Overreacts and Adjusts*, 22 J. PORTFOLIO MGMT. 71 (1996); Grant McQueen et al., *Delayed Reaction to Good News and the Cross-Autocorrelation of Portfolio Returns*, 51 J. FIN. 889 (1996).

64. Thus, the recent adoption by the SEC of rules requiring comparison of stock option performance with performance of the market as whole should be seen as a comparison of apples and oranges. *Id.*

65. It is also possible that diversification makes the market more volatile. Although investors buy stocks without much regard to company-specific factors—thus, creating arguably artificial interest on the buy-side—they may quickly sell companies that stand out because of the announcement of bad news. Also, it may be too that bad news is inherently more trustworthy than good news. *See* Hazen, *supra* note 37.

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to worry about the interests of any particular type of investor. Nevertheless, all investors would probably prefer a rule which prevents intentional diversion of return from one form of investment to the other.

Clearly, investors select certain securities with some sense of expected risk and return. Where management decisions have the effect of merely favoring one security over another by allocating to one some element of return which is up for grabs, it is unclear that anyone has standing to complain. But where management enhances the return of one group at the expense of another group, the case may well be different. It is at least reasonable to think that diversified stockholders would generally support a rule against zero-sum diversions of returns because of uncertainty about whether a given investor will be on the long or short end of such diversions at any given point in time.[66]

Moreover, redistribution is a two-way street. One can well imagine bondholders seeking to impose conditions limiting risky strategies which would increase bondholder safety somewhat, but would also reduce the potential for stockholder gains by more. Management presumably has a duty to the stockholders to avoid creditor overreaching under any formulation of management duty. Still, it is difficult to imagine that stockholders would object to a general maxim against zero-sum diversions. That is not to say that stockholders would positively prefer such a rule, but it does suggest that management should not be exposed to liability for following such a rule.

Finally, even if it is agreed that managers owe a duty to the stockholders and the stockholders alone, it is quite another thing to say that management *should* take advantage of opportunities to divert value from other investors for the benefit of the stockholders in cases in which other investors have neglected to negotiate protections.[67]

In summary, although it is clear that rational investors diversify, and thus superficially arguable that management duty to the stockholders should be construed with diversified shareholders in mind, on closer anal-

66. The argument is a straightforward application of Rawls' concept of the veil of ignorance. JOHN RAWLS, A THEORY OF JUSTICE 136-42 (1971). The recent development of so-called "life cycle funds," which seek to pursue an evolving investment strategy for investors as they age, seems to support the notion that investors would prefer a rule of fairness over time.

67. Brudney, *supra* note 5. Although common stockholders will often prefer to undertake risky strategies—the losses from which may affect other investors adversely—it is not necessarily the case that stockholders prefer such investments *because* part of the losses will be borne by other levels of investors. In the foregoing example, shareholders would still obviously prefer the riskier strategy even if the worst case scenario was merely a zero profit. In other words, stockholder indifference to risk is not a matter of redistribution of investor wealth, though redistribution may sometimes occur. Conversely, it is noteworthy that the *Principles of Corporate Governance* allow management to take into account the interests of other constituencies so long as to do so does not harm the long-term interests of stockholders. One is reminded of the admonition to doctors to do no harm.

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ysis it is probably the better view that management duty should be interpreted as if it is owed to the corporation or to a reasonable undiversified stockholder. Such a conception of management duty makes sense even if in fact a given corporation's stock is owned predominantly by diversified shareholders. In other words, management should never be subjected to liability for any business decision solely because the business decision is contrary to the interests of diversified stockholders. Thus, even in the absence of an other-constituency statute, management has the benefit of something very similar to the expanded version of fiduciary duty.

THE LIMITS OF STOCKHOLDER ACTIVISM

How much difference does it make in the real world if management duty is construed as duty to firm—that is, undiversified stockholders—rather than duty to diversified stockholders? Institutional investors have all the votes they need to have their way. If they cannot get management to serve their interests, they have the power to install new management. No matter what we do about fine-tuning the duty of care, institutional shareholders will still be able—at least in theory—to call the shots. So who cares what the rule is if the parties are going to work around it anyway?

The simple answer is that companies do not manage themselves. If an institutional stockholder wants a better return, it must find a manager to seek it. A deal must be struck with the manager. And the manager is free to negotiate out of unabashed self-interest, at least until that manager has assumed the new position. Moreover, typically a manager will negotiate for a piece of the action, which in turn will mean that managers will manage as if they were undiversified owners. Thus, it may be that a somewhat diluted fiduciary duty is the best deal which investors can ordinarily get and that even diversified shareholders must settle for fiduciary duty as it stands.[68]

To be sure, there may be managers willing to serve the interests of diversified stockholders—presumably for a fee. Indeed, takeover specialists are arguably such a class of managers. The fact that takeover specialists break up viable companies if the pieces may be sold off at a profit demonstrates that at least some managers are willing to take extreme steps in

68. Although it may at first seem fallacious to import the interests of bondholders to argue that such interests should be respected to some extent, the argument for management duty based on the interests of a diversified stockholder does not seem to depend on the stockholders owning only stock. In any event, it is unclear that any rule requiring management to divert returns from other constituencies could ever be enforced. As one moral philosopher put it, ought implies can. The idea here is that any duty that requires managers to pursue the interests of stockholders to the detriment of other constituencies is simply unenforceable, which is not to say that there may not be some managers who do exactly that. They simply cannot be forced to by legal rules. Moreover, it will ordinarily be impossible for other constituencies to prove that management has acted to divert wealth unmotivated by the prospect for independent stockholder gain.

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order to maximize return for diversified stockholders. That solution is, however, too easy. The problem of management compensation remains, even as to the takeover specialist. If there are gains to be had from more aggressive management, what is to prevent the takeover specialist from appropriating them?

The answer is competition. Studies indicate that most of the gain from takeovers goes to the stockholders and that takeover specialists make only ordinary returns on the average.[69] This should be a surprising finding. Takeover artists are underdiversified and should tend to be more risk-averse than diversified investors. In the case of the ordinary manager, risk aversion translates into a preference for low-risk low-value firm-level strategies (as in the Acme Industries example). But in the case of a takeover artist, risk aversion translates into a preference for quick returns. In other words, takeover specialists compensate themselves for the added risk of nondiversification by arranging to realize returns quickly.[70]

The claim that takeovers may be motivated by short-term gains and may result in the sacrifice of more profitable long-term firm-level strategies is at least believable because underdiversified takeover specialists will tend to prefer quick resale of target companies. Moreover, takeover specialists will presumably tend to look for such opportunities in that any company that can be bought and sold for a short-term gain will be an attractive target.[71]

69. *See* GILSON & BLACK, *supra* note 54, at 299-311. Note that even ordinary gains may represent a loss to target stockholders in that the same gains could have gone to enhance stockholder return in the absence of a takeover if only incumbent management had taken steps to make the same changes that the acquirer made.

70. Indeed, there is evidence that prevailing bidders often overpay for targets, and thus, suffer from what has come to be called the "winner's curse." *See* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989). Worry over the winner's curse may mean that, as short-term players, takeover specialists may indeed be tempted to divert wealth from other constituencies in order to make a deal pay off. On the other hand, averages can be deceptive. Over what period are they calculated? A gain of 10% over the course of six months would only be a gain of five percent over a full year and less over longer periods. The short-term versus long-term distinction has been dismissed by most commentators on the quite sensible grounds that one can quite easily translate gains over any term into present dollars and quickly determine whether a long-term strategy is in fact worth more than a short-term strategy. It is, therefore, reasonable to think that market prices will reflect long-term value, or indeed the maximum value over any time horizon to the extent that the market believes that management will in fact pursue the value-strategy in question. *See generally* Hazen, *supra* note 37.

And what about the variety of fees that bidders typically pay to themselves in connection with doing a deal? It may well be enough, if the risks are sufficiently low as in a prepackaged bust-up, for the bidder to break even so as to stay in business simply as a bidder. Indeed, it has been suggested that at least some of the takeover movement was fueled by the need for M&A departments of investment banks to have something to do. (For an amusing look at how the process might work, see the movie *Working Girl*.)

71. Takeover specialists may even seek out companies that seem to ignore high-profit short-term strategies in favor of well-concealed long-term strategies. In order for such a

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Nevertheless, the fact that takeover specialists may step in to serve the interests of diversified stockholders does not necessarily mean that fiduciary duty should require all managers to manage in such a mode. The fact that some companies can be broken up or even liquidated at a profit

takeover to be profitable, the takeover specialist must be able to buy at less than short-term value, but that would seem to be no problem if the market perceives that short-term strategies have been ignored. (Of course, supposedly high-value, long-term projects may not in fact be worth as much as incumbent management seems to think, and may indeed be worth less than short-term projects given the common tendency of management to want to empire-build.)

This scenario depends on the possibility that the takeover specialist can buy at a price lower than value and thus, presumes that the stock market is often inefficient in pricing stocks based on long-term value. Otherwise, there would be no gain. How likely is it that the market is that inefficient? It is not unlikely. Companies tend to keep their long-term strategies secret to the extent they can. Moreover, the securities laws do not generally require disclosure of forward-looking information; indeed, they discourage predictions, though the recent development and partial codification of the bespeaks caution doctrine has given management new license to discuss such plans and projections without as much fear of liability under federal securities law. *See* 15 U.S.C. §§ 77z-2, 78u-5 (1994 & Supp. I 1995) (both added by PSLRA). *See generally* Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 BUS. LAW. 481 (1994). Moreover, if a company pursues a secret long-term strategy, the market may conclude that the firm has neglected to pursue profitable short-term strategies, which may often be more obvious. In other words, a company that is in fact good at concealing its plans from competitors will likely be undervalued. *See generally* GILSON & BLACK, *supra* note 54, at 589-609 (discussing, among other theories, differences in pricing of real assets from financial assets); Hazen, *supra* note 37. Whether or not planning for the long term somehow increases the risk of takeover, the preservation of long-term gains is recognized in the *Principles of Corporate Governance* as a rationale for resisting takeover. *See* PRINCIPLES, *supra* note 1, § 6.02 (stating that, in deciding to resist, a board may take into account interests of other constituencies "if to do so would not significantly disfavor the long-term interests of shareholders"). A similar rationale has been offered to justify greenmail in some cases. *See generally* Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail,* 95 YALE L.J. 13 (1985).

This suggests a potential difficulty in the notion that takeovers are prompted by stockholder taste for short-term gains. Of all constituencies, diversified stockholders ought to be most in favor of high-value long-term projects because they can afford to wait for their money (again assuming there is no excessive discount for liquidity). Why, then, is the worry so often expressed that greedy stockholders are ultimately behind the takeover movement?

In addition, real assets may have peculiar value to certain potential buyers. For example, competitors of the target company may buy up the pieces of a target simply to eliminate competition. If some gains can only be had by limited numbers of potential buyers, it stands to reason that the stock market may not strongly reflect such possibilities. By the same token, however, takeover specialists must take the limited resale market into account in planning a bid, which would tend to reduce the amount that bidders would be willing to bid or to increase the focus on quick, pre-planned resales.

It is always possible, too, that some exogenous constraint might cause a manager to ignore high-value long-term projects in favor of low-value short-term projects. Risk aversion is just such a factor. Indeed, it may be a very powerful factor. Diversified investors are willing to wait for their returns so long as the return is high enough to compensate for the delay in terms of time value of money. Companies that pay out over the long term are balanced out by companies that pay out over the short term. Moreover, with a liquid market—assuming

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cannot mean that all companies can or should be broken up or liquidated. There is a natural limit to the number of companies which can be managed in takeover mode. For every seller there must be a buyer. And ultimately, when a body of assets comes to rest, management must manage with a long-term view. Thus, stockholders would not want all managers to manage all the time as takeover specialists do and would not bargain for any such rule of fiduciary duty. It is clear that long-term managers are a necessary part of the system. Indeed, the takeover market depends on them.

the market can be trusted to set fair prices (albeit with some discount for liquidity)—diversified investors will be able to cash out long-term returns at any time. But a takeover specialist is anything but indifferent. The longer the takeover specialist must hold an acquired company before it is sold off, the more risk he takes. Thus, the takeover specialist will almost always prefer a bird in the hand to two in the bush. To be sure, if the takeover depends on selling off pieces of the target, the ultimate buyers will only pay a price consistent with long-term management. After all, the pieces must come to rest at some point.

There may be situations in which even the most free-wheeling market for corporate control with minimal regulation of the takeover process may not go as far toward serving the interests of diversified stockholders as they would like. For example, one could imagine an industry with overcapacity (and, therefore, inferior rates of return) in which the assets had no other ready use. Even though a diversified stockholders might prefer to see one or more firms in such an industry simply dissolved, no one would bother to take over a firm just for the purpose of dissolving it unless the firm had liquidation value in excess of the purchase price. No one competitor may find it worthwhile to buy a rival just to reduce capacity. Again, the proposal made by old-man Potter, in the movie *It's a Wonderful Life*, that the board of BBL vote to dissolve the corporation because it was superfluous, comes to mind. Of course, Potter was in the unique position of already being on the board of directors, so he did not need to buy his way into a position of power. Nevertheless, the board voted down the proposal, which presumably would have required the consent of the shareholders anyway but only on the condition that George Bailey assume the position of CEO.

Movie plots aside, unless management has an enforceable duty to serve the interests of diversified stockholders, no one can force a dissolution. Moreover, if the solution to the overcapacity problem is for one of several competitors to dissolve, who is to say which one should go? Thus, even if there were a theoretically enforceable duty to dissolve, it could not in fact be enforced against any one firm's management. And even if it could somehow be enforced, such a rule might have undesirable side effects. It might sometimes be enforced where the elimination of competitors was in fact motivated by the potential for monopoly profits rather than merely an adequate rate of return (though it is unclear how one would determine what constitutes an adequate rate of return in the absence of a competitive market). Of course, one could argue that the antitrust laws should take care of such worries. But if competition is generally desirable (even competition that sometimes leads to inferior rates of return), then fiduciary duty should at least not discourage it by imposing a duty to dissolve rather than compete where diversified stockholders might prefer it. On the other hand, the fact that a duty to diversified stockholders does not always go as far as diversified stockholders might like—that is, the fact that it is not perfect—does not necessarily mean that there is a better formulation of the duty.

The essential point of this lengthy note is in a sense beside the point. In the end, it is not really important to know why there are takeover specialists. It is perfectly clear that takeover specialists exist and that they often step in to maximize stockholder wealth when for some reason incumbent management fails to do so.

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Principles of fiduciary duty must presumably take into account the conditions under which such managers manage.[72]

Even if there are managers who are willing to manage in the interests of diversified stockholders, that will only mean that the implicit stockholder-management bargain will be struck somewhere between the duty-to-stockholders model and the duty-to-entity model. How do we decide where in this indeterminate range to locate the duty? The answer seems fairly simple. Only the end points are well-defined. One or the other should presumably be the default rule. As between the two, it seems quite clear that the takeover model of management cannot be applied in the case of companies operating in the normal course. Thus, if we must choose between the two, we should choose the duty-to-firm model.

But must we choose? Stockholders may be better off with two classes of managers, one class specializing in ordinary day-to-day operations and another specializing in restructurings and redeployment of assets. The two classes of managers could follow two different formulations of fiduciary duty. Perhaps we could even work out a way for the two classes of managers to compete with each other for control of particular companies. In fact, the system of corporate governance is already arranged that way. Arguably, managers operating in takeover mode are required to maximize stockholder gain, while those operating in day-to-day mode are not. The only real problem is drawing the line between the two modes of management.

MANAGEMENT DUTY AND STOCKHOLDER RIGHTS

It does not necessarily follow (from the proposition that management duty should be seen as derived from the interests of undiversified stockholders) that stockholder rights should be based on the interests of undiversified investors. Just as legal rules about management decision-making should be based on rational management behavior, legal rules about the rights of investors should be based on rational investor behavior. In short, a stockholder's right to recover is not necessarily symmetrical with management duty to serve stockholders.

To allow investors to recover damages or obtain other relief in connection with a risk which the investor has hedged away through diversification is to compensate the investor for a loss that is never suffered. Indeed, stockholders themselves should favor a rule which precludes suit in connec-

72. It is fair to say that one of the central ideas here is that the corporation is, or should be, thought of more as an entity than one might be inclined to do with all the nexus-of-contracts rhetoric that is going around. In other words, the issue here is akin to the debate over whether a partnership is an entity or an aggregate, a controversy that (despite its scholastic ring) has been quite a durable issue in the law of business organizations. *See* Rima Fawal Hartman, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH. & LEE L. REV. 1761, 1774-75 (1993).

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tion with risks that can be diversified away. The reason is the same one that leads investors to prefer to do their own diversifying: it is cheaper to insure against the risk of mismanagement through diversification than it is to insure against such risk through litigation.[73]

How Much Diversification Is Enough?

In order to determine the effect of diversification on stockholder rights, one might want to determine first the extent of investor diversification. The more diversified stockholders may be presumed to be, the narrower their rights should be to pursue actions for mismanagement. Although it is unclear how much diversification is enough, it is also unclear that we need to know. Investors will eliminate company-specific risk until it is either gone or sufficiently small that no further effort is warranted. However much diversification makes ultimate sense, it remains fair to presume that investors have diversified away any risk that can be diversified away. Thus, it seems fair to presume that investors are fully diversified at least for purposes of determining the scope of a stockholder's right to sue for mismanagement.[74]

73. The recent 1995 advertising campaign in connection with securities litigation reform, in which various investors (including the Beardstown Ladies) made statements to the effect that excessive litigation hurts everyone, was based on a perfectly cogent argument. Of course, the advertisements were presumably paid for by the targets of such suits and could, therefore, be dismissed as self-serving. On the other hand, all legislation is self-serving in the sense that no one would propose a bill that did not carry with it some advantage. What would be the point? The trick of course is connecting the proposed reform with some broader public interest. *See generally* Richard A. Booth, *State Takeover Statutes Revisited*, 88 MICH. L. REV. 120 (1989).

In a recent lecture, Professor Grundfest described a gnome that might randomly go about a crowded room picking pockets of small amounts of money and placing the money in other pockets. He suggested that people in the room (potential victims) might keep their money divided up in small quantities in different pockets as a way of protecting themselves from the gnome. That is, more pockets with lesser amounts of money in each one would minimize the loss from any particular theft and maximize the chances of gain from others' losses. Professor Grundfest then posed the question: how much would a person in the room pay for protection against such redistributions? The answer: not much given that the random gains would almost always match the random losses. The point of the story, aside from illustrating how diversification works, is that compensating investors for the entire loss in market value from a "fraud on the market" (as seemed to be called for in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988)) is far in excess of the actual loss suffered. Easterbrook and Fischel have suggested that some bright line amount such as one percent of the market loss resulting from an actionable misstatement or omission ought to be the rule. *See* EASTERBROOK & FISCHEL, *supra* note 1, at 341.

74. *See generally* Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733 (1994). This is not to say that the extent of investor diversification is never relevant as a legal matter. It still may be necessary to determine how much diversification is enough in cases involving financial advisers. That is, where a fiduciary such as an investment adviser or trustee has somehow caused an investor to assume excess risk by failing to diversify sufficiently, the investor ought to be able to recover. In such a case, it will be vital to know

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Assuming complete diversification, where should we draw the line between actionable and non-actionable mismanagement? Although easy answers are naturally suspect, the answer here is in fact quite easy. Management should be subject to liability only if intentional wrongdoing can be shown. Investors can diversify away the risk of merely negligent bad management. Some questionable decisions will turn out well, while others will result in losses. But where management knowingly inflicts a financial loss on the firm (as where a business decision carries no identifiable prospect of gain), diversification is no protection. All such decisions will result in loss no matter how diversified one is. In other words, investors cannot shuck the risk of intentional wrongdoing.[75]

To be sure, the requirement of intentional mismanagement is a more lenient standard, from the point of view of management, than the business judgment rule (which many view as quite lax already). The law, as stated by the courts, seems to be that management may be held liable for negligence or gross negligence, although the American Law Institute's *Principles of Corporate Governance* provide that management may only be held liable when a decision is uninformed or irrational, a standard which seems to come closer to recklessness.[76]

how much diversification is enough. For example, is it good enough for an investor to invest in, say, 10 different stocks, or should all investors be advised to be fully diversified? *See, e.g.*, Erlich v. First Nat'l Bank of Princeton, 505 A.2d 220 (N.J. Super. 1984).

75. It is for similar reasons that insurance companies routinely exclude claims for punitive damages and that such awards are treated as income to the recipient rather than as compensation for tax purposes. *See, e.g.*, Hudak v. Safeco Insurance Co., No. 0101731, 1991 WL 258997 (Conn. Super. Nov. 22, 1991); *but cf.* Sarrio v. McDowell, No. CIV.A. 85-1692, 1987 WL 32336, at *1 (E.D. La. Dec. 23, 1987).

76. For a recent article noting the discrepancy between the standard of care and the standard of liability, see Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993). *See generally* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287 (1994); Larry D. Soderquist, *The Proper Standard for Directors' Negligence Liability*, 66 NOTRE DAME L. REV. 37 (1990).

The difference between reasonable and rational would seem to be something like the difference between the standard for a new trial and judgment notwithstanding the verdict, that is, "against the weight of the evidence" versus "no reasonable basis."

It bears noting that the federal courts have concluded that there must be intent (scienter) in order to make out a case for fraud under the federal securities laws. *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). The rule was codified with respect to forward-looking statements in the PSLRA which added § 27A to the 1933 Act and § 21E to the Exchange Act, both of which require actual knowledge on the part of the speaker that the statement was false or misleading. Although the safe harbor applies only to a limited class of statements, it is likely that the standards set forth there will influence the courts in connection with interpretation of the "bespeaks caution doctrine" and, indeed, all fraud litigation. *See* 15 U.S.C. §§ 77z, 78u-5 (1994 & Supp. I 1995). The PSLRA also amended § 20 of the Exchange Act to allow for aiding and abetting liability in SEC enforcement actions, but again only where it is shown that the defendant acted with actual knowledge. *See id.* § 78t-1. Finally, the PSLRA added § 21D to the Exchange Act requiring that in all private litigation under that act, the plaintiff must allege the required state of mind with particularity, stating facts

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Negligence or Intent

The conflict between the negligence (or recklessness) standard and the intent standard is more apparent than real. Although the courts say that negligence or gross negligence is the rule, they appear to mean that intentional harm must be shown. The handful of cases in which the courts have found a breach of the duty of care (without also at least identifying a duty of loyalty problem or finding that the board failed to inform itself or failed to manage altogether) seem to suggest that the board must *try* to lose money for the corporation before the courts will find liability.[77]

The classic example of a decision that will fail the business judgment rule is a no-win decision, that is, a decision in which there is some prospect of loss but no prospect of gain. The example, however, seems to be the rule. The no-win situation seems to be the *only* situation in which a business decision will be found to be in breach of the duty of care. Yet, undertaking a no-win business strategy seems to be more than mere negligence. The possibility of a financial loss is more than merely foreseeable.

But does undertaking a no-win strategy really rise to the level of intentional infliction of financial harm? The answer depends on one's definition of loss and on what one means by a no-win decision. The standard of care for business judgments must be analyzed in the context of the decisions to which it applies. The essential goal of business is to generate financial return. But not just any return will do. The return must be at least a market rate of return. An investor would not agree to invest for anything less, given that there are always other places to put one's money that will generate a market rate of return. Moreover, the higher the risk inherent in the investment, the greater the return must be. An investor

that give rise to a "strong inference" that the required state of mind was present. *See id.* § 78u-4. Although this provision does not explicitly mention any particular state of mind, it seems clear that Congress must have been referring to case law as it existed in 1995.

Of course federal securities law deals with disclosure and not with substantive duty, and one could therefore argue that the need for scienter in securities fraud may proceed from considerations that somehow differ from those that apply to forward-looking management decisions. The problem is that one would think that the standard for the latter should be more difficult to meet. After all, the decision is the difficult part; saying what it is should be rather easier to get right. In any event, if one considers the issue from the point of view of management, both disclosure and substantive duty are similar in the sense that getting it wrong is a risk that management takes. The fact that the wrongs arise in different contexts can be dealt with by considering the decision-making process that leads to the wrong; that is, by considering the context. *See* EASTERBROOK & FISCHEL, *supra* note 1, at 339-45 (discussing optimal damages in securities cases, risk aversion of management, and the need for a scienter requirement).

The author cannot help but note here that the law (or at least the legal approach to reasoning through precedent) seems somehow able to short-cut the reasoning process by intuiting a rule even before its sense is fully appreciated. Then again, that is an observation that has often been made by scholars of law and economics. *See* POSNER, *supra* note 10, at 20 (discussing implicit economic logic of law of nuisance).

77. *See infra* notes 80-91 and accompanying text.

would never agree to invest in a risky venture for an ordinary rate of return. Although it is difficult to say how much more return must be offered in exchange for additional risk (let alone to measure risk), it seems quite clear that additional risk calls for additional return.

The Duty to Seek an Adequate Return

The distinction here is between a simple return and an economic return. In economic terms, a return of zero is a return equal to the economic rate. A positive return is one that exceeds by some amount the return which is just adequate to compensate the investor for the use of his or her money. In other words, the idea of economic return focuses on opportunity cost. In order for an investment decision to make sense, it must cover the cost of the funds devoted to it. If the investment does not hold out the prospect of at least a market rate of return, then in fact it is a money loser in the sense that the market rate of return (whatever it may be at a given moment) is always available.

If one posits a duty to make an adequate return, then the decision to invest company assets for no prospect of gain may be seen as inflicting intentional loss. Anything less than a market rate of return (or indeed some higher level of return if there is additional risk) may be thought of as entailing a loss in the economic sense.[78]

Thus, although a rule which recognizes a breach of fiduciary duty only in cases of intentional infliction of loss may sound like a radical departure, that is in fact quite close to where the law stands.[79] Indeed, one might even argue that the intent standard is a somewhat more rigorous standard than the business judgment rule as applied in that business decisions which hold out the prospect of simple return (but less than a market rate of return) may fall short of protection under the intent standard even though such decisions may be protected under the business judgment rule.

Case Law

A closer look at those few cases in which management has been found liable for a breach of the duty of care suggests that something like the intent standard as outlined here is at work.

78. Needless to say, if a corporation or its board finds itself in a situation in which a loss is unavoidable, it is perfectly reasonable for it to choose among the least of the evils presented. Just as the notion of economic return calls on the idea of opportunity cost to define what constitutes a gain, an intentional decision to suffer the smallest possible loss where all of the alternative courses of action entail loss may be seen in a sense as a gain.

79. Alternatively, given that the ultimate purpose of business is to generate financial return, a business decision that carries with it no prospect of gain may be seen as lacking in business purpose and thus, as irrational in the sense that the decision is in no way tied to the generic business purpose of generating return. *See* PRINCIPLES, *supra* note 1, § 1.42 (defining "waste of corporate assets").

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In *Litwin v. Allen*,[80] for example, the board of a bank was found liable for having agreed to purchase certain bonds at face value subject to an option allowing the seller to buy them back for a period of six months at the same price paid by the bank. At the time of the original sale, the bonds were trading at slightly more than face value, which meant the bank would receive slightly more than a market rate of interest (as determined on the date of the sale) during the period it held the bonds. They were, however, falling in price even as the negotiations proceeded. After the sale, the value of the bonds dropped by about twenty percent during the six-month option period, and the seller ultimately declined to exercise the option to repurchase, leaving the bank with a significant loss when it finally sold the bonds. The court described the deal as, in effect, a no-win proposition.[81] The truth is, however, that the purchase of the bonds was not a sure loser. The bank stood to receive interest at roughly the market rate, although by agreeing to hold the bonds for six months and to sell them back to the seller, the bank assumed the risk of a drop in price and forwent any potential appreciation. In short, the board agreed to a roughly ordinary return, even though it assumed a higher than ordinary degree of risk.

In *Joy v. North*,[82] another case involving a bank, the board (which was dominated by the Chief Executive Officer (CEO)) acquiesced in a series of loans to a real estate developer that ultimately exceeded in total amount the legal limit the bank could lend to any one borrower. Although it became apparent, well before the limit was reached, that the borrower was in trouble, the bank continued to lend additional funds. In the end, the bank took possession of the property on which the loans were made, including assuming an additional mortgage obligation, and then charged off almost $2.7 million as a bad debt. The plaintiff commenced a derivative suit and the board formed a special litigation committee which recommended that the suit be dismissed on the grounds that there was little chance that the directors would be held liable under the business judgment rule. The Second Circuit, reviewing the decision to seek dismissal rather than the decisions to make the loans, disagreed. As the court saw it, the bank had undertaken excessive risk for the prospect of merely an ordinary return.[83] Thus, the court found that it was quite likely that the board would be held liable.[84]

Interestingly, although the decision in *Joy* was that the derivative suit should not be dismissed because it was likely to succeed, Judge Winter's opinion is noteworthy because it sets forth a series of cogent justifications for the business judgment rule that are nonetheless overcome in the context

80. 25 N.Y.S.2d 667 (App. Div. 1940).
81. *Id.* at 699; *see* Joy v. North, 692 F.2d 88, 896 (2d Cir. 1982).
82. 692 F.2d 880 (2d Cir. 1982).
83. *Id.* at 896.
84. *Id.*

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of the case before the court. As Judge Winter explains, the business judgment rule is a recognition: (i) that investors voluntarily assume the risk of mismanagement; (ii) that after-the-fact litigation is a poor way to review forward-looking decisions made under uncertainty; and (iii) that diversified stockholders may prefer risky investments if they carry the prospect of greater return than safer investments.[85] Nevertheless, as Judge Winter points out, a no-win decision is not protected by the business judgment rule.[86] Indeed, the decision in *Joy* falls short of the standard of care, even though it may well have generated a positive (simple) return for the bank.[87]

In addition to the foregoing cases, decisions requiring the payment of dividends where there is no business purpose for retaining the funds may be seen as another expression of the same idea. In *Dodge v. Ford Motor Co.*,[88] for example, the plaintiff stockholders sought damages from the board in connection with the decision to reduce dramatically the price of Ford automobiles, and sought to have the court compel the payment of dividends. Although there was evidence that the decision to use available funds to build new facilities which would allow the company to charge lower prices was motivated by Henry Ford's desire to do good rather than to make money for his stockholders, the court declined to second-guess the decision to invest much of the company's available funds in the expansion plans.[89] As to $19 million in surplus funds for which the company admitted it had no needs or plans, however, the court ordered that the funds be distributed to the stockholders as a special dividend.[90] Thus, although the case is a classic example of the business judgment rule and the court's reluctance to second-guess investment decisions, the court also invaded one of the areas which is said to be among the most protected: namely, decisions to pay or not to pay dividends. The rationale, simply stated, was that the company could retain funds only to the extent that the board had a business purpose in doing so—that is, only so long as the company put the funds to work generating investment return for the stockholders. Thus, the case is also a classic statement of the essential corporate contract.[91]

85. *Id.* at 886.

86. *Id.*

87. It is sometimes said that the standard of care for managers of banks and financial institutions is higher than that for other sorts of businesses. *See* Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981). It may be, however, that the nature of banking is such that a higher level of ordinary caution is the norm. *See* Bates v. Dresser, 251 U.S. 524 (1920). It may also be that business decisions in the context of banking tend to be more quantifiable given that they often involve simple comparisons of interest rates, as in *Litwin* and *Joy*.

88. 170 N.W. 668 (Mich. 1919).

89. *Id.* at 682-85.

90. *Id.* at 681-82.

91. Cases involving failure to manage may also be seen as expressing the essential contract that management undertakes at least to try to make an adequate return for the stockholders while seeking to avoid any avoidable risk of loss. *See, e.g.*, Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

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Depending on one's definition of return, both *Litwin* and *Joy* can be seen as cases involving a duty to avoid losses. Yet, as *Joy* itself points out, diversified stockholders prefer that the companies in which they invest pursue the highest risk-adjusted gain irrespective of the possibility of loss. To be sure, many cases in which the courts have found a duty to avoid loss (such as the failure-to-manage cases) have involved unnecessary losses—that is, losses which could have been prevented through vigilance and were not the result of calculated risks undertaken in seeking higher profits. Nevertheless, failure-to-avoid-loss cases are quite common, whereas failure-to-seek-gain cases are quite rare.[92]

Negligence and Subtle Conflicts

Even though after-the-fact litigation is a poor way to review business decision-making, the no-win rule seems somehow too narrow. Is there no situation in which a merely negligent decision should give rise to liability? Probably not. Negligence is an odd standard to apply in the context of business decision-making (or indeed any forward-looking decision-making). The essence of negligence is foreseeability. Yet in the context of a business decision there is no negligence if management foresees a risk

92. One could view the failure to manage cases as examples of cases in which liability is imposed for failure to maximize gains, but it is clear in most of such cases that any active management would have sufficed even if it had been designed just to break even. Thus, any judicial statement to the effect that management should seek to maximize stockholder wealth in such cases must be taken as dictum. *But cf.* Bartle v. Home Owners Cooperative, 127 N.E.2d 832 (N.Y. 1955) (determining that failure to seek profits was not sufficient to pierce the corporate veil). On the other hand, where there is a corporate gain that is simply there for the taking and involves little or no chance of loss or failure, one might say that there is a duty to maximize gain. *Joy* is an example of such a case in connection with the decision to maintain a derivative suit. *See also* Miller v. American Telephone & Telegraph Co., 507 F.2d 759 (3d Cir. 1974) (suing to require collection of debt); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (same, but duty of loyalty implicated). One could also view such cases, however, as examples of corporate waste—that is, giving away a corporate asset (the claim) for nothing. Thus, once again it is difficult to distinguish between losses and gains.

In *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), a securities "fraud on the market" case, the Court considered the defense that the merger target issued a false statement about the status of merger negotiations because of a desire to assure the success of the deal and thus, to maximize stockholder gains. Although expressing doubt as to whether keeping negotiations secret would in fact tend to maximize gains to target stockholders, the Court rejected any such defense in the context of a case involving affirmative lying to the market. There is, after all, no affirmative requirement under the federal securities laws that information about pending merger negotiations be disclosed in the absence of some coincidental transaction or filing calling for such information.

Legal scholars have since debated the question whether a company should be free to reserve the right to lie to the market if there is a good business reason for doing so, and have generally concluded that any such reservation would be equivalent at best to a right to remain silent which already exists. *See* Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945 (1991).

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and takes it anyway because of the prospect of gain. To be sure, management may be negligent in informing itself about the risks and rewards of a given move, but the negligence standard can have no application to the move itself. With regard to the decision itself, the standard must be one that limits liability to situations in which management undertakes a course of business knowing that the gains do not justify the risks.

On the other hand, the avowed negligence standard may be seen more as a denial of the need to show intent rather than as a positive expression of the need to show foreseeability. Why, after all, would a businessperson ever enter into a no-win deal? When it comes to accidents, it is easy enough to see why people fail to exercise reasonable care. Simply put, being careful sometimes seems like too much trouble. But business people are unlikely to undertake money-losing ventures out of laziness. It is always easier, and usually safer, to do nothing.

Why would management ever inflict an intentional loss on the firm? Although one cannot rule out simple meanness (such as a scorched earth response to a hostile takeover attempt), in many cases intentional infliction of loss may signal that some unidentified conflict of interest is lurking about. In other words, intentional infliction of loss may be a surrogate for a duty of loyalty analysis in cases in which the conflict of interest cannot be found but must be presumed to have motivated the questionable business decision.[93] The logic is rather like that of looking for a new planet based on unexplained perturbations in the movements of a known planet.

The Plight of the Undiversified

The foregoing discussion has assumed that stockholders are in fact diversified because a rational stockholder will always diversify if it is possible to do so. But what about stockholders who are in fact undiversified? There may be situations in which undiversified stockholders should have a cause of action for mismanagement but in which diversified stockholders should be precluded from suing because they are protected by their own diversification.

No doubt there are many stockholders who are in fact undiversified or under-diversified. But to the extent that such investors have failed to take steps to avoid risks which they can easily and cheaply avoid, it is difficult to see why they should be compensated. In a very real sense, they may be seen as contributorily negligent or as having voluntarily assumed the risk of mismanagement or as having failed to exercise due diligence or reasonable care in protecting their own interests.

Moreover, if such investors are afforded a remedy, the same remedy will presumably be available to investors who have in fact protected themselves.

93. For an analysis of *Litwin* that proceeds along similar lines, see ROBERT C. CLARK, CORPORATE LAW 127-28 (1986); *see also supra* note 16.

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As to such investors, any remedy would constitute a double recovery. Unless some reliable way of distinguishing diversified from undiversified (or under-diversified) investors can be fashioned, a rule which allows recovery for mere negligence will shift the costs of mistakes in situations in which they should not be shifted. Moreover, any such effort to classify investors will presumably be quite costly to administer and will thus foist deadweight losses on the capital markets.[94]

94. One alternative would seem to be some sort of variable concept of fiduciary duty that requires management under certain circumstances to maximize stockholder value, but under other (normal) circumstances merely to "satisfy" stockholders (to use the word coined by Herbert Simon for doing just well enough). Although such a scheme might seem unwieldy, it is in fact close to what has evolved in connection with takeover and sale of control cases.

The argument here for the duty-to-firm standard is in essence just another application of the famous Coase Theorem. *See generally* R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). More precisely, the argument is a corollary of the theorem. The theorem is that in the absence of transaction costs, the placement of property rights makes no difference as to the ultimate use of the property. Those who have the right to use (or prevent the use of) a property and those who have a more productive use for it will bargain with each other until the property ends up in its most productive use. The corollary is that where transaction costs do in fact impede the ability of parties to shift valuable rights, their initial placement is important. As one scholar has argued quite convincingly, employees and employers would usually bargain with each other (if they could) for the employer to bear the costs of statistically predictable accidents, in part because the employer can spread the cost over many employees through reduced wages. Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 563-65 (1988); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1234-36 (1984). In other words, the employer will assume the risk of accidents because he or she is diversified and can pass the cost on in the form of lower wages. Thus, the employer is indifferent to the deal, but the employees gain significantly through reduced risk.

A similar dynamic would presumably exist in any negotiation between stockholders and managers over a manager's duty to maximize profits. On the other hand, in the case of vicarious liability, it is the diversified employer who has all the bargaining power and who can take or leave the deal. Thus, employees may tend to give up more in aggregate wages than accidents really cost. A bargaining situation in the context of management duty is different. Stockholders will diversify irrespective of liability rules. Thus, it might be argued that they would insist on something more or that management would offer to pay somehow for a rule of reduced liability.

Moreover, in the case of vicarious liability, employers recognize that employees may be less careful if they are no longer liable and the rate of accidents may rise. Thus, employers will retain the ability to punish employees for recklessness or reward them for taking care. Interestingly enough, Professor Sykes argues that financial rewards for avoiding accidents will usually be more effective than financial penalties for causing them because employees tend to have relatively little wealth, and financial disincentives tend to create excess deterrence (or no deterrence at all if the penalty exceeds an employee's ability to pay). Of course, the employer always retains the ultimate power of firing the employee.

A similar pattern is reflected in management incentives and disincentives. Stock options reward management for doing a good job but do little to punish for doing a bad job other than frustrating the manager's expectations. And, of course, it always remains possible to remove management from office. Thus, it may be that stock options and other forms of contingent compensation constitute both the obvious incentives and the "give-back" that

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Still, the question remains whether there are circumstances in which a rational stockholder may fail to diversify. Obviously, management itself is rationally undiversified, but we need not worry about management unless for some reason managers begin to sue themselves.[95]

Closely Held Corporations

One rather obvious example of a rational but undiversified stockholder is a stockholder in a closely held corporation. By definition, a closely held corporation is one in which there is no active market for the shares.[96] Thus, stockholders in such corporations do not have the option of selling their shares and cashing out. By the same token, stockholders in a closely held corporation will tend to be undiversified. Although it is entirely possible that a stockholder in a closely held corporation may be sufficiently wealthy that he or she also has other significant investments (and indeed it may be common among certain classes of investors such as venture capitalists), clearly we cannot fault those investors who fail to diversify because they have most of their wealth tied up in a closely held business.[97]

one would expect to see in a negotiation between stockholders and management in exchange for relief from the duty of care. *See* EASTERBROOK & FISCHEL, *supra* note 1, at 339-44 (discussing the ability to spread losses as a rationale for fastening losses on a particular party and the problem with management liability in that connection). It may be too that there is no give-back at all given that management controls the negotiation.

As the author has argued elsewhere, limited liability for corporations may ultimately be justified by a similar line of reasoning. That is, limited liability does not in fact protect an entrepreneur because, for example, a potential creditor may insist on a personal guarantee. But limited liability does shift the burden of seeking a guaranty to the potential creditor, who tends to be better able to diversify, thus allowing negotiations to arise in situations in which creditors might otherwise refuse to bargain. *See* Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 NW. U. L. REV. 140, 157 (1994). For a look at whether property rules and liability rules do in fact help bargaining to occur, see Louis Kaplow & Steven Shavell, *Do Liability Rules Facilitate Bargaining? A Reply to Ayres and Talley*, 105 YALE L.J. 221, 224-27 (1995); Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713 (1995).

95. Takeover specialists and the arbitragers that service them may also be seen as rationally undiversified, but inasmuch as they may be viewed as potential substitute managers, it is difficult to see why their interests should be considered in formulating the contours of fiduciary duty any more than should the interests of management generally as an undiversified stockholder. Such classes of investors are either responsible for the decisions they make or are perfectly capable of taking care of themselves. Indeed, in a sense, they are paid to forgo diversification and should not be compensated separately for the losses that they may incur as a result of doing so.

96. *See* Galler v. Galler, 203 N.E.2d 577, 583 (Ill. 1965); Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505, 515 (Mass. 1975); *see also* MODEL STAT. CLOSE CORP. SUPP. §§ 11-17 (1984) (imposing share transfer prohibitions and various buy-sell obligations on corporations electing statutory close corporation status).

97. *See* Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 181 (1985). It could be argued that if there is a significant discount for liquidity in the stock market, then all stockholders need the right to sue to be made whole. But in most cases, stockholders will also get the benefit of any such discount when they buy.

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The law has, of course, responded to the special needs of closely held corporations, primarily by positing a duty among stockholders not to use their powers of control to compromise the interests of other stockholders.[98] Moreover, the courts have recognized a broad range of protectable interests among stockholders in closely held corporations. For example, the courts have recognized that stockholders in a closely held corporation may have an interest in participating in management, including sitting on the board of directors, serving as an officer, and having a job.[99] In addition, many states have enacted statutes allowing the courts to take extraordinary steps to assure the survival of a closely held corporation that falls into a management deadlock.[100]

Recall that the central argument being made here is that even diversified stockholders will prefer, or at least agree, that management should manage with a view to the interests of an undiversified stockholder. Thus, where the ideas of duty-to-stockholder and duty-to-firm diverge, the latter should prevail. If fiduciary duty is construed as duty-to-firm rather than as duty-to-stockholders (as I have argued here it should be), then that duty will serve the interests of stockholders in closely held corporations. The problem of divergence between management and stockholder interests arises because of public trading and the diversification which it makes possible. It is thus only natural that the problem disappears in the context of a corporation whose shares are not actively traded. There is, in short, no need for a special business judgment rule for closely held corporations, and indeed none has developed. Rather, rules such as those that seek to pre-

98. *See, e.g., Donahue*, 328 N.E.2d at 515-16; *see also* Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 801 (Mass. 1981) (explaining that a minority stockholder in a closely held corporation has a duty not to use veto power to the detriment of the firm).

99. *See, e.g.*, Wilkes v. Springside Nursing Home, Inc. 353 N.E.2d 657 (Mass. 1976).

100. *See* MODEL STAT. CLOSE CORP. SUPP. §§ 40-43 (1984). Although some courts, such as the *Donahue* court, cite the expectations of majority stockholders as to participation in management as a factor to be considered in determining whether a given corporation is in fact a closely held corporation, majority stockholders in a public corporation have an expectation of participation. Moreover, stockholders in a close corporation may use their power to remove other stockholders from management positions when there is a valid business purpose for doing so, although management dissension may not be used as an excuse for advantage-taking by the majority or indeed by a minority with veto power. *See Wilkes*, 353 N.E.2d at 662. Thus, expectation of participation in management seems far less important than lack of a public market in imposing heightened scrutiny in the context of closely held corporations. *See* PRINCIPLES, *supra* note 1, § 1.06 (defining "closely held corporation" with reference only to small number of shareholders and no active trading market).

The idea that fiduciary duty should be interpreted differently depending on the status of the corporation is not exclusive to the close corporation. *See* Richard A. Booth, *Federalism and the Market for Corporate Control*, 69 WASH. U.L.Q. 411, 436 (1991) (discussing the possibility of listing categories for companies at various stages of growth); Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987) (discussing possible justification for takeover defenses among growth companies but not mature companies).

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serve the corporate existence through extraordinary remedies have evolved. It is no mere coincidence that such remedies have not evolved in the realm of public corporations, where diversified stockholders may in fact prefer that some companies simply go out of business.[101]

Target Stockholders

In addition to closely held corporations, there are situations in which it is rational for diversified stockholders to behave as if they are undiversified and in which they may legitimately complain about negligent mismanagement. Consider a stockholder's decision-making process when faced with the option to sell in response to a tender offer. A rational stockholder will ordinarily be a passive price-taker. But if the stockholder is offered a premium in exchange for the sale of one of his or her stocks, it is unclear that the logic of diversification applies. The stockholder is, in effect, engaged in a negotiation with a potential buyer who is not diversified but who is interested in acquiring control of the target company. Should the target stockholder simply take whatever price is offered, provided it exceeds the (former) market price? Or should the target stockholder consider why the bidder wants this particular company and what the bidder might be willing to pay? Arguably, a strategy of selling for any offer over the market price may lead the stockholder to sell low on the average. Thus, diversification fails to offer protection just as it fails to offer protection from intentional mismanagement. In short, a target stockholder may rationally hold out for the highest possible price and thus base his or her decision to tender on company-specific considerations.

Interestingly enough, the law has responded to some extent to such special situations by imposing the so-called intermediate standard of care. As the Delaware courts have held, when a company is for sale, management has a duty to conduct a free and open auction so as to maximize stockholder gain. That is, the courts will in effect recognize shareholder claims for negligent mismanagement in at least these circumstances, which, as it happens, are also circumstances in which diversification matters little.[102]

101. On the other hand, there is no well-developed duty of care in partnership law, which may well be attributable to the fact that partners are personally liable for the excess obligations of the firm. *Compare* UNIFORM PARTNERSHIP ACT §§ 20-22 (1914) *with* REVISED UNIFORM PARTNERSHIP ACT §§ 403-404 (1994).

102. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114-15 (Del. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179-80 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); *see also* PRINCIPLES, *supra* note 1, § 6.02 (adopting a reasonable response standard but placing burden on the plaintiff to prove unreasonable response). *See generally* GILSON & BLACK, *supra* note 54, at 1023-1156

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It should not be surprising that a duty to maximize stockholder wealth has been found in cases involving such "end-period" transactions. Regrettably, a sports analogy seems to fit here. A basketball player whose team is behind by one or two points with one second left on the clock will rationally shoot from anywhere on the court. A shot that would never be taken in the middle of the game becomes worth the risk at the very end. There is nothing to lose and no reason not to try. Indeed, it would be negligent not to try—although it would be negligent to take the shot in the middle of the game. Similarly, management faced with a situation in which its firm will inevitably be sold may be under a duty to maximize the price at which the sale occurs.[103]

In summary, the duty-to-firm model comports remarkably well with what the courts do. Although many commentators (and indeed courts) have asserted that management has a duty to maximize stockholder wealth, in practice, management has never had such a duty, except in end-period situations in which the company is up for sale. At most the courts have recognized a duty to seek an adequate return or to avoid loss.

(discussing an intermediate standard). *See also* PRINCIPLES, *supra* note 1, Reporter's Note to Introduction of Part VI (suggesting possible applicability of closely held corporation cases in cases involving public corporations in transactions in control and tender offers).

To be sure, the worry that led to the development of the intermediate standard was that management might seek to resist a takeover primarily because of its desire to remain in control. Thus, many earlier cases reviewing defensive tactics approached the issue as a matter of the duty of loyalty. *See id.* at § 6.02 cmt (a).

Consistent with the analysis here, the Delaware courts have at least attempted to limit the application of the intermediate standard of review to cases involving the sale of a company and have sought to avoid its application to transactions involving (for example) mergers designed to effect a strategic combination of companies rather than a sale of one company to another. *See* Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 46-48 (Del. 1993); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150-51 (Del. 1989); Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1932 (1991). Thus, although many commentators expressed shock at the seemingly harsh application of the business judgment rule in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)—a case which involved a friendly sale of the subject company (Trans Union)—the outcome of the case is not out of line with later Delaware cases if it is viewed as a sale of control case. *See* Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 137 (1988).

103. As with all sports analogies, this one too breaks down if it is pushed too far. Management may have an interest in its own reputation extending beyond end-period decisions.

There is a potential inconsistency in requiring management to maximize stockholder wealth in end-period transactions and other constituency statutes that seem to require consideration of stakeholder interests primarily in such circumstances. The inconsistency, however, is largely illusory. As the author argues here, management generally cannot be challenged for considering stakeholder interests in the normal course because such considerations may always be couched in terms of long-term stockholder interests. If stakeholder statutes are interpreted primarily to allow management to resist misappropriation of the wealth of other constituencies, the duty to maximize stockholder wealth but not at the expense of other groups still makes sense. *See* PRINCIPLES, *supra* note 1, § 6.02 cmt. (a).

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A NOTE ON THE CORPORATION AS CONTRACT

The argument here is one that flows from a distinctly contractarian view of the corporation. It is ironic, however, that the idea of fiduciary duty as duty-to-firm rather than duty-to-owner may be seen as ultimately based on the implicit contract between stockholders and management. Scholars of the corporation-as-contract school have typically argued for profit maximization as the governing norm for management.[104] Yet it seems clear that if one follows through with a contractual analysis of fiduciary duty one must take into consideration the interests of management in the bargain.

Although the idea of the corporation as a "nexus of contracts" seems uncontroversial, many scholars of corporation law disagree quite strongly with the idea that a corporation is nothing more. The idea that the corporation is merely an elaborate contract seems to suggest that corporation law is nothing more than a search for the agreement which the parties would have provided for themselves if they had thought about it. But, it is argued, society may have an interest in regulating how the corporate form is used.[105] To put it crudely, the argument seems to be that there is little point in having legal rules if they are merely intended to enforce behaviors that, when regulated, people would freely choose anyway. The idea seems to be that contract is not law, and if contract is enough, law is redundant.

104. *See supra* note 1 and accompanying text.

105. *See* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1404 (1985); Robert C. Clark, *Agency Costs Versus Fiduciary Duties, in* CORPORATIONS: LAW AND POLICY 333-39 (2d ed. 1988). Regarding the rather simplistic point that the law should "do something," see David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 251-61. *See generally* David Millon, *New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993). On the other hand, the argument that the corporation is nothing more than a nexus of contracts may prove too much. It is widely accepted that bondholders have contractual rights. Presumably, the same goes for other stakeholders. It is also widely accepted that stockholders have very few rights that are enforceable as a matter of contract. If the corporation is a contract to which bondholders only owe contractual duties, how does the implicit contractual duty of good faith differ from fiduciary duty? In short, if the contract approach to fiduciary duty is correct, then why do the rights of bondholders differ from those of stockholders? Perhaps there is more freedom to supply terms in connection with discovering fiduciary duty than there is in contract law. Indeed, the conventional wisdom is that the courts have very little freedom to discover unwritten terms in contract disputes, suggesting that the law of fiduciary duty is in fact something quite different from contract law. In any event, it is odd that proponents of the corporation-as-contract view should be so hostile to other constituency statutes; it suggests that the idea of the corporation as contract may be a disingenuous invention designed more to serve a political agenda. *See* Clark D. Stith, *Federalism and Company Law: A "Race to the Bottom" in the European Community*, 79 GEO. L.J. 1581, 1613-15 (1991); *see also* Charles Yablon, *Modern Corporate Theory: Public Utility or Private Part? A Comment on Professor Wolfe's Paper*, 50 WASH. & LEE L. REV. 1705, 1708 (1993) (arguing that labels such as contractarian and communitarian are just a smoke screen).

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Even though such a notion of law may at first seem intuitively correct, and although there are many laws that many people would not obey if they were not the law, such a view of what constitutes law is certainly not the only possible view. An equally valid rationale for a law—indeed, possibly a more valid rationale—is that it seeks to enforce behaviors in which rational actors would voluntarily engage under ordinary circumstances but may occasionally find convenient to ignore. In other cases, it may be that rational actors would behave in one (desirable) way if they could be sure that everyone else would do so too, but in the absence of a rule requiring such behavior would pursue an alternative (undesirable) course of action. In short, some or even much law may be more descriptive than normative.[106]

It can be difficult to tell whether a law or a judicial opinion is one or the other. A good example of such ambiguity is *Smith v. Van Gorkom.*[107] Did the court set down a new normative standard for boards considering the sale of their companies, or did the court find that this particular board had failed to do what other reasonable boards were thought to be doing at the time? Is the decision a normative effort to raise the standards of directorial deliberations, or is it a descriptive decision in which the court concluded that the board in question had fallen down on the job? The answer is far from clear, and not that important except insofar as it shows that there is a place for descriptive law.

Moreover, even if much law is descriptive, that does not mean that there is no need for legal norms. In fact, there are numerous situations in which an off-the-rack rule can come in handy. Casebooks are full of examples in which the parties have failed to agree or have failed to record their agreement, whether through neglect, or design, or because the issue is one of first impression. Thus, the worry is not about the cases in which the parties have negotiated a standard, but rather about the many cases in which they have not.[108]

106. The author is reminded of a statement by Myers McDougal that one knows that international law exists because countries follow it. *See generally* Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1397 (1992); Ian Ayres, *The Possibility of Inefficient Corporate Contracts*, 60 U. CIN. L. REV. 387, 389 (1991). For an argument that even filling gaps is more than necessary, see William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898 (1993). For arguments that market failure may be quite common and that there is a significant role for normative law, see William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180 (1992); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

107. 488 A.2d 858 (Del. 1985).

108. To be sure, many such cases would seem to be examples of end-period opportunism. But so what? That does not mean they have no genuine controversies or require no resolution. Indeed, it is at least conceivable that sometimes shareholders take advantage of management in such circumstances by suing over decisions that might otherwise slide by without opposition. (Of course shareholders—or, more precisely, the lawyers who represent them—are wont to sue over just about anything, but it is entirely possible that the courts are more inclined to entertain such suits more seriously in end-period situations.)

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This is not to suggest that legal reasoning should be supplanted by empiricism. In other words, it is not enough to determine, for example, that greenmail reduces stockholder wealth on the average, to justify an out-and-out prohibition of the practice. An average, after all, is only that. It may reflect several transactions in which stockholders enjoy a gain, as well as some in which they suffer a loss.[109] Thus, it is one of the more important purposes of the legal process to determine which cases are which, and along the way to parse the factors to be considered in future cases.

In the end, then, fiduciary duty may be no duty at all, but rather a process. Indeed, a number of scholars have argued that fiduciary duty is an open-ended settling-up process.[110] In a sense, it is an agreement to

109. *See* Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 514 (7th Cir. 1989) (discussing the nature of averages). Many defensive tactics designed to ward off hostile takeovers as well as state statutes designed to make hostile takeovers more difficult, have been shown to result on the average in a decrease in stockholder wealth. Yet an average decrease may include many instances in which the tactic was wealth-increasing. Thus, even the tactic that many see as the most heinous—greenmail—may sometimes be beneficial. *See* Macey & McChesney, *supra* note 71, at 15. Similarly, as the author has noted elsewhere, although the United Kingdom (for example) requires any bidder acquiring 30% or more of a target company stock offer to buy out the remaining stockholders (presumably because it is recognized that the purchase of a bare controlling interest may sometimes or often be motivated by a plan to loot the acquired company), the law in the United States has allowed for such transactions (presumably because sometimes they are nothing more than they appear to be, that is, just another, often cheaper, alternative way for control to be sold). Thus, in the United States such transactions may be reviewed as a matter of fiduciary duty if there appears to be abuse, but they are not banned altogether by requiring (in effect) that all sales of control involve an opportunity for all the stockholders to participate. *See* PRINCIPLES, *supra* note 1, § 5.02. *See generally* Richard A. Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635 (1988).

110. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 119-21 (1989).

For an alternative view of fiduciary duty, see Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990); Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425 (1993). Professor Mitchell seems to argue that fiduciary duty has been diluted by a recognition that some self-interested transactions by an agent with the principal may be allowed to stand. There can be little doubt that such is the state of the law. *See* PRINCIPLES, *supra* note 1, § 5.02. Indeed, *Principles of Corporate Governance* avoids the use of the phrase "duty of loyalty" in favor of the more neutral-sounding "duty of fair dealing." *See id.* at Part V, Introductory Note (a). Although this author agrees to some extent with Professor Mitchell in that the standard of care ought to be interpreted as a duty to the firm, the author parts company with him by suggesting that management is likely to be the constituency whose interests are most nearly congruent with those of the firm. Moreover, as the author has argued elsewhere, many interested transactions (such as cash-out mergers) may be beneficial to both sides, and many other transactions involve the appropriation of a benefit that either cannot be shared with or does no harm to the interests of the principal. *See, e.g.*, Richard A. Booth, *The Business Purpose Doctrine and the Limits of Equal Treatment in Corporation Law*, 38 SW. L.J. 853 (1984); Richard A. Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630, 639-40 (1985); *see also* PRINCIPLES, *supra* note 1, § 6.02 (explaining that management may consider interests of

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leave certain terms of a bargain ill-defined, perhaps because it is not worth it to predict all the controversies that may arise, or perhaps because some predictable controversies are so divisive that they would scuttle worthwhile deals from the inception. Oddly enough, fiduciary duty is rather similar to an agreement to arbitrate. Despite traditional hostility to arbitration of corporate governance disputes,[111] however, such arbitration would be remarkably similar to the process of litigating fiduciary disputes. In both cases, the rules are largely made up as one goes along. Although arbitrators may not manifestly ignore the law, they have no particular duty to apply it accurately[112] (which may be why the process is called arbitration). Indeed, in arbitration it seems that one can often recover for mere unfairness. In a sense, then, the arbitration process seems to create additional rights. In the case of fiduciary duty the courts engage, in effect, in a search for the terms of the contract which the parties would have agreed to if they had addressed the issue in question. Clearly, the court in a fiduciary duty case is not called on to find the actual agreement between the parties. There is no such agreement except an agreement to abide by what the court says it is. In any event, it is unclear how stockholders and managers can be ill-served by a process that seeks to determine what the agreement would have been if it had been negotiated. Thus, it is important to attempt to define the interests of stockholders.

CONCLUSION

Although most legal scholars seem to agree that the duty of corporation management is to maximize the wealth of stockholders, such a standard of management duty is ambiguous because it fails to consider whether the model stockholder is diversified or undiversified. The answer makes a difference. A diversified stockholder is risk-neutral and will not care if maximizing return may involve even the risk of bankruptcy. An undiversified stockholder, on the other hand, is risk-averse and will prefer that management maximize return while minimizing risk. Although rational investors diversify to avoid company-specific risk, it is impractical to measure fiduciary duty by reference to diversified stockholders. Indeed, even diversified stockholders will prefer that management behave as if it owed its duty to undiversified stockholders. In practice, this means that management duty should be seen as owed to the corporation but not necessarily to the stock-

constituencies other than shareholders if to do so would not significantly disfavor the long-term interests of shareholders). Thus, fiduciary duty may be most accurately seen as a way by which the principal may double check to be sure that the terms have been fair. In the absence of an identifiable conflict of interest, few if any cases should run afoul of the doctrine. For a similar view of fiduciary duty, see Cooter & Freedman, *supra* note 16.

111. *See e.g.*, *In re* Vogel, 268 N.Y.S.2d 237 (1966); Ringling Bros.-Barnum & Bailey Combined Shows Inc. v. Ringling, 53 A.2d 441 (Del. 1947).

112. *See* UNIF. ARB. ACT § 12, 7 U.L.A. 280 (1955).

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holders. Ironically, the one constituency that identifies most with the fortunes of the corporation as a corporation is management. Although a diversified stockholder can afford to win some and lose some, management cannot. It is management that stands to lose the most, both financially and reputationally, if the corporation fails. Thus, management interests are more consistent with those of so-called other-constituencies than might be thought, and management is not likely to pursue high-risk strategies even in the absence of other-constituency statutes that allow for the consideration of interests other than those of stockholders. Such statutes are therefore either redundant or merely confirmatory of the status quo. Moreover, because management will ordinarily pursue its own self interest, at least in the absence of conflict, management should never be held liable for negligent mismanagement except in the case of end-period transactions.

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