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# THE EFFICIENT NORM FOR CORPORATE LAW: A NEOTRADITIONAL INTERPRETATION OF FIDUCIARY DUTY

Thomas A. Smith\*

To economically oriented corporate law professors, distinguishing between directors' fiduciary duty to shareholders and a duty to the corporation<sup>1</sup> itself smacks of reification<sup>2</sup> — treating the fictional corporate entity as if it were a real thing. Now the orthodox view among corporate law scholars is that the corporate fiduciary duty is a norm that requires firm managers to “maximize shareholder value.”<sup>3</sup> Giving the corporation itself any serious role in the analysis of fiduciary duty, the thinking goes, obscures scientific insight with bad legal metaphysics.

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1. “[A] distinction,” Lawrence Mitchell notes, “that has been slighted in the law.” Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEXAS L. REV. 579, 586 (1992); see also Donald E. Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511, 512 (1984).

2. The Oxford English Dictionary defines reification as “the mental conversion of a person or abstract concept into a thing.” 13 THE COMPACT EDITION OF THE OXFORD ENGLISH DICTIONARY 532 (2d ed. 1989).

3. See, e.g., ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 97 (1995) (Corporate law scholars “generally agree[ ] that management’s principal fiduciary duty is to maximize the return to the common shareholders . . . .”); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993); A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Kenneth B. Davis, Jr., *Discretion of Corporate Management to Do Good at the Expense of Shareholder Gain — A Survey of, and Commentary on, the U.S. Corporate Law*, 13 CAN.-U.S. L.J. 7, 8 (1988) (“[M]aximization of shareholder value is the polestar of managerial decisionmaking.”); A.A. Sommer, Jr., *Whom Should the Corporation Serve?: The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33 (1991). For a good summary of the shareholder primacy norm in legal scholarship, see D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277-83 (1998).

Some recent scholarship<sup>4</sup> and legislation, such as constituency statutes,<sup>5</sup> have challenged this "shareholder primacy"<sup>6</sup> view. Contestants on both sides of the debate over corporate fiduciary duty assume, however, that economic analysis inevitably favors shareholder primacy.<sup>7</sup> Critics of shareholder value maximization encourage this assumption by making their case turn, in part, on criticisms of economic methodology itself<sup>8</sup> and on invocations of moral and political values

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4. See, e.g., PROGRESSIVE CORPORATE LAW (Lawrence G. Mitchell ed., 1995); Margaret M. Blair, *Stakeholders as Shareholders, Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*, 109 HARV. L. REV. 1150 (1996); William W. Bratton, Jr., *Public Values and Corporate Fiduciary Law*, 44 RUTGERS L. REV. 675 (1992); Wai Shun Wilson Leung, *The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-Shareholder Interests*, 30 COLUM. J.L. & SOC. PROBS. 587 (1997); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993); David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991) [hereinafter Millon, *Redefining Corporate Law*]; Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263 (1992) [hereinafter Mitchell, *A Critical Look*]; Mitchell, *supra* note 1.

5. See, e.g., FLA. STAT. ch. 607.0830(3) (1997); GA. CODE ANN. § 14-2-202(b)(5) (1994); HAW. REV. STAT. § 415-35(b) (1993 Replacement); ILL. ANN. STAT. ch. 32, para. 8.85 (Smith-Hurd Supp. 1992); ME. REV. STAT. ANN. tit. 13A, § 716 (West 1981); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 1992); MINN. STAT. ANN. 302A.251 (West 1985); MISS. CODE ANN. 79-4-8.30(d) (Supp. 1988); N.J. STAT. ANN. 14A:6-1(2) (West 1969); N.M. STAT. ANN. 53-11-35(D) (Michie Supp. 1993); OHIO REV. CODE ANN. 1701.59(E) (Baldwin 1995); WIS. STAT. ANN. 180.0827 (West 1995). Some apply only when an acquisition proposal is under review. See ARIZ. REV. STAT. ANN. § 10-2702(1996); IDAHO CODE § 30-1602, -1702 (1995); IOWA CODE ANN. 491.101B (West 1991); LA. REV. STAT. ANN. § 12:92 G (West 1994); MO. REV. STAT. § 351.347 (1994). Some place other constituencies in putative equality with shareholders. See IND. CODE ANN. 23-1-35-1(f) (West Supp. 1998); IOWA CODE ANN. § 491.101B (West 1991); 15 PA. CONS. STAT. ANN. § 515 (1995).

For scholarly reaction to constituency statutes, see Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971 (1992); William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385 (1990); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992); Patrick J. Ryan, *Calculating the "Stakes" for Corporate Stakeholders as Part of Business Decision-Making*, 44 RUTGERS L. REV. 555 (1992); Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991).

6. See, e.g., Dodge v. Ford Motor Co., 170 N.W. 668, 684 (1919); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEXAS L. REV. 865 (1990); John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313 (1992); Smith, *supra* note 3, at 277. For other statements of duty to shareholders in case law, see *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986); *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Francis v. United Jersey Bank*, 432 A.2d 814, 824 (N.J. 1981).

7. See EASTERBROOK & FISCHER, *supra* note 3, at 68; 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, 26-29 (1991). For an unsympathetic account of the link between shareholder primacy and economic analysis, see Johnson, *supra* note 6, at 884-86. Both proponents and critics, however, believe that shareholder primacy is grounded in an economic view.

8. Lyman Johnson, for example, inveighs as follows:

most economists would find controversial at best.<sup>9</sup>

Nevertheless, the economic approach to corporate law does not foreordain the maximization of shareholder value as the primary norm of corporate law. The economic case for shareholder value maximization is, in fact, initially puzzling and ultimately unconvincing. If economic efficiency is the normative guidepost for substantive law, the principal norm of corporate law cannot be the maximization of shareholder value.

It is easy to see why this must be so. The corporate fiduciary duty, according to the leading economic analysis of corporate law, is a principle that fills gaps in the "corporate contract."<sup>10</sup> The "corporate contract" is the metaphorical contract consisting of the sum of the voluntary arrangements among the various parties who contribute resources to the corporate enterprise and have claims against it.<sup>11</sup> Discovering

[W]hile the notions of accountability and efficiency serve as [the economic] model's apparent lifelines to more widely shared social norms, the dreary egoistic underpinnings make it clear that those notions are only enticing window dressing; they are not essential. The contractual model subscribes to the root norm that, in a pinch, people do — therefore they should — act to save their own skin. If that is one's sense of life, why should the ethos in work and business or corporate law be different? . . . [It] reminds one of B.F. Skinner's work with pigeons.

Johnson, *supra* note 6, at 895-96 (citations omitted).

9. See, e.g., Lynne L. Dallas, *Working Toward a New Paradigm, in* PROGRESSIVE CORPORATE LAW 35, 39-49 (Lawrence G. Mitchell, ed., 1995); David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies, in* PROGRESSIVE CORPORATE LAW 1, 4-10 (Lawrence G. Mitchell, ed., 1995); Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997); Paul N. Cox, *The Public, the Private and the Corporation*, 80 MARQ. L. REV. 391 (1997); Lyman Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215 (1992); Johnson, *supra* note 6; David Millon, *Default Rules, Wealth Distribution, and Corporate Law Reform: Employment at Will Versus Job Security*, 146 U. PA. L. REV. 975 (1998); Millon, *Redefining Corporate Law, supra* note 4; David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201 (1990); Marleen A. O'Connor, Symposium, *Corporate Malaise — Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 3 (1991); 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) [hereinafter O'Connor, *Restructuring*]; Orts, *supra* note 5; Lewis D. Solomon, *Humanistic Economics: A New Model for the Corporate Constituency Debate*, 59 U. CIN. L. REV. 321 (1990).

10. EASTERBROOK & FISCHEL, *supra* note 3, at 90-93.

11. The contractual approach to the firm was developed by economists, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 794 (1972); Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390-92 (1937); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 307-08 (1976); William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1521 (1982); Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1200 (1984); and applied by lawyers, see, e.g., Lucian Arye Bebchuk, *Contractual Freedom in Corporate Law — Foreword: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989) [hereinafter Bebchuk, *Contractual Freedom*]; Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1840-46 (1989) [hereinafter Bebchuk, *Limiting Contractual Freedom*]; Henry N. Butler & Larry E. Ribstein, *State Anti-Takeover*

the correct gap-filling principles for the corporate contract involves hypothetical bargain analysis — asking what contractual terms rational parties would have agreed to had they addressed ex ante the matter that falls into a contractual gap.<sup>12</sup> For corporate contracts, the prevailing view is that this gap-filling principle should be “maximize shareholder value.” According to this view, that is the substance of the corporate fiduciary duty.

One can adopt the contractual approach to corporate law and agree that the fiduciary duty is essentially a principle for filling gaps in corporate contracts. Nevertheless, the next step in the argument for the prevailing view, that the substance of this gap-filling principle should be shareholder value maximization, does not follow. Rational corporate investors in a hypothetical bargain setting would not agree to shareholder value maximization as their gap-filling rule. The main point of this Article is to explain why they would not and to explain what they would choose instead.

Rational corporate investors would not choose shareholder wealth maximization as their gap-filling rule because of what investor rationality entails. In economic analysis of corporate law, it is standard to treat shareholders as rational in the sense described in basic finance theory, in particular, the Capital Assets Pricing Model (“CAPM”). Investors who are rational in the CAPM sense would hypothetically agree to a gap-filling principle, but it would not be “maximize shareholder value.” Under CAPM, rational investors will diversify among all classes of capital assets, including both corporate stocks and bonds. In fact, they will hold the “market portfolio,” that is, a portfolio that is a microcosm of all capital assets, in which each type of capital asset has the same place proportionally in the rational investor’s portfolio as it does in the capital market as a whole. Thus it would be irrational for investors to agree to a principle that required the value of their shares to be maximized if it meant reducing the value of their bonds (or of any other nonresiduary class of capital assets they might hold) by more than the increase in the value of their stock. The shareholder value maximization norm allows, and under plausible assumptions even requires, managers to make inefficient decisions which hypothetical rational investors would not permit ex ante. Rational investors would therefore not agree to it.

To what corporate law norm would rational investors hypothetically agree? They would agree to a norm that told managers to maxi-

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*Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611, 615-17 (1988). For a critical view of contractualism, see William W. Bratton Jr., *The “Nexus of Contracts” Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989).

12. See EASTERBROOK & FISCHER, *supra* note 3, at 90-91; Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982); 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, 25 (1991).

mize the value of the diversified portfolios that CAPM says rational investors would hold. As a gap-filling principle, this would require firm managers to make the choices that would maximize the value of the sum of financial claims against the corporation, because these claims will be held proportionally by rational CAPM investors holding the market portfolio.<sup>13</sup> If a public corporation were financed half by stock and half by bonds, a rational investor holding the market portfolio would have his investment in that corporation divided evenly between its stock and its bonds. He would obviously not agree to a rule that allowed managers to make choices that diminished the value of his bonds by more than they increased the value of his stock. He would insist on a rule that required managers to maximize the value of the sum of the two classes of claims against that corporation. This rule would be the gap filler which rational investors would agree managers should follow if the corporate contract did not provide otherwise. This would be the content of the fiduciary duty rational investors would accept *ex ante*.

Articulating this duty has interesting consequences. A fiduciary duty running to the corporation itself would be most consistent with the gap-filling rule that emerges from hypothetical bargain analysis. This rule would require corporate managers (absent explicit contractual terms to the contrary) to take whatever actions maximized the value of "the corporation" — maximized, that is, the sum of the value of financial claims against the corporation — whether doing so primarily benefited shareholders or some other class of corporate claimants. Far from mysteriously reifying the corporation, this approach requires nothing more conceptually murky than addition. This reformulation of the duty is notably inconsistent, however, with treating one class of corporate claimants, such as common shareholders, as the exclusive and direct beneficiaries of the fiduciary duty, as is now standard in economic analysis of corporate law. It is also inconsistent, however, with making all or several classes of claimants against the corporation direct and simultaneous beneficiaries of the fiduciary duty, as seems to be suggested by some advocates of bondholder rights.<sup>14</sup> The "neotraditional" conception of fiduciary duty I propose, a duty running to the corporation itself, would require actions of man-

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13. A financial claim is a legal claim against a financial asset — a claim that might arise, for example, from ownership. A financial asset is an asset such as a stock, bond, right, certificate, etc., as distinguished from a tangible, physical asset. For example, real property is a physical asset, but shares in a real estate investment trust (REIT) or stock or bonds of a company that held property as an investment would be financial assets. See JOHN DOWNES & JORDAN ELLIOT GOODMAN, *FINANCE AND INVESTMENT HANDBOOK* 311 (4th ed. 1995). Many assets, such as tort claims, are not normally considered financial assets but can be converted into financial assets through a process of "securitization." See, e.g., Thomas A. Smith, *A Capital Markets Approach to Mass Tort Bankruptcy*, 104 *YALE L.J.* 367, 419-32 (1994).

14. For authors suggesting a fiduciary duty to bondholders, see *supra* note 4.

agers that would sometimes benefit one class of claimants and sometimes another, depending on the circumstances. Once one dispenses with misguided fears of reification, there is nothing particularly troubling about this approach.

There is, however, more than a mere theoretical quibble in the difference between a fiduciary duty owed to the shareholders of public corporations to maximize the value of their shares and a duty owed to the corporation to maximize its value. It is true that managers of a "plain vanilla" public corporation, one with a simple capital structure and little debt, might have incentives to maximize the sum of the value of all financial claims against that corporation. When corporate capital structures get more complicated in certain ways, however, the shareholder value maximization version of fiduciary duty will mislead managers. And there is every reason to expect corporate capital structures will become increasingly complex in just those ways, as Professor Hu, one of the leading prophets of financial complexity, has convincingly argued.<sup>15</sup> For example, the "equity" of firms can be (and is being) sliced up into various derivative securities.<sup>16</sup> Stock can be structured as claims on the profits of certain parts of the issuer's business rather than on the whole business of the corporation.<sup>17</sup> Firms can become highly leveraged<sup>18</sup> and can issue hybrid securities.<sup>19</sup> These innovations strain traditional concepts of fiduciary duty. This problem is not as difficult to resolve, however, as Professor Hu seems to think. The neotraditional conception of fiduciary duty I propose responds,

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15. See Henry T.C. Hu, *New Financial Products, The Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEXAS L. REV. 1273 (1991).

16. See *id.* at 1277; see also Bernard J. Karol & Mary B. Lehman, *Equity Derivatives*, 27 REV. OF SEC. & COMM. REG. 121 (1994); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEXAS L. REV. 1319 (1991); Thomas A. Russo, *Regulation of Equity Derivatives*, 815 PLI/CORP 335 (1993); Saul Hansell, *Is the World Ready for Synthetic Equity?*, INSTITUTIONAL INVESTOR, Aug. 1990, at 54; Claire Makin, *Hedging Your Derivatives Doubts*, INSTITUTIONAL INVESTOR, Dec. 1991, at 113.

17. See THE HANDBOOK OF EQUITY DERIVATIVES 3-32 (Jack Clark Francis et al. eds, 1995); Jeffrey Allen, *Reinventing a Corporation: The "Satellite" Structure of Thermo Electron*, 11 J. APP. CORP. FIN., Summer 1998, at 38; Jeffrey Allen & John McConnell, *Equity Carve-outs and Managerial Discretion*, 53 J. FIN. 163 (1998); Hu, *supra* note 15, at 1288-1300; Bernard J. Karol, *An Overview of Derivatives as Risk Management Tools*, 1 STAN. J.L. BUS. & FIN. 195, 203 (1995); Dennis E. Logue et al., *Rearranging Residual Claims: A Case for Targeted Stock*, 25 J. FIN. MGMT. 43 (1996); Roni Michaely & Wayne H. Shaw, *The Choice of Going Public: Spin-offs vs. Carve-outs*, 24 J. FIN. MGMT. 5 (1995); Vikram Nanda, *On the Good News in Equity Carve-outs*, 46 J. FIN. 1717 (1991).

18. See Allen, *supra* note 17.

19. See JOHN F. MARSHALL & VIPUL K. BANSAL, FINANCIAL ENGINEERING: A COMPLETE GUIDE TO FINANCIAL INNOVATION 475-492 (1992); *Issuers Opt For Hybrid Securities*, 2 INS. FIN. & INV. No. 26 (1997); Karol, *supra* note 17, at 203; Kerry Capell, *High Yields, Low Cost, Funny Names*, BUS. WK., Sept. 9, 1996, at 122; R.S. Salomon, Jr., *Profitable Hybrid*, FORBES, Apr. 24, 1995, at 404.

for all its simplicity, remarkably well to these challenges, as I explain below.

This Article begins by describing in Part I the familiar conflict between the interests of shareholders and those of bondholders. I add a new point by stressing, however, that this problem is not limited, as is often supposed, to the “vicinity of insolvency,”<sup>20</sup> to use Chancellor Allen’s phrase.<sup>21</sup> It will, under standard and plausible assumptions of modern finance theory, *never* be efficient for firm managers to “maximize shareholder value,” as long as there are fixed claims such as bonds in the firm’s capital structure. The “vicinity of insolvency,” strictly speaking, is determined only by the riskiness of the investments available to the firm. If financial markets are complete, as modern finance theory usually assumes, available investments will not be limited by their riskiness. The capital market will offer a complete menu, including even extremely risky investments. Some of these risky opportunities will increase the expected value of stock, the residual claims on a firm, but decrease the value of nonresidual claims by even more, thus decreasing the expected value of the sum of financial claims against the firm. Thus the “vicinity of insolvency,” as Chancellor Allen has imagined it, cannot be defined, and therefore the moment at which a firm enters it is indeterminate. In a simple world of firms with stock and debt and complete capital markets, it will be inefficient for managers to maximize shareholder value, because that would mean managers should pick very risky and inefficient bets.

This problem motivates Part II of this Article, which attempts to formulate an efficient version of the corporate fiduciary duty. Economic analysis of corporate law, as I noted above, views the corporation as a nexus of contracts, and the corporate fiduciary duty as a “gap-filling principle.” Economic analysts typically determine gap-filling principles by using hypothetical bargain analysis — asking what gap-filling principle rational parties would have agreed to *ex ante*. In Part II, I use hypothetical bargain analysis to show that rational investors would not choose shareholder value maximization as a norm, but rather would choose maximization of corporate value as a norm. This analysis, as I noted above, involves a conception of investor rationality derived from CAPM.

In the remainder of the Article, I turn to some practical applications. In Part III, I look briefly at some areas of public corporation law that illustrate the indifference of corporate law to merely distributional transactions, a phenomenon that is easiest to explain in light of rational investor indifference to transactions of these kinds. In Part

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20. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. Civ.A.12150, 1991 WL 277613, at \*34 (Del. Ch. Dec. 30, 1991).

21. See Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors*, 46 VAND. L. REV. 1485, 1511-12 & n.87 (1993).



IV, I summarize the issues Hu has raised concerning the stresses financial innovation and the disaggregation of equity is putting on traditional conceptions of fiduciary duty in corporate law. The norm of maximizing corporate value — what I term the “neotraditional” approach — is, I suggest, an intuitively appealing way to relieve this stress. Part V is a brief conclusion.

## I. THE INEFFICIENCY OF THE SHAREHOLDER VALUE MAXIMIZATION NORM

Corporate law scholars generally assume that efficiency arguments inevitably lead to the conclusion that maximizing shareholder value should be the primary norm of corporate law.<sup>22</sup> This conclusion, however, is unwarranted. In fact, the shareholder value maximization norm, if strictly applied, would require firm managers to make socially inefficient choices. This analysis follows from the familiar corporate law problem of the firm in the “vicinity of insolvency.”<sup>23</sup>

### A. *Shareholder Value Maximization Mandates Inefficiency*

In this Part, I use a numerical example to show how a norm to maximize shareholder value mandates inefficiency and then explore some implications.

#### 1. *An Inefficient Risky Investment*

Consider the choice faced by the managers of XYZ corporation. They must choose between only two investment opportunities. Investment 1 is relatively safe; Investment 2, risky. XYZ corporation is solvent. It has assets worth \$20 million and liabilities of \$15 million, all of which is owed to bondholders.

Investment 1 requires an outlay of \$10 million and has a 90 percent probability of being worth \$12 million, and a 10 percent probability of being worth \$8 million, after one period. Thus Investment 1 has an expected value of \$11.6 million, and net of the initial outlay of \$10 million, a value of \$1.6 million. Put another way, shareholders have a 90 percent chance of a \$2 million gain, and a 10 percent chance of a \$2 million loss, for an expected gain to shareholders from Investment 1 of \$1.6 million.

All of the expected gain from Investment 1 would go to the share-

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22. For discussions of maximizing share value as socially efficient, see EASTERBROOK & FISCHER, *supra* note 3, at 38; Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 203-05 (1991); Matheson & Olson, *supra* note 6, at 1329; and Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32.

23. See, e.g., Lin, *supra* note 21.

holders because the claim of bondholders is fixed at \$15 million. Whether Investment 1 pays off at \$12 million or \$8 million, XYZ will have enough value left in it to pay the bondholders all of the \$15 million that is owed to them.

Investment 2, on the other hand, is much more risky. It also requires an outlay of \$10 million, but it has a 10 percent probability of paying off grandly at \$200 million. But it has a 90 percent probability of wiping the company out by generating losses of \$20 million, equal to all of the assets of the company. Investment 2 has an expected value of only \$2 million, and, net of the required initial outlay of \$10 million, a value of negative \$8 million. From the perspective of social wealth, it is obviously a bad investment — it has a negative net expected value.

Shareholders, however, will not view it as so bad. If Investment 2 pays off at \$200 million, shareholders will get all of it. If the bet pays off at negative \$20 million, on the other hand, shareholders will not lose the entire \$20 million, because they enjoy limited liability. Instead, they will lose their equity in XYZ, which is only \$5 million. Thus the expected value of Investment 2 to shareholders is 10 percent of \$200 million plus 90 percent of negative \$5 million, for a total expected gain to shareholders of \$16.5 million. Net of the \$10 million initial outlay, Investment 2 has an expected value to shareholders of \$6.5 million.

Bondholders, of course, would bear the brunt of the risk of Investment 2. If Investment 2 pays off big, they will be no better off than before; they will still be paid only their fixed claim of \$15 million. If Investment 2 fails, however, they will lose their investment, which was worth \$15 million before the risky bet was made.<sup>24</sup> With the former event having a 10 percent chance of happening, and the latter a 90 percent chance, bondholders face an expected loss of \$13.5 million from Investment 2.

Faced with the choice between Investment 1 and Investment 2, corporate managers exclusively loyal to the shareholders should choose Investment 2, even though it has a net expected value of less than Investment 1. That is, managers loyal to shareholders will choose Investment 2, even though it is inefficient. In terms of normative economic theory, this is an absurd result. There must be something wrong with the simple formulation of corporate fiduciary duty as a duty to “maximize shareholder value.”

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24. I am assuming that bond covenants do not prevent the risky, inefficient bet. If bond covenants were complete, then no risky, inefficient bet would be unanticipated. They are not, however. See *infra* text accompanying note 53.

## 2. In the "Vicinity of Insolvency"

Corporate law scholars will recognize that the illustration above is similar to those used to illustrate the "vicinity of insolvency," the region in which managers are said to have incentives to make excessively risky investments.<sup>25</sup> Because of this problem, Delaware corporate law recognizes an exception to the rule that managers owe their fiduciary duty exclusively to shareholders. In the *Credit Lyonnais* case,<sup>26</sup> Chancellor William Allen opined that "in the vicinity of insolvency," the fiduciary duty "shifts" from being owed to shareholders to being owed to creditors.

One could argue that the illustration above is merely an instance of a firm operating in the vicinity of insolvency. It is already well known, one could say, that in this vicinity, managers have incentives to make inefficient choices, and corporate law recognizes an *exception* in this region to the general rule that managers have a duty to maximize share value. For this objection to have any force, however, there must be some region which is *outside* the vicinity of insolvency: it must be the case that, except in unusual settings, the norm of shareholder value maximization *does* yield efficient choices.

In fact, however, this is not the case. Rather, firms are *always* in the vicinity of insolvency because all it takes for any firm, no matter how solvent, to become insolvent is to lose a sufficiently risky bet.<sup>27</sup> One can construct for any firm, no matter how solvent (so long as it has debt and limited liability), a bet sufficiently risky that it would increase the value of its shares, while it decreased the total value of the company — a bet, that is, that would be socially inefficient for the firm to make. For example, take very solvent firm ABC, which has assets of \$100 million and liabilities of \$10 million. By making a highly leveraged bet in, say, the derivatives market, it would have, let us suppose, a one in one hundred chance of gaining \$10 billion, and a 99 percent chance of losing the firm's entire value. This bet would have a present value of \$10.9 million to shareholders, while it would have an

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25. See Rima F. Hartman, Note, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH. & LEE L. REV. 1761, 1766 (1993); Stephen R. McDonnell, Comment, *Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors' Burden From Shareholders to Creditors*, 19 DEL. J. CORP. L. 177, 209-10 (1994).

26. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. Civ.A.12150, 1991 WL 277613, at 1 (Del. Ch. Dec. 30, 1991).

27. Just ask the people at Long-Term Capital Management. See generally Carol J. Loomis, *A House Built On Sand: John Meriwether's Once Mighty Long-Term Capital Has All But Crumbled. So Why Did Warren Buffett Offer to Buy It?*, FORTUNE, Oct. 26, 1998, at 110; Anita Raghavan & Matt Murray, *Financial Firms Lose \$8 Billion So Far — Global Fallout from Russia Hits Big Banks, Others; Meriwether Fund Hurt*, WALL ST. J., Sept. 3, 1998, at A2; Leah Nathans Spiro, *How Long-Term Rocked Stocks, Too*, BUS. WK., Nov. 9, 1998, at 160.

expected value to the corporation of only \$1 million. The price of this lottery-ticket-like bet is, let us suppose, \$10 million. Thus it has a net expected value to the corporation of negative \$9 million — obviously a bad bet for the firm. Yet managers maximizing shareholder value would still choose this investment over any similarly priced bet that had an expected value of less than \$10.9 million for the shareholders, even though other bets would be better for the corporation.

That, however, has to do with the firm being in the vicinity of insolvency only in a trivial sense. It is just that the closer to insolvency a firm is, the less risky a bet has to be for its loss to push the firm into bankruptcy. If managers really *are* duty bound to maximize the value of shares, then they are duty bound to make inefficient choices like the one just illustrated as long as these choices are available, and they will be. The conflict of interest between shareholders and bondholders, therefore, does not merely result in inefficient incentives when the firm is in the vicinity of insolvency. It exists whenever there are inefficient risky bets available that would increase share value but decrease firm value. In theory, and increasingly in reality, this is all the time.

A possible reaction to my argument above would be to dismiss it as invoking excessively unlikely events. This reaction, however, would be inappropriate. It may seem that opportunities to bet the company on a long shot are rare and therefore that my argument does not raise a serious problem with the shareholder value maximization norm. This and other practically minded objections to my argument are likely based on misunderstandings of how a corporate law norm should function, as I discuss below.

### 3. *Complete Capital Markets*

It may seem that managers rarely make bets like those illustrated above, unless their company is about to fail. If these occurrences are very rare, the problems they create for fiduciary duty theory, one might argue, are of academic interest only. This objection, however, misses the point. These occurrences may be rare, but not because managers lack opportunities to make long-shot bets. Indeed, modern finance theory typically assumes (with increasing realism) the near completeness of capital markets.<sup>28</sup> In complete capital markets, it is possible to bet on nearly any possible future world state, including low probability ones. Managers can, in theory, bet the company on very risky opportunities, and there is no reason to suppose that these opportunities are rare. There are an infinite number of possible investments that, while inefficient, would increase the value of a given com-

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28. See JOHN C. COX & MARK RUBENSTEIN, *OPTIONS MARKETS* 436-45 (1985); FRANK J. FABOZZI & FRANCO MODIGLIANI, *CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS* 645-50 (1992).

pany's stock. The claim that share-value-increasing but inefficient bets are not available would fly in the face of capital-market completeness, a fundamental assumption of modern finance theory.<sup>29</sup>

The abundance of these opportunities for the firm becomes more obvious if one considers that bets that must be expected to lose money for the firm as a whole cannot be scarce as long as there are people willing to take the firm's money. Any risk neutral party should be willing to be the counter-party of a bet that has a negative expected value for the firm but a positive expected value for the other party. If firms were willing to pay an unfair price for bets, so long as they were risky enough, and so long as they increased share value, there could be no shortage of parties willing to relieve firms of their money. This sort of bet would amount to a collusion between equity holders and third parties to impose costs on the fixed claimants of the firm and split the benefits among themselves. This sort of behavior is hardly universal among managers, but not for lack of opportunity — and not because it would be disloyal to shareholders.

The assumption of complete capital markets is increasingly realistic. The emergence of financial derivative markets means practically unlimited opportunities exist for firms to bet, where they are so inclined, on possible but low probability future states of the world. Derivative debacles prove that it is entirely possible for large firms to be wiped out, as Barings Bank was, by huge derivative losses.<sup>30</sup> Yet in the unlikely event Mr. Leeson's rogue bets on behalf of Baring's had paid off, its shareholders might have profited handsomely.

### B. Agency Costs

If managers of solvent corporations do not lack the opportunity to make inefficient bets that would increase shareholder value, then why do managers rarely bet the company on long shots? It is not because they are loyally serving the interests of the diversified shareholders who figure so prominently in the conventional economic analysis of corporations. Managers loyal to shareholders would make such bets. In practice, managers apparently make these bets only when firm insolvency looms.<sup>31</sup> When the firm is on the brink of bankruptcy, man-

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29. See Michael J. Brennan, *Corporate Finance over the Past 25 Years*, FIN. MGMT. Summer 1995, at 9.

30. See Nicholas Denton, *The Barings Crisis: Disaster, Just When Most Things Were Going Right*, FIN. TIMES, Feb. 27, 1995, at 3; Peter Martin & F.T. Writers, *The Barings Collapse: Blunders that Bust the Bank*, FIN. TIMES, Mar. 24, 1995, at 24; Richard W. Stevenson, *Barings Fiasco: Unbridled Ambition*, L.A. DAILY NEWS, Mar. 5, 1995, at B1.

31. See Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993); Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991).

agers' interests are aligned *too* well with those of shareholders.<sup>32</sup> Managers want to avoid the stigma of bankruptcy and the loss of their firm-specific human capital.<sup>33</sup> For managers, there is little solace in managing their firm only slightly into bankruptcy. To avoid it, they will take desperate chances. When the firm is comfortably solvent, the conventional wisdom is that managers will be more risk averse than relatively risk neutral shareholders would prefer. Unlike diversified shareholders, managers typically have specialized much of their personal wealth in one firm. Also unlike shareholders, managers typically do not participate fully in the upside potential of the firm. Diversified shareholders, it is often observed, would prefer managers to make all investments with a positive net discounted present value to shareholders, even if they are very risky. Managers, however, will not do this, being far more exposed than the shareholders to firm-specific risk. In fact, if investors owned only the common stock of the firm, they would prefer that managers undertake even riskier projects that had negative discounted present values, so long as the expected result would increase the value of their stock.

The divergence of the attitudes toward risk of shareholders and managers gives rise to agency costs in the conventional view of corporations. Manager agents will not take risks shareholder principals would prefer they take. This standard view goes wrong, however, by implicitly overvaluing the interests of shareholders. This over-weighting stems from the assumption that managers should be analyzed as agents of diversified shareholders. But why should this be so? Shareholders are a legal category, not a natural category of economics. By analyzing firms in terms of the "shareholders," it is the conventionalists who are indulging in reification.<sup>34</sup> Legal scholars have adjusted their thinking to the imperative of diversification that comes from modern finance theory, but only as far as they may without leaving the legal category of the "shareholders" behind. The result is a hybrid that does not quite make economic sense.

Legal scholars have not fully appreciated the extent to which modern finance has left the analysis of Berle and Means's *Private Property and the Modern Corporation* outmoded. That influential book still

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32. Interests of managers and investors are not usually perfectly aligned. See Jensen & Meckling, *supra* note 11.

33. For discussions of firm-specific human capital, see MASAHIKO AOKI, *THE CO-OPERATIVE GAME THEORY OF THE FIRM* (1984); Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70 J. POL. ECON. 9 (Oct. Supp. 1962); Harry DeAngelo & Linda DeAngelo, *Managerial Ownership of Voting Rights*, 14 J. FIN. ECON. 33, 34-38 (1985); Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 313-19 (1978).

34. See Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996).

weighs heavily on corporate law scholarship. Berle and Means stressed that the shareholder in the modern corporation, with his mere atom of property, has no power to control management. Ownership and control are split, in their vision, producing a radioactive alienation that threatens to poison economic life. The remedy, they thought, was to recharacterize firms as virtual public utilities with public duties.<sup>35</sup> The rational investor of modern capital asset pricing models, viewed through the lens of Berle and Means, looks like an aggravated version of what they feared. Thus the mythology of the lost age of the active shareholder owner lives on into contemporary corporate scholarship. The diversified investor of modern finance theory, however, is not a particularly frightening version of Berle and Means's shareholder. It (usually an institution) is not a "shareholder" as we have been taught to think of shareholders at all. The rational investor is diversified across all classes of capital assets and consequently is, in spite of much academic cheerleading to the contrary,<sup>36</sup> largely passive.<sup>37</sup> If this rational investor is the starting point, what agency costs should matter?

The agency costs that matter are properly seen as the divergence between what self-interested managers do and what rational investors would have them do. Rational investors will have a stake in that part of the firm's capital that trades on the debt market, just as they will have a stake in that part of the firm's capital that trades in the stock market. Thus when managers fail to be as risk neutral as diversified shareholders would have them be, this does not necessarily mean they are more averse to risk than rational investors who own a proportional stake in the firm's debt would have them be. This does not mean that the agency costs are trivial, but it does suggest that the conventional picture of managers as agents of "the shareholders" exaggerates agency costs. Rational investors will not be as risk-loving as would be investors holding only equity.

If the bulk of a firm's capital comes from rational investors, investors heavily positioned in the firm's equity might nevertheless yield a disproportionate influence over managers. In this case, the firm-specific investments of managers might mitigate the pressure toward excessive risk-taking that risk-preferring shareholders might put on managers. Public choice theory suggests that smaller groups with narrower interests tend to wield more influence than do larger groups with diffuse interests. Narrow special interest lobbies are able routinely to exercise more influence in the legislative process than diffuse

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35. See BERLE & MEANS, *supra* note 3, at 327.

36. See, e.g., Lawrence A. Cunningham, *The Essays Of Warren Buffet: Lessons For Corporate America*, 19 CARDOZO L. REV. 5 (1997); Isaac C. Hunt, Jr., *Plain English — Changing The Corporate Culture*, 51 U. MIAMI L. REV. 713, 718 (1997).

37. See Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1 (1997).

groups such as taxpayers can.<sup>38</sup> There is a danger that something similar may occur in the context of corporate governance. Consider a public corporation that has two groups of shareholders, one of which is fully diversified according to the CAPM mandate and another that has specialized in the corporation's common stock. The tendency of economic analysis of corporate law is to view this allocation of ownership as benign, because it reduces monitoring costs. Mark Roe and others have argued, for example, that restrictions on ownership by financial intermediaries of large stakes in public corporations should be lifted, because strong owners would make good monitors of firm managers, who otherwise tend to shirk, self-deal, and otherwise generate excessive agency costs.<sup>39</sup>

Having a strong "interest group" focused specifically on the value of the firm's stock, to the exclusion of the other financial claims against it, however, will not necessarily be efficient. Especially if the firm is highly leveraged, the specialized-equity interest group may have an incentive to use its influence, through the corporate governance system, to get managers to take excessive risks. This would harm rationally diversified investors in the firm. If the firm has more debt than equity in its capital structure, rational investors will own more of the firm's debt than its equity. Investors who own much more of the firm's equity than its debt may push managers to adopt inefficient strategies that increase the value of firm stock but decrease the value of firm debt by more. Thus, it seems entirely plausible that investors specialized in firm equity will have more influence over management than rationally diversified investors but quite different incentives respecting risk. It is partly to avoid incentive problems like these that leveraged buyouts sometimes impose an ownership structure requiring investors to buy tranches of the refinanced target's securities, so that they will be proportionally invested in every level of the target firm's capital structure after the buyout.<sup>40</sup> Put another way, there are likely to be significant agency costs arising from the divergence of the inter-

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38. See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 53-65 (1971); KAY L. SCHLOZMAN & JOHN T. TIERNEY, *ORGANIZED INTERESTS AND AMERICAN DEMOCRACY* 82-85 (1986); Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371, 392 (1983); Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988); Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y, 671 (1995) (reviewing MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994)).

39. See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 21-25, 263-87 (1994); see also Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM. 117 (1988).

40. See Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy*, in *DISCUSSING THE REVOLUTION IN CORPORATE FINANCE* 158, 158-167 (Donald H. Chew, Jr. ed. 1998).



ests of shareholders specializing in ownership of a particular firm, who act as strong owner monitors, and the interests of rational investors, who own not only stock but also debt of the firm. There is no reason to expect the interests of the former group to coincide with those of the latter.

### C. *Taking Corporate Law Norms Seriously*

Law and economics traditionalists might concede that in some circumstances a duty to maximize the value of shares might be inefficient but still think this is not such a big problem. In this Section, I argue that this would be a misguided attitude.

The main justification for complacency about the shareholder value maximization norm is probably the belief that the central problem of corporate law has been, and perhaps will always be, the agency costs generated by managers who are disloyal to anybody but themselves. One might think that loyalty by firm managers to shareholder interests, carried to the point where managers actually make inefficient choices, is unlikely ever to be a serious problem except "in the vicinity of insolvency," and that problem is already addressed in doctrine. One could also suppose that the enforcement costs necessary to bring about perfect compliance of managerial behavior with the shareholder value maximization norm would be so great that they would not be justified by the marginal benefits to shareholders. So shareholders would not want perfect compliance with the norm in any event.

This is the kind of seemingly practical argument that often appeals to corporate law scholars. On reflection, however, it is wrongheaded. In fact, the argument could be rephrased as saying that under real-world conditions, the norm of maximizing shareholder value is a good approximation of the norm of maximizing the total value of the corporation. The claim would be that managers have sufficient incentives to be disloyal so that loyalty to shareholders to the point of inefficiency, that is to the point where shareholder value is increased at the cost of decreasing total firm value, is unlikely ever to be a problem. This argument, however, has to invoke implicitly the very norm of firm value maximization. It defends the shareholder value maximization norm by implicit reference to what is functioning as the real, underlying norm, namely the maximization of firm value, or efficiency. If it does not do that, it is difficult to imagine what the defense of shareholder value maximization could possibly be. Even if one were to concede that in standard settings, maximizing shareholder value (as far as managers can practically be made to do it) does maximize firm value, what is the proponent of shareholder value maximization supposed to say to the hypothetical situation in which maximizing shareholder value does *not* maximize firm value? What could possibly be the economic justi-

fication for maximizing shareholder value under these circumstances *anyway*? There is the fallback position — that shareholder value maximization is what creditors have agreed to and that shareholder value maximization is just enforcing the corporate contract. But this is simply begging the question — forgetting conveniently that from the beginning we are discussing what the *gap-filling default rules* should be. By hypothesis, creditors have not agreed to shareholder value maximization. If they had agreed to it, then there would be nothing to discuss. (I discuss the claim that corporate contracts with creditors require no gap filling in more detail in the next Section.)

Proponents of shareholder value maximization must, therefore, either implicitly invoke the firm value maximization/conventional efficiency norm if they defend shareholder value maximization by claiming it is efficient in all but exotic cases, or implausibly assert that corporate contracts with creditors are, uniquely in the world of contracts, gapless. Furthermore, even if shareholder value maximization may be the efficient norm in all but exotic circumstances, this would seem less than a compelling reason for not explicitly using a norm that should be efficient in all circumstances, even exotic ones. The idea that corporate managers are under a general duty to maximize the value of the corporation has the virtues of unity and coherence, which make it easier to understand and easier to explain.<sup>41</sup>

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41. A defense of shareholder value maximization might take yet another form, but one that is equally unpersuasive. One might claim shareholder value maximization is what one might call a supererogatory norm. This is a normative prescription that takes a hyperbolic form, as if to take into account the probability of human weakness. Thus a general obligation to be generous to the poor might take the form of an ethical prescription (such as some might read into the New Testament, for example) to give all one's belongings to the poor. One might think there is little danger that people will take this prescription so much to heart that they will actually inefficiently impoverish themselves, but they may take it seriously enough to actually live up to the real underlying obligation, which is to be generous to the poor. Similarly, one might state an ethical obligation in an unqualified way, also so as to take account of this "discount," when one in fact would admit of exceptions. Similarly, the norm "maximize shareholder value" might be the formula that managers, inclined to serve their own interests rather than those of the firm anyway, would respond to best, not actually maximizing shareholder value, which would harm themselves and not even be efficient, but, urged on by the norm's various enforcement mechanisms, take actions to some degree consistent with efficiency. There are, however, at least two problems with this view. First, it is imprecise. Neither managers nor their critics can derive from this supererogatory norm clear instructions about what they should and should not do. Second, this supererogatory norm is parasitic upon the norm of efficiency. We must still justify the overstatement of "maximize shareholder value" in terms of the norm we really adhere to, which presumably is maximizing firm value. This position would seem difficult to hold, however, in instances in which the maximization of share value and that of firm value actually conflict, which is the case with which we are primarily concerned.

#### D. *Contracts with Shareholders and Creditors and Duties to Bondholders*

Proponents of shareholder wealth maximization disagree with writers who argue that corporate directors should owe a fiduciary duty to the bondholders of the corporation as well as to shareholders.<sup>42</sup> Shareholder wealth advocates affirm the corporate law doctrine that while shareholders benefit from the fiduciary duty owed them, bondholders have a relationship with the corporation that is strictly contractual — at least in the sense that managers owe them no fiduciary duty.<sup>43</sup> The idea that creditors, including bondholders, have a relationship with the corporation which is strictly contractual is well-established corporate law doctrine.<sup>44</sup>

The debate over whether bondholders ought to benefit from a fiduciary duty has taken place against the obscuring background of arguments over “contractual” versus communitarian views of the corporation.<sup>45</sup> In this setting, the term “contract” gets confusing.

42. Quite an extensive literature has developed on this topic. See, e.g., Bainbridge, *supra* note 3; William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 735-39 (1984); John C. Carter, *The Fiduciary Rights of Shareholders*, 29 WM. & MARY L. REV. 823, 826 (1988); J.A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9, 16 (1987); Thomas R. Hurst & Larry J. McGuinness, *The Corporation, the Bondholder and Fiduciary Duties*, 10 J.L. & COM. 187, 209 (1991); Hideki Kanda, *Debtholders and Equityholders*, 21 J. LEGAL STUD. 431 (1992); Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156, 1173 (1993); Jeffrey G. MacIntosh, *Designing an Efficient Fiduciary Law*, 43 U. TORONTO L.J. 425 (1993); Millon, *Redefining Corporate Law*, *supra* note 4; Ann E. Conaway Stilson, *Reexamining The Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors*, 20 DEL. J. CORP. L. 1 (1995); Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1; Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27 (1996).

43. Courts have traditionally held that managers owe no fiduciary duty to bondholders. See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989); *Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988); *Speer v. Dighton Grain, Inc.*, 624 P.2d 952, 961 (Kan. 1981); *Merriman v. Smith*, 599 S.W.2d 548, 552-56 (Tenn. Ct. App. 1979); *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).

44. See DOUGLAS M. BRANSON, *CORPORATE GOVERNANCE* §10.05, at 556 (1993); C. HUGH FRIEDMAN, *CALIFORNIA PRACTICE GUIDE: CORPORATIONS CH. 6-C*, ¶6:247.24 (Westlaw 1984); WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* §6-2, at 220 (5th ed. 1993).

45. See Albert H. Barkey, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 CREIGHTON L. REV. 47 (1986); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997) [hereinafter Brudney, *Contract and Fiduciary Duty*]; Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821 (1992) [hereinafter Brudney, *Corporate Bondholders*]; Michael E. Debow & Dwight R. Lee, *Shareholders, Nonshareholders and Corporate Law: Communitarianism and Resource Allocation*, 18 DEL. J. CORP. L. 393 (1993); David M.W. Harvey, *Bondholders' Rights and the Case for a Fiduciary Duty*, 65 ST. JOHN'S L. REV. 1023 (1991); David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in *PROGRESSIVE CORPORATE LAW*, *supra* note 4, at 1-33; Millon, *Redefining Corporate Law*, *supra* note 4; Mitchell, *supra* note 4; Mitchell, *supra* note 1; Lawrence E. Mitchell, *The Fairness Rights of Corporate*

Contractarians argue that the corporation is best understood as a nexus of contracts and that the relationship of shareholders to the firm is essentially contractual.<sup>46</sup> They also argue that shareholders are beneficiaries of a fiduciary duty, while bondholders have only a contractual relationship with the firm.<sup>47</sup> But what does this mean? If the corporation is a nexus of contracts, is not everyone's relationship within the nexus contractual? Contractarians must be using the term contract in two different senses, one literal and one more metaphorical.

Corporate-law contractarians argue that those who provide the firm with inputs agree to certain terms specified by provisions of statutory corporate law, the firm's articles of incorporation and bylaws, and other rules that govern the claims of the various input providers. These rules are not part of a literal contract, but a contract is still a good model of the voluntary, self-interested arrangement that constitutes a joint business venture among many different parties. "Contract" is used here as a metaphor or analogy that captures the essence of the actual web of voluntary arrangements. The idea is similar to, but not nearly as fanciful as, the classic description of fundamental social relations as a "social contract."<sup>48</sup>

It would be impractical for any input provider to specify this "contract" in complete detail.<sup>49</sup> The costs of trying to make the

*Bondholders*, 65 N.Y.U. L. REV. 1165 (1990); O'Connor, *Restructuring*, *supra* note 9; Orts, *supra* note 5. *But see* Bainbridge, *supra* note 9, at 856, 904 n.22.

46. See EASTERBROOK & FISCHER, *supra* note 3, at 37-39; Alchian & Demsetz, *supra* note 11, at 787-89 & n.14; Bebchuck, *Contractual Freedom*, *supra* note 11, at 1397; Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV., Summer 1989, at 99; William J. Carney, *The ALP's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 900, 905-11 (1993); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1706 (1989); Jensen & Meckling, *supra* note 11, at 310-11.

47. See EASTERBROOK & FISCHER, *supra* note 3, at 38; Bainbridge, *supra* note 3, at 1443; Macey, *supra* note 7, at 36-39; C. Robert Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 J. CORP. L. 61 (1993); Tauke, *supra* note 42; Van Der Weide, *supra* note 42, at 31-32.

48. See, e.g., SOCIAL CONTRACT: ESSAYS BY LOCKE, HUME, AND ROUSSEAU (Ernest Barker ed., 1948); THE SOCIAL CONTRACT FROM HOBBS TO RAWLS (David Bouche & Paul Kelly eds., 1994); Michel Rosenfeld, *Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769, 849 n.363 (1985).

49. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989) [hereinafter Ayres & Gertner, *Filling Gaps in Incomplete Contracts*]; Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992) [hereinafter *Strategic Contractual Inefficiency*]; Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 873 (1992); Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159 (1994); Russell Hardin, *Magic on the Frontier: The Norm of Efficiency*, 144 U. PA. L. REV. 1987, 1999 (1996); Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216 (1992); Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391 (1992) (reviewing EASTERBROOK & FISCHER, *supra* note 3) [hereinafter Ayres, *Making a Difference*].

corporate "contract" complete would be greater than the benefits. Instead of attempting to spell out completely all of the duties managers owe shareholders, the standard contractualist now holds that corporate law subjects managers to a broad fiduciary duty. According to Easterbrook and Fischel, leading proponents of the contractual view of the corporation, the fiduciary relationship is characterized by its open-endedness. Bondholders, Easterbrook and Fischel would agree, are also participants in the corporate "contract." They are among the parties who pool their resources in the firm. Unlike shareholders, however, bondholders do have a literal, detailed contract with the firm. Gaps in the bondholders' contract are smaller and fewer than those in the shareholders' "contract" because the costs of specifying the former contract are lower. This difference in cost is partly due to the difference in the nature of their claims. The fixed claims of creditors must be protected against a relatively known and describable set of threats such as fraudulent transfers and subordination to other creditors. Creditors typically get certain "boilerplate" proscriptions built into their contracts that limit the risk that the firm will fail to fulfill its obligations.<sup>50</sup> Because the relationship between the firm and bondholders is not so open-ended,

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50. On bond covenants generally, see Clifford W. Smith, Jr. et al., *Financial Engineering: Why Hedge?*, in THE HANDBOOK OF FINANCIAL ENGINEERING 126, 132-34, and (Clifford W. Smith, Jr. & Charles W. Smithson eds., 1990); and Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979). For discussions of shareholder-bondholder conflict, see Avner Kalay, *Stockholder-Bondholder Conflict and Dividend Constraints*, 10 J. FIN. ECON. 211 (1982); Rose-Ackerman, *supra* note 31; and George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992). For discussion of poison put bond covenants, see Leland Crabbe, *Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants*, 46 J. FIN. 689 (1991), and Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997). Also of interest are the following: Elazar Berkovitch & E. Han Kim, *Financial Contracting and Leverage Induced Over- and Under-Investment Incentives*, 45 J. FIN. 765 (1990); William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92; 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, 1216 n.27 (1991); Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463 (1996); Mai E. Iskandar-Datta & Douglas R. Emery, *An Empirical Investigation of the Role of Indenture Provisions in Determining Bond Ratings*, 18 J. BANKING & FIN. 93 (1994); Ileen Malitz, *On Financial Contracting: The Determinants of Bond Covenants*, FIN. MGMT., Summer 1986, at 15; Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931 (1993) [hereinafter Kahan & Klausner, *Antitakeover Provisions in Bonds*]; Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565 (1995) [hereinafter Kahan & Klausner, *The Qualified Case Against Mandatory Terms in Bonds*]; Gene Labor, *Bond Covenants and Forgone Opportunities: The Case of Burlington Northern Railroad Company*, FIN. MGMT., Summer 1992, at 71, 72 n.1; Kenneth Lehn & Annette Poulsen, *Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts*, 34 J.L. & ECON. 645 (1991); ILEEN B. MALITZ, THE MODERN ROLE OF BOND COVENANTS 43-44 (1993); Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW 413 (1986).

bondholders do not need or get the benefits of a fiduciary duty owed to them, in the standard view. Maximizing the value of equity, on the other hand, involves entrepreneurs seeing opportunities others do not see and making the most of them.<sup>51</sup> This duty is unavoidably much more vague.

The corporate "contract" with shareholders thus has great need of a gap-filling principle provided by the fiduciary duty, while the contract with fixed claimants on the firm needs it much less. This point, stressed by many corporate scholars, is well taken, but tends to be exaggerated. It does not imply that contracts with creditors do not also need a gap-filling principle. All contracts have gaps.<sup>52</sup> Contractors cannot anticipate all future contingencies. While the nature of bondholder claims is profoundly different from that of equity, both variable and fixed corporate claimants will have need of principles to fill the gaps in their incompletely specified voluntary arrangements.

Economic analysts of corporate law, however, taking Easterbrook and Fischel as exemplary, have tended to suggest that contracts with debt holders never need gap filling because contracting costs are so low. Yet this assumption is too implausible to bear scrutiny. For it to be true, contracting with debt holders would have to be costless, which obviously it is not.<sup>53</sup> In their book *The Economic Structure of Corporate Law*, Easterbrook and Fischel seem to argue — but they are not entirely clear on this point — that corporate law reserves *fiduciary* duty for voluntary arrangements that are especially open-ended, like that between the firm and shareholders. In their later work, however, they seem to take a somewhat different position, arguing that the doctrine of fiduciary duty corresponds to no distinctive economic reality.<sup>54</sup>

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51. See FREDERICK BANARD HAWLEY, *ENTERPRISE AND THE PRODUCTIVE PROCESS* (1907); ISRAEL KIRZNER, *COMPETITION AND ENTREPRENEURSHIP* (1973); FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* (1921); Patrick J. Gunning, *The Meaning of Entrepreneurship in Economic Theory: Historical Perspective*, in 1 *ENTREPRENEURSHIP, INNOVATION, AND ECONOMIC CHANGE* (1992).

52. See, e.g., Ayres & Gertner, *Filling Gaps in Incomplete Contracts*, *supra* note 49; Ayres & Gertner, *Strategic Contractual Inefficiency*, *supra* note 49, at 730; Barnett, *supra* note 49; Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 *HARV. J.L. & PUB. POLY.* 639 (1989); Ayres, *Making a Difference*, *supra* note 49.

53. For bond contracts to be literally gapless, contracting costs would have to be zero (or vanishingly small) because there are an infinite number of contingencies that potentially may affect payment and other important features of the bonds. Only if contracting costs were vanishingly small would it be economical for the bond contract to spell out the parties' rights and duties under all circumstances that might conceivably arise. See, e.g., Ayres & Gertner, *Strategic Contractual Inefficiency*, *supra* note 49; Per-Olof Bjuggren, *A Transaction Cost Perspective on Financial Distress and Capital Structure*, 15 *INTL. REV. L. & ECON.* 395 (1995); Brudney, *Corporate Bondholders*, *supra* note 45; Frank H. Easterbrook, *High-Yield Debt as an Incentive Device*, 11 *INTL. REV. L. & ECON.* 183 (1991); Joseph McLaughlin, *Challenges to Underwriters and Their Counsel in the Modern Capital Markets Environment*, 792 *PLI/CORP* 401 (1992).

54. See EASTERBROOK & FISCHEL, *supra* note 3, at 91.

Rather, they argue, the efficient allocations of benefits and duties are different in different economic settings. Thus in each of the different settings of business corporations, labor unions, and trusts, fiduciary duty has a different content.

Yet in all cases, they argue, the principles imposed by the law are nevertheless those to which rational parties would have agreed *ex ante*. In trust law, corporate law, labor law, and other areas, “fiduciary duty” thus means the same thing but also different things: the same thing because in each area the law requires fiduciaries to do the efficient thing, what rational parties would have agreed to *ex ante*; but also different things because in different settings, rational parties would agree to different things. For example, Easterbrook and Fischel suggest that the fiduciary duties of labor union officials are less stringent than those of ordinary trustees because union members can hold officials accountable more readily than trust beneficiaries can trustees.<sup>55</sup>

In this Article, I am concerned only with fiduciary duty for purposes of corporate law. I am not trying to develop here a theory that works for all of the many applications of fiduciary duty, or even to suggest such a thing is possible. I do take it, however, that a hypothetical bargain analysis — asking what parties would have agreed to *ex ante*, as a proxy for what is efficient — is at the core of Easterbrook and Fischel’s analysis of the corporate fiduciary duty. My point is that this sort of analysis, correctly applied, leads to unexpected results, results whose simplicity and elegance ought to recommend them to those who prize coherence in legal theory. In particular, hypothetical bargain analysis is just as applicable to contracts between the firm and creditors, and other fixed claimants, as it is to the “contract” between the firm and shareholders. Indeed, it would be strange if the application of contract law’s hypothetical bargain analysis to corporate law were appropriate for metaphorical (shareholder) contracts but not for real (bond) contracts. Real contracts are, after all, the sort of contracts the default rules of which hypothetical bargain theory was used to explore in the first place. The obligations owed by managers to creditors are usually not characterized in law as fiduciary. The gaps in the specification of obligations to fixed claimants, however, have to be filled, as a normative matter of efficiency, just as do the larger gaps in “contracts” with shareholders, by a principle that requires managers to do what rational parties would have agreed to *ex ante*.

#### E. *Fiduciary Duty and Gapless Contracts with Creditors*

This appropriate stress on what investors would have agreed to *ex*

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55. See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 437 (1993).

ante decouples two points which together cause confusion. It is natural to suppose that if creditors such as bondholders have essentially an express contractual relationship with the firm, then there is little gap filling for any fiduciary principle to do in the creditors' contracts with the firm, and the fiduciary principle should be thought of mainly as a principle that completes the *shareholders'* contract with the firm. In a sense, this is correct, but it is also misleading. Even if it is the case that bondholder contracts with the firm are gapless, it is still a mistake to imagine that the hypothetical contract from which we derive corporate fiduciary duty arises from negotiations between or among "the shareholders" and anybody else. It is a logical mistake to infer from the completeness of bond contracts, and the idleness of fiduciary duty as a gap filler in that context, that shareholders, rather than rational investors more generally, are the only parties to the hypothetical corporate contract. Ironically, this logical mistake, which I believe subtly animates much of corporate contractualist analysis of fiduciary duty, is an instance of reification. It is as if contractualists imagine there are shareholders and bondholders in the hall where the corporate contract is being negotiated. Because contracting costs are lower for bondholders, they finish negotiating their contracts first and leave. The shareholders remain and have to settle on the broad fiduciary duty because to specify their contracts completely would be too costly. Thinking of shareholders in this way, however, reifies them as a separate class. Sixty years of Berle- and Means-influenced thinking makes it difficult not to do so. Nevertheless, reifying shareholders this way has no warrant in modern finance theory. Shareholders as a separate class, the Berle and Means "owners," represent a nostalgic longing for a political economy that never existed.<sup>56</sup> In any event, modern finance theory has little room for them. Rational investors are not exclusively shareholders, but are widely diversified across asset classes. The diversified investors who hypothetically negotiate the corporate contract will internalize the costs and benefits of different fiduciary rules to the bonds they hold whether or not there are gaps in bond contracts. They will only agree to a fiduciary rule that calls for gaps to be filled in the corporate "contract" with the principle of the maximization of

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56. For the flavor of this, see the elegiac last chapter in A.A. BERLE & V.J. PEDERSON, *LIQUID CLAIMS AND NATIONAL WEALTH* 199 (1934). Berle and Pederson opine,

Plainly, there is more than a material loss in this dissolution of the element of property. The loss is at least equally spiritual. Possession of a liquid asset gives him a momentary possibility to fulfill his desire; and projects that possibility into the future; but the thing it gives him is precisely that and no more. It does not give him necessarily the possibility to create; and it precludes (at least to the extent of these assets) any possibility of having a function in terms of property. There is no escape from the fact that the truly liquid asset is a dead asset; as it enters into production it becomes less liquid; what has happened has been the splitting of the atom of property so that he has the dead part, and someone else the living.

*Id.* at 203. The influence of this kind of progressive romanticism in American legal thought deserves an essay in its own right.



firm value, not shareholder value, even if we imagine bond contracts were gapless.

So far I have only sketched the argument for taking the maximization of firm value as the principle to which these rational parties would agree as the appropriate norm for filling gaps in corporate contracts. In the following Part, I argue in more detail that this is the rule rational investors in corporations would choose as a gap filler.

## II. THE HYPOTHETICAL BARGAIN AMONG RATIONAL CORPORATE INVESTORS

In their influential book on corporate law,<sup>57</sup> Easterbrook and Fischel express the standard view that “the holders of [residual claims],” who “bear the marginal risks of the firm[,] . . . have the best incentives to make the optimal investment and management decisions [for the firm] — not perfect, just best.”<sup>58</sup> In fact, this standard view is quite wrong, and the confident assumption of this proposition as economic truth is the source of perhaps subtle, but deep and persistent, confusion in corporate law scholarship. In fact, as the examples above show, the incentives of residual claimants are too risk-preferring to be efficient. They would have managers increase the value of residual claims even if it decreased the total value of financial claims against the firm, and they would always have these incentives, not just in unusual cases. So who does have the best incentives to make optimal investment and management decisions for the firm? It turns out this question has a pleasing answer. It is rational investors. Since they are proportionally invested in all the financial claims on the firm, just as CAPM mandates, they have these optimal incentives. Thus the diversified portfolio that CAPM mandates is also the portfolio which, when held by rational investors, gives them precisely the correct incentives to make, or to influence management to make, “the optimal investment and management decisions” for the firm. Rational investors, not shareholders, have the best incentives.

Why do Easterbrook and Fischel miss this point? Were one to ask them, “best of whose incentives to make optimal decisions?” their answer would presumably be, “best among shareholders, preferred shareholders, junior creditors, senior creditors, and so on — best of the various classes in the capital structure of the firm.”<sup>59</sup> But these

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57. See EASTERBROOK & FISCHEL, *supra* note 3.

58. *Id.* at 91.

59. I do not address the complicated issues involved in duties firm decisionmakers might owe to workers, communities, and “other constituencies” of the corporation. This is because conventionally, human capital is not included in the portfolios that modern portfolio theory describes. This is obviously a serious limitation of modern portfolio theory. Ravi Jagannathan and Zhenyu Wang argue that if the market index is redefined to include human capital and betas are allowed to vary with the cyclical fluctuations in the economy, beta becomes a

categories are imposed by law, not finance. Easterbrook and Fischel, for all their economic sophistication, remain trapped in the antique world of Berle and Means. To maximize the value of its portfolio, a rational investor must be shareholder, senior bondholder, and everything in between, all at once. To have the right incentives to maximize the value of the firm, the rational investor must have the correct incentives respecting investment and management decisions of the firm. And the rational investor will have those incentives as a natural consequence of diversifying its portfolio to maximize value. Thus diversification theory, management's incentives to maximize the value of investment in the firm, and the normative content of corporate law are all tightly linked, but not in the way economic corporate law scholarship has heretofore explained. It is not "the shareholders," but rational investors, by virtue of diversifying to maximize the value of their portfolios, who have the best (indeed, with the usual strong assumptions, perfect) incentives to maximize the value of the firm.

Once this point is grasped, a socially efficient corporate law norm is not difficult to formulate. It is simply that managers should make the decision, such as the investment choice, that maximizes the value of the firm.<sup>60</sup> This does not necessarily entail maximizing the value of the residual claims, such as common stock, of the firm but rather entails maximizing the total value of all financial claims on the firm. In the example in Part I above, managers would be violating this rule by choosing Investment 2 over Investment 1, even if Investment 2 were better for shareholders. In the next Section, I show how hypothetical bargain analysis leads to this result.

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much better predictor of returns on assets. See Ravi Jagannathan & Zhenyu Wang, *The Conditional CAPM and the Cross-Section of Expected Returns*, 51 J. FIN. 3 (1996). One could imagine a very ambitious theory that would defend a general version of fiduciary duty that would fill all gaps in the corporate contract depending on what would maximize the total value of all assets, including human capital, that were contractually committed to the corporation. Such a theory might, however, not give workers more protection than they currently have. Moreover, hypothetical contract analysis that uses highly diversified investors as its personnel is more appealing in settling gap-filling principles for contracts with financial claimants than it would be for firm contracts with human capital investors. Treating shareholders as if they were diversified across asset classes is not grossly unrealistic, and it is not normatively offensive, because it treats shareholders as doing what they should be doing anyway. Considerations such as the decreasing marginal utility of wealth become relevant, however, in considering default rules governing conflicts of financial and human capital providers.

60. Cf. Barkey, *supra* note 45. Barkey argues for a duty of "global wealth maximization" which is similar to the proposal I make in this Article. He argues, however, that this duty follows from Black-Scholes option-pricing theory, making a connection I am not sure I follow. He seems to mean that under option-pricing theory, a bondholder is in a sense a residual claimant and as such should benefit from a fiduciary duty. As I explain in Section IV.A.1, I think the idea that fiduciary duty should follow from the residual status of a claim is just a mistake. He also seems to reject the idea that investors would be indifferent to maximizing firm value via wealth transfers from bondholders to stockholders or vice versa. Instead, he suggests the firm should have to compensate bondholders for such "expropriations." I do not endorse that view. I also find Barkey's article opaque at several crucial points. *See id.* at 69.

### A. Rational Corporate Investors

Hypothetical bargain analysis<sup>61</sup> determines what rule hypothetical investors in a public corporation would agree to ex ante to fill gaps in the corporate contract. The first step in the analysis is to characterize the investors and describe what rational behavior on their part is. The second step is to explain which corporate law norm rational investors of the sort described would pick.

I take corporate investors for purposes of this analysis to be perfect adherents of CAPM — the Capital Assets Pricing Model. CAPM is not uncontroversial, but it remains the leading asset pricing model and a central tenant of modern finance.<sup>62</sup> In any event, my purpose here is not to defend CAPM but to use CAPM as the best available description of rational investment behavior.

CAPM is familiar to modern corporate law scholars. It is standard in the corporate law literature to take into account the consequence of CAPM that rational investors will be highly diversified. For example, in Easterbrook and Fischel's critique of laws regulating takeovers and

61. The literature on hypothetical bargaining theory is huge. See, e.g., BRUCE ACKERMAN, *RECONSTRUCTING AMERICAN LAW* 46-72 (1984); RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 79-85 (3d ed. 1986); Ayres & Gertner, *Filling Gaps in Incomplete Contracts*, *supra* note 49; Bainbridge, *supra* note 9; Barnett, *supra* note 49; Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISC. L.J. 59 (1993); Bebchuk, *Limiting Contractual Freedom*, *supra* note 11, at 1824; Daniel P. Brudney, *Hypothetical Consent and Moral Force*, 10 LAW & PHIL. 235 (1991); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815 (1991); Clark, *supra* note 46; John C. Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Coleman et al., *supra* note 52; Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 271-79, 283-99 (1986); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 702 (1982); [hereinafter Easterbrook & Fischel, *Corporate Control Transactions*]; Theodore Eisenberg, *Symposium on the Law and Economics of Bargaining Commentary on 'On The Nature of Bankruptcy: Bankruptcy and Bargaining*, 75 VA. L. REV. 205 (1989); Thomas Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990); Robert A. Long, Jr., *A Theory of Hypothetical Contract*, 94 YALE L.J. 415 (1984); Jonathan R. Macey, *Courts and Corporations: A Comment on Coffee*, 89 COLUM. L. REV. 1692 (1989); Larry E. Ribstein, *Fiduciary Duty Contracts In Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997); Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171 (1995); Robert E. Scott, *Conflict and Cooperation In Long-Term Contracts*, 75 CAL. L. REV. 2005 (1987); Ayres, *Making a Difference*, *supra* note 49.

62. See, e.g., RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 101 (2d ed. 1995); Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 478 (1998); Jeffrey S. Glaser, *The Capital Asset Pricing Model: Risk Valuation, Judicial Interpretation, and Market Bias*, 50 BUS. LAW. 687, 716 (1995); D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons From Kmart*, 74 N.C. L. REV. 1037, 1066 (1996); Cheol S. Eun, *The Benchmark Beta, CAPM, and Pricing Anomalies*, 46 OXFORD ECON. PAPERS 330 (1994); *Risk and Return: Capital-asset Pricing Model*, *ECONOMIST*, Feb. 2, 1991, at 72; *Three Pioneers of Finance*, *ECONOMIST*, Oct. 20, 1990, at 99.

tender offers, they consider how different rules would affect diversified stock investors who own stock in both takeover targets and potential acquirers.<sup>63</sup> A law that resulted in losses to the value of acquirer stock that were greater than gains realized in the value of target stock would be inefficient from the viewpoint of the diversified stockholder. There is little disagreement that shareholder welfare has to be considered in light of the fact that in modern finance theory, rational shareholders are diversified.

While corporate law scholars assume that CAPM tells shareholders to diversify, they usually seem to assume, however, that this means merely that rational shareholders should own stock in at least a certain number of different firms.<sup>64</sup> The diversification that CAPM actually prescribes goes well beyond this. A striking result of CAPM is its demonstration that a rational investor will hold a "market portfolio" and either buy risk-free assets or borrow at the risk-free rate, as necessary to maximize portfolio value in light of the particular rational investor's attitude toward risk.<sup>65</sup> The market portfolio is the aggregation of everyone's financial holdings. Since under CAPM every investor's portfolio of risky assets is identical, every rational investor must own a slice, bigger or smaller, of the market portfolio. Thus under CAPM, every rational investor holds the same portfolio of risky assets: each risky asset portfolio is a bigger or smaller slice of the same pie. But, bigger or smaller, each slice has the same ingredients and has them in the same proportions as every other slice and as the pie as a whole. The weights of various types of risky assets in each rational investor's

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63. See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

64. See Smith, *supra* note 37.

65. For some discussions of CAPM in the last ten years, see THOMAS E. COPELAND & J. FRED WESTON, *FINANCIAL THEORY AND CORPORATE POLICY* 185-211 (2d ed. 1983); Edward A. Bernstein, *Law & Economics and the Structure of Value Adding Contracts: A Contract Lawyer's View of the Law & Economics Literature*, 74 OR. L. REV. 189 (1995); Lawrence A. Cunningham, *Conversations from the Warren Buffett Symposium*, 19 CARDOZO L. REV. 719 (1997); Lawrence A. Cunningham, *Introduction to the Warren Buffett Symposium Papers*, 19 CARDOZO L. REV. 221 (1997); Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575 (1991); Eugene F. Fama & Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds*, 33 J. FIN. ECON. 1 (1993); Eugene F. Fama & Kenneth R. French, *The Cross-Section of Expected Stock Returns*, 47 J. FIN. 427 (1992); Nicholas L. Georgakopoulos, *Why Should Disclosure Rules Subsidize Informed Traders?*, 16 INTL. REV. L. & ECON. 417 (1996); Glaser, *supra* note 62; Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1498 & n.247 (1993); Richard H. Koppes & Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing*, 20 J. CORP. L. 413 (1995); Louis Lowenstein, *Efficient Market Theory: Let the Punishment Fit the Crime*, 51 WASH. & LEE L. REV. 925 (1994); Robert F. Reilly, *The Use and Misuse of CAPM*, 13 AM. BANKR. INST. J. 29 (1994); Smith, *supra* note 37; Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475 (1997); and Samuel C. Thompson, Jr., *A Lawyer's Guide to Modern Valuation Techniques in Mergers and Acquisitions*, 21 J. CORP. L. 457 (1996).

portfolio are thus the same under CAPM. If stock represents 25% of all assets in the capital market, every rational investor will have a portfolio of risky assets that consists of 25% stock by weight. If stock of XYZ corporation represents 1/nth of a percent of all assets in the capital market, the ideally rational investor would hold 1/nth of a percent of her portfolio in XYZ stock. While the risky asset portfolios of rational investors under CAPM are identical, investors will differ, according to their risk preferences, in the amount they invest in risk-free assets or how much they borrow at the risk-free rate ("leveraging") to buy more risky assets. CAPM therefore pictures rational investors as being far more diversified than just owning twenty different kinds of stock, even though corporate law scholars often incorrectly assume that CAPM's diversification mandate is fulfilled for practical purposes by owning twenty or so different types of stock.<sup>66</sup> Ideal CAPM investors in fact are diversified across all classes of capital assets and hold particular assets in proportion to the percent that the class of assets represents of the capital market as a whole.

Critics of CAPM often object to its idealization and the lack of realism in its assumptions.<sup>67</sup> While not unassailable, CAPM has empirical support,<sup>68</sup> and perhaps more telling, no better, inconsistent theory seems currently available. Whatever the validity of criticisms of CAPM on grounds of realism might be, however, they would seem out of place in a critique of hypothetical bargain analysis, a type of analysis which inevitably involves idealization. Hypothetical bargain analysis looks at what ideally rational parties would do if they knew certain things *ex ante*. To reject the exercise because it employs idealizations is to reject the hypothetical bargain methodology entirely. One may certainly do this. A general defense of hypothetical bargain theory is beyond the scope of this Article. My point is that, as a standard tool of economic analysis of corporate law and the basis of current thinking on the economics of corporate fiduciary duty, hypothetical bargain

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66. See Smith, *supra* note 37, at 22.

67. See LOUIS LOWENSTEIN, SENSE AND NONSENSE IN CORPORATE FINANCE 195-208 (1991); Brennan, *supra* note 29; Eun, *supra* note 62; Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 253-56 (1984); Jagannathan & Wang, *supra* note 59, at 4; Burton G. Malkiel & Yexiao Xu, *Risk and Return Revisited*, 23 J. PORTFOLIO MGMT., No. 3, at 9 (1997); Stout, *supra* note 65; Richard Roll, *What Every CFO Should Know About Scientific Progress in Financial Economics: What Is Known and What Remains to Be Resolved*, FIN MGMT., June 23, 1994, at 69; Robert Teitelman, *The Revolt Against Free-Market Finance. (A Group of Thinkers and Practitioners Reject Current Free-Market Economic Beliefs)*, INSTITUTIONAL INVESTOR, June, 1992, at 37; Wayne H. Wagner, *Ten Myths and Twenty Years of Betas*, J. PORTFOLIO MGMT., Sept. 22, 1994, at 79; Beta Beaten, ECONOMIST, Mar. 7, 1992, at 87; *Tales from the FAR Side — Financial Markets' Evaluation of Risk Determines the Way Firms Invest. What If the Markets Are Wrong? / Judging Risk*, ECONOMIST, Nov. 16, 1996, at 86.

68. A nice assessment of the current status of CAPM debate can be found in the most recent edition of the classic popular investors' guide, BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 251-76 (1996).

analysis leads to results different from those usually supposed. Since CAPM is the theoretical ground for using diversified investors in economic analysis of corporate law at all, it makes sense to model investors as complying with the CAPM mandate closely. To do otherwise would require some theoretical justification, and none is apparent. Defenders of shareholder value maximization who want to rely on hypothetical bargain analysis would have to have some reason for using shareholders rather than rational CAPM investors in their model, but if they are invoking CAPM for supposing shareholders are diversified, it is arbitrary not to model investors as being as diversified as CAPM would have them be. If we take rational CAPM investors as the right personnel for our model, then the next question is, what corporate law norm would they choose?

To begin to answer this question, one can first note that under CAPM, rational investors will not divide themselves up into stockholders and bondholders. So when we imagine the hypothetical bargaining setting in which various claimants on the corporation are settling on their gap-filling principle, we do not have to distinguish between stockholders and bondholders. Under CAPM, we have investors whose risky asset portfolios are identical as far as their weights are concerned. They differ from one another only in the size of their portfolios, and in how they lever or unlever them to take account of their risk preferences.

### B. *The Efficient Corporate Law Norm*

Rational investors thus have risky asset portfolios that are identical as regards the weights of various risky assets. Consequently, they will not find it hard to agree on a gap-filling rule. They will agree on a simple rule: managers should make the choice that will maximize the value of rational investors' diversified portfolios.

This result conflicts with the accepted wisdom of what efficiency prescribes for a corporate law norm. If our gap-filling principle is to "maximize the value of rational investors' diversified portfolios," then shareholder value will not always be maximized. Consider again the rational investor's portfolio of risky assets. Consisting as it does of a representative sampling of all capital assets on the market, it will include both stocks and bonds of every firm, including XYZ corporation. If XYZ managers face a choice between two investments (such as Investment 1 and Investment 2 above) — the second of which will increase the value of stock, but by less than it decreases the value of bonds, and the first of which will increase the sum of the value of stock and bonds, even though it would increase stock value by less than the second investment — rational investors will unambiguously prefer that managers choose the first investment. The first investment would not maximize the value of investors' shares, but it would maximize the

value of their diversified portfolios. Rational investors in the hypothetical contract setting would reject the norm "maximize shareholder value," because it would result (to the extent it was followed) in some investment choices that reduced the value of their diversified portfolios. Their preferred instruction to managers would instead be to "do things that increase the value of our diversified portfolios." Managers could then do things that reduced the value of bonds (unless prohibited by actual contract terms) only if they increased the value of stock by more.

### C. *From Portfolios to Corporations*

The efficient norm for corporate law is different from shareholder wealth maximization not only in substance but in form as well. Because the norm is derived from what rational CAPM investors would choose in a hypothetical bargain, and these investors are diversified across classes of capital assets, the norm cannot be formulated as being owed exclusively or primarily to any one legal class of asset holders. If the object is to maximize the value of a diversified portfolio of securities, obviously a norm that requires the value of a particular asset class such as equity shares to be maximized is bound to fail. This leaves the question of how the efficient corporate law norm should be formulated.

The history of corporate law offers an attractive possibility. Until well into this century, lawyers and judges<sup>69</sup> conceived of the corporate fiduciary duty as running to "the corporation" itself rather than primarily or exclusively to the shareholders.<sup>70</sup> These earlier commenta-

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69. Chancellor Allen, however, seems to be hinting at this idea in the language he uses in *Credit Lyonnais*:

At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to *the corporate enterprise*. . . . [T]he board [of directors] . . . had an obligation to *the community of interest* that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.

Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. Civ.A.12150, 1991 WL 277613, at \*34 (Del. Ch. Dec. 30, 1991) (emphasis added) *reprinted in* 17 DEL. J. CORP. L. 1099, 1155, 1157 (1992).

70. See *United States v. Byrum*, 408 U.S. 125, 138 (1972) (holding that directors have a fiduciary duty to promote the interests of the corporation); *Guth v. Loft, Inc.*, 2 A.2d 225 (Del. Ch. 1938), *aff'd*, 5 A.2d 503 (Del. 1939) (holding that directors are charged with an unyielding fiduciary duty to the corporation and its shareholders); HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS § 122a (1927) (stating that directors and other officers of a corporation have a fiduciary relation toward the corporation); 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.10, at 4-233 (2d ed. 1997) ("Directors owe a duty of loyalty to the corporation and its stockholders . . ."); 3 BETH A. BUDAY & BAIL A. O'GRADNEY, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 837.50, at 181 (rev. vol. 1994) (stating that directors must act for the benefit of the corporation and the shareholders); 11 SIMON M. LORNE, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 1A.02[1][6] (1999) (stating that the beneficiary of the

tors did not have modern financial theory in mind. Nor did their conception of the fiduciary duty as being owed to the corporate entity arise from any solicitude toward claimants other than shareholders. Nevertheless, corporate legal history offers a convenient device for conceptualizing the norm that emerges from hypothetical bargain analysis.

Hypothetical bargain analysis suggests rational shareholders would prefer a norm that would have managers maximize the value of an abstraction, namely the sum of the values of the various components of rationally diversified portfolios. This abstraction is mathematically simple, but it is abstract nonetheless. In trying to embody such an abstract norm in legal rules, one must turn to an abstract entity that can stand as the object of the duty. It cannot be efficient to make the holders of one asset class the sole beneficiaries of a maximization duty, unless it is always efficient to maximize the value of that class of assets, or at least unless exceptions to such a rule could be clearly defined. As this is not the case, the corporate norm must be formulated in some other way. The natural alternative is to think of the duty as being owed to the corporation itself.

As historians of corporate law know, early twentieth-century corporate law theorists devoted astonishing energy to developing the theory of the corporate entity or personality.<sup>71</sup> Much of this work will strike the contemporary reader as obscure and metaphysical. The heavy influence of idealist philosophy accounts for some of this obscurity.<sup>72</sup> Economists will naturally find old idealist conceptions of the

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fiduciary duty is unclear, however three choices exist: the corporate entity itself, the shareholders generally, or the minority shareholders); 3 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 2d § 47:27, at 47-71 (1997) (“[O]fficers of corporations, are fiduciaries as to corporate stockholders as well as to the corporation itself . . .”); 18B AM. JUR. 2D CORPORATIONS § 1689, at 541 (1985) (stating that “it is well established that [directors] occupy a fiduciary, or more exactly a quasi-fiduciary, relation to the corporation and its stockholders”).

71. See W. Jethro Brown, *The Personality of the Corporation and the State*, 21 L.Q. REV. 365 (1905); George F. Canfield, *The Scope and Limits of the Corporate Entity Theory*, 17 COLUM. L. REV. 128 (1917); George F. Deiser, *The Juristic Person* (pts. 1-3), 57 U. PA. L. REV. 131, 216, 300 (1908-1909); John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655 (1926); W.M. Geldart, *Legal Personality*, 27 L.Q. REV. 90 (1911); Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 217 (1985); Harold J. Laski, *The Personality of Associations*, 29 HARV. L. REV. 404 (1916); Elvin R. Latty, *The Corporate Entity as a Solvent of Legal Problems*, 34 MICH. L. REV. 597, 599-600 (1936); Arthur W. Machen, Jr., *Corporate Personality* (pts. 1 & 2), 24 HARV. L. REV. 253, 347 (1910-1911); Gregory A. Mark, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441 (1987); Max Radin, *The Endless Problem of Corporate Personality*, 32 COLUM. L. REV. 643 (1932); Bryant Smith, *Legal Personality*, 37 YALE L.J. 283 (1928); Paul Vinogradoff, *Juridical Persons*, 24 COLUM. L. REV. 594 (1924); Martin Wolff, *On the Nature of Legal Persons*, 54 L.Q. REV. 494 (1938).

72. See O. GIERKE, *POLITICAL THEORIES OF THE MIDDLE AGES* (F. W. Maitland trans., 1st ed. 1922); FREDERICK HALLIS, *CORPORATE PERSONALITY* 49-72 (1930); H.J. LASKI, *THE FOUNDATIONS OF SOVEREIGNTY* 250-91 (1921); F.W. Maitland, *Moral Personality and Legal Personality*, in 3 *THE COLLECTED PAPERS* 304, 315 (H.A.L. Fisher ed., 1911).



corporation off-putting,<sup>73</sup> but the idealist taint on the idea of the corporate entity is just a contingency of the history of ideas. One need not think of the corporate entity in ways empirically oriented utilitarians are apt to find ridiculous, such as its having some difficult-to-define quality of personhood. To do important work, the corporation need not have an ontological status of the sort idealist philosophers or their intellectual heirs are wont to ascribe to collective entities of various sorts, such as states and social classes.

Rather, one can think of the corporation in the same way utilitarians typically think of collective entities in their usual analyses of policy questions. Many legal economists evaluating policy choices will regard as normatively preferable the choice that is Kaldor-Hicks superior to other options.<sup>74</sup> One state of the world is Kaldor-Hicks superior to another if moving to that state would generate gains that could more than compensate losses from the move.<sup>75</sup> As a kind of shorthand for this result, the legal economist may say "society" is better off for the making of a Kaldor-Hicks superior move. What she means, however, is only that the sum of individual utilities is greater in the Kaldor-Hicks superior world than in its alternative. She is not claiming some peculiar ontological status for society, and then claiming "it" is somehow better off. Economists are rarely accused of "reification" because they refer to "society."<sup>76</sup> Addition is not reification.

Yet using "society" in this sense is still normatively useful. Consider how one would formulate a duty one might wish to put on policymakers to make the efficient choice.<sup>77</sup> One could not formulate that duty as owing to one class of individuals more than to another, if efficiency were the goal. If one wanted policymakers to be duty bound to choose efficiently, one would find useful some abstract noun such as "society" to stand in as the object of the duty to maximize the sum of individual utilities. In fact, it is commonplace in utilitarian thinking to use abstract collective entities to serve as shorthand for the sum of in-

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The very embodiment of reification, of course, is G.W.F. HEGEL, *THE PHENOMENOLOGY OF SPIRIT* (Arnold V. Miller trans., 5th ed. 1977).

73. See EASTERBROOK & FISCHER, *supra* note 3, at 12; Bainbridge, *supra* note 9, at 863 n.22.

74. See POSNER, *supra* note 61, at 13; RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 48-115 (1981).

75. See JULES L. COLEMAN, *MARKETS, MORALS AND THE LAW* 98 (1988); POSNER, *supra* note 61, at 3-26; Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549, 550-51 (1939).

76. Perhaps "rarely" is an exaggeration. For criticisms of reification in various contexts, see Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 *WASH. & LEE L. REV.* 1565, 1578-79 (1993) (reification of "corporation"); Charles A. Reich, *The Individual Sector*, 100 *YALE L.J.* 1409, 1441 (1991) (of "society"); and Steven L. Winter, *The Meaning of "Under Color of" Law*, 91 *MICH. L. REV.* 323, 334 (1992) (of "state").

77. See KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* 46-60 (1963).

dividual interests. To say “society” corresponds to everybody seems inaccurate, since utility maximization, or more correctly wealth maximization, might require advancing one person’s interest ahead of another’s. In fact, “society” used this way corresponds more nearly to an abstract quantity, the sum of the respective utilities or wealth of individuals.

The corporation can be thought of this way as well. The corporate entity thought of this way has an economic meaning if we conceive of it simply as shorthand for the sum of the values of all the various voluntary arrangements that make it up. To say that a manager owes a duty to “the corporation” to maximize the value of the corporation is simply one way of stating a gap-filling principle that applies to all of the contracts that make up the corporation. It is no more mysterious to say this than it is to say that a policymaker has a duty to do the thing that will make “society” best off, where society is understood to mean the sum of the interests of individuals who make up society.

Given its somewhat lurid historical associations with idealist philosophy, it is understandable that empirically oriented legal economists view the corporate “entity” with suspicion.<sup>78</sup> There certainly have been those who have reified the corporation.<sup>79</sup> My proposed conception of the corporate entity, however, is economically meaningful and entails no disreputable ontological commitments. A reformulated duty to maximize the value of the corporation involves no reification. It is merely a shorthand way of expressing a duty to maximize the sum of the value of the various financial claims on the corporation, which, to be ontologically fastidious, are only indirect claims on other participants in the firm’s enterprise.

#### D. “Other Constituencies” of the Corporation

Corporate law scholars have devoted much attention in the last several years to the question of what duties, if any, managers have to constituencies of the corporation other than shareholders. The reason for this is largely historical. Corporate-control market activity in the 1980s and early 1990s led to changes of control of many American firms. One of the main motives for many of these transactions was to reallocate firm resources to more efficient uses, a project that involved terminating workers and closing facilities that could no longer be used profitably. Management threatened by control transactions and workers and other interests in communities where plants might be closed thus had a common interest in getting state legislatures to enact

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78. For denunciations of reification, see EASTERBROOK & FISCHER, *supra* note 3, at 11-12; Victor Brudney, *Association, Advocacy, and the First Amendment*, 4 WM. & MARY BILL RTS. J. 1, 67 (1995); Jensen & Meckling, *supra* note 11, at 311.

79. See *supra* notes 71-72.

antitakeover legislation. A prominent feature of state antitakeover legislation was provisions that enable firm managers to take into account the interest of constituencies of the corporation such as workers, creditors, and local communities in deciding whether to oppose a hostile takeover. Academic commentators tended to polarize in their public-policy evaluations of these statutes.

This Article, however, bears only indirectly on this debate. This is because finance theory presently has little to add to the weighing of the interests of, say, production line workers against those of financial claimants against the corporation. There are compelling theoretical reasons arising directly from modern finance theory for treating providers of capital to the firm as being diversified in a certain way. This Article stresses that in light of modern finance theory it is as incorrect to treat shareholders and bondholders as separate opposing interests for purposes of determining default rules as it would be to assume shareholders are not diversified. Any model that proposes to fill gaps in the contracts of providers of capital to the firm should take the consequences of modern finance theory seriously into account.

This does not mean, however, that with no additional theoretical warrant, we can somehow extend the analysis to all providers of inputs to the firm. In some very general sense, one who uses efficiency as a normative guide should ask, does a permissive regime for corporate control transactions, for example, hurt some participants in corporate enterprises more than it helps others?<sup>80</sup> Some commentators have examined Pareto-efficient rules under which losers in corporate transactions would be compensated by winners.<sup>81</sup> These debates, however, are more ambitious than anything I attempt here. There is as yet no consensus about how to define legal duties among all constituencies of the corporation, particularly workers and other providers of human capital. This Article stresses, however, that the current prevailing position, that the shareholders are and ought to be the primary beneficiaries of the fiduciary duty, is indefensible in light of standard financial theory, even now, before more difficult and perhaps intractable questions about the relations of financial and nonfinancial inputs to the firm have been entirely resolved. The difficulty of the latter, more global set of questions should not obscure what clarity may be brought to the duties owed to financial claimants on the corporation. Some future theory may elegantly model and explain the firm and its relations to all the diverse financial and nonfinancial parties in its entire network of contracts. We already have, however, in CAPM a powerful

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80. Jeffrey MacIntosh, for example, organizes possible efficient forms of corporate fiduciary duty into several categories, including Pareto-superior and Kaldor-Hicks efficient forms of the duty. See MacIntosh, *supra* note 42, at 429-30. My proposal would presumably fall into the Kaldor-Hicks category. *But cf. supra* note 59 (giving an example where Kaldor-Hicks efficiency may be an inappropriate norm).

81. See MacIntosh, *supra* note 42, at 435-40.

theory about rational financial behavior. Shareholder value maximization is not a plausible candidate for fiduciary duty under that theory.

### III. THE INDIFFERENCE OF PUBLIC CORPORATION LAW TO DISTRIBUTIONAL ISSUES

Conceiving of the corporate law norm as maximizing the value of the corporation has some interesting consequences. The fiduciary gap-filling rule that flows from hypothetical bargain analysis mandates maximization of firm value, but the rule is indifferent among equally efficient distributions among different asset classes of public corporations.<sup>82</sup> When one considers the permissive attitude corporate law takes in the public corporation context toward gap-filling decisions with distributional consequences, this formulation of fiduciary duty seems descriptive of, or at least consistent with, some actual practice. I briefly consider below three areas where this thesis is borne out: leveraged buyouts (LBOs), targeted share repurchases, and recapitalizations affecting preferred stock. The doctrines that produce the judicial results found in these areas differ, but one could regard the principle as the same. Unless express terms of the corporate contract provide otherwise, managers may take steps to maximize firm value regardless of the horizontal or distributional effects on particular assets classes.

#### A. LBOs, Bondholders, and Fiduciary Duties

In the late 1980s, the RJR/Nabisco transaction and other large LBOs generated considerable controversy. One debated feature of LBOs was the losses they could cause to the market value of bonds outstanding when acquirers bought the target firm. Acquirers often financed LBOs partly through the issuance of new debt by the target firm. Even if existing debt of the target was senior to the new debt, the market value of the old debt could fall, partly because in practice absolute priority is usually not strictly observed in bankruptcy.<sup>83</sup> Thus

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82. The efficient gap-filling rule mandates that the size of the corporate pie be maximized but does not mandate any particular division of the pie among various classes of investors in the corporation.

83. See John D. Ayers, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963 (1989); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988); Carliss Y. Baldwin & Scott P. Mason, *The Resolution of Claims in Financial Distress: The Case of Massey Ferguson*, 38 J. FIN. 505 (1983); Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1468 (1990); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747 (1989); Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009 (1987); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1836 (1998); David A. Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After Ahlers*, 63 AM. BANKR. L.J. 221 (1989); Jerold B. Warner, *Bankruptcy, Absolute Priority,*

the new debt, even though junior, could effectively dilute the claims of senior bondholders.

This effect was particularly stark in the RJR/Nabisco deal, where bondholders reportedly lost approximately \$40 million in market value from the pretransaction value of their bonds.<sup>84</sup> Bondholders of RJR/Nabisco sued their issuer, claiming that by approving the LBO, the target board had violated a fiduciary or similar duty that they owed bondholders.<sup>85</sup> While bondholders lost this case, they won the support of some academic commentators. David Millon, for example, has argued that bondholders in cases like RJR/Nabisco ought to benefit from fiduciary protection. Managers should be regarded, he argues, as having a duty to treat shareholders and bondholders according to a rule of Pareto-optimality.<sup>86</sup> That is, managers should not be able to make an investment decision, such as to approve an LBO, even if it would make shareholders better off, if it would make bondholders worse off.

To test Millon's claim, it might seem we should ask whether Pareto-optimality is the rule to which hypothetical shareholders and bondholders would agree as a gap-filling principle for the corporate contract.<sup>87</sup> As I noted above, the main response of economic analysts to arguments of Millon and other bondholder advocates has been to insist that bondholders have in effect contracted out of any fiduciary protection in the hypothetical bargain.<sup>88</sup> In this view, bondholders

and the Pricing of Risky Debt Claims, 4 J. FIN. ECON. 239 (1977); Lawrence A. Weiss, *The Bankruptcy Code and Violations of Absolute Priority*, 4 J. APPLIED CORP. FIN. 71 (1991).

84. See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989); BRYAN BURROWS & JOHN HELYAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* (1990); Bratton, *supra* note 50; Nancy W. Graml, *Bondholder Rights in Leveraged Buyouts in the Aftermath of Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*, 29 AM. BUS. L.J. 1 (1991); Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993); Kahan & Klausner, *Anti-takeover Provisions in Bonds*, *supra* note 50, at 932 n.1; Kahan & Klausner, *The Qualified Case Against Mandatory Terms in Bonds*, *supra* note 50; Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647 (1996); F. John Stark III et al., *"Marriott Risk": A New Model Covenant to Restrict Transfers of Wealth from Bondholders to Stockholders*, 1994 COLUM. BUS. L. REV. 503; Kenneth N. Gilpin, *Bid for RJR Nabisco Jolts Bonds*, N.Y. TIMES, Oct. 21, 1988, at D11; Wayne E. Green & Sonja Steptoe, *Metropolitan Life Joins Backlash Against Leveraged Buy-Outs*, WALL ST. J., Nov. 18, 1988, at C1; Glenn Ruffenach & Randall Smith, *RJR Nabisco Gets Major Jolt in Debt Ratings*, WALL ST. J., Jan. 29, 1990, at A3; Ames Sterngold, *Kohlberg Leads Latest Nabisco Bids*, N.Y. TIMES, Nov. 30, 1988, at D1.

85. See *Metropolitan Life*, 716 F. Supp. at 1508.

86. See Millon, *Redefining Corporate Law*, *supra* note 4, at 267-68.

87. See Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 761 (1978); Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 61, at 702; McDaniel, *supra* note 50, at 447; Morey W. McDaniel, *Bondholders And Stockholders*, 13 J. CORP. L. 205, 246 (1988).

88. See EASTERBROOK & FISCHEL, *supra* note 3, at 52; Bainbridge, *supra* note 3, at 1443; Macey, *supra* note 7, at 36-39; Kenneth Lehn, *The Lessons of Marriott*, WALL ST. J., Mar. 11, 1993, at A14.

have agreed to shareholder value maximization as the gap-filling rule, or contracts with bondholders are assumed to be effectively gapless. In either event, bondholders do not enjoy fiduciary protection. This response, however, is weak. The argument that bond contracts need no gap filling, which I criticize above, seems especially disingenuous in the LBO context, when one considers the surprise with which bondholders and bond markets greeted the financial innovations spawned by LBOs.<sup>89</sup> One could also argue that the emergence of event risk covenants,<sup>90</sup> devices intended to protect existing bondholders from losses caused by LBOs, is evidence that creditors had not anticipated bond losses by LBOs.<sup>91</sup> If one grants that bond contracts do require a gap-filling principle, then the question of what it should be remains.

If one envisions the appropriate gap-filling principle as emerging from a hypothetical contract negotiation between bondholders and shareholders, then Millon's proposal might seem correct. Bondholders, one might argue, would have little reason to agree to anything less than Pareto-optimality, since such a rule would not allow managers to favor shareholders at their expense. Yet proponents of shareholder wealth maximization might equally well contest this point. They might argue that bondholders would agree to a rule that shareholder value be maximized, subject only to the express constraints in bond contracts. Bondholders would prefer to have no open-ended protection, they could argue, because the cost of this protection to them in terms of lower interest rates would be too high.<sup>92</sup>

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89. See Christopher Farrell, *Bondholders Are Mad as Hell — and They're Not Going to Take It Anymore*, BUS. WK., Feb. 6, 1989, at 82; Christopher Farrell, *Takeovers and Buyouts Clobber Blue-Chip Bondholders New Debt to Finance—or Fend Off—Corporate Raiding Sends Prices Tumbling*, BUS. WK., Nov. 11, 1985, at 113; Wayne E. Green & Sonja Steptoe, *Metropolitan Life Joins Backlash Against Leveraged Buy-Outs*, WALL ST. J., Nov. 18, 1988, at C1; Gary Hector, *The Bondholders' Cold New World. (Securities Devalued Because of Leveraged Buyouts and Other Debt-Riddled Deals)*, FORTUNE, Feb. 27, 1989, at 83; James E. Leberer, *Taking a Look Back at the Year in Fixed-Income Securities*, WASH. POST, Jan. 1, 1989, at H6; Paul Richter, *The Deal That Burst the Bubble for KKR Buyouts: The Bankruptcy Filing of Hillsborough Holdings, Formerly Jim Walter Corp., Was the End of an Era for an Investment Giant Of The '80s*, L.A. TIMES, Jan. 9, 1990, at D1; Linda Sandler, *Southland's Junk Bonds Face Trouble*, WALL ST. J., Sept. 7, 1989, at C3; Linda Sandler, *"Predators Ball" Belles Will Be Buy-Out Bonds*, WALL ST. J., Apr. 4, 1989, at C3.

90. See Stark et al., *supra* note 84, at 566-81 (describing development of event risk covenants).

91. See Bratton, *supra* note 50, at 156; Graml, *supra* note 84, at 34-35; Stark et al., *supra* note 84, at 509; Peter D.W. Heiberling, *Event Risk Provisions Protect Bondholders Against Takeovers*, 22 NAT'L L.J., June 5, 1989, at 22; Daniel Hertzberg, *Poison Put Bonds Are Latest Weapon in Companies' Anti-Takeover Strategy*, WALL ST. J., Feb. 13, 1986, at A5; Larry Light, *Investors Are Developing a Taste for This Poison*, BUS. WK., July 10, 1989, at 78.

92. See Hurst & McGuinness, *supra* note 42 at 211-12; Kahan & Klausner, *Antitakeover Provisions in Bonds*, *supra* note 50, at 937-38; Kahan & Klausner, *The Qualified Case Against Mandatory Terms in Bonds*, *supra* note 50; Macey, *supra* note 7, at 36; Andrew J. Nussbaum, *Like Money in The Bank? An Economic Analysis of Fiduciary Duties to Protect the S&L Deposit Insurance Fund*, 44 ADMIN. L. REV. 355, 365-66 (1992); Schwarz, *supra*

The important thing to notice about this disagreement between bondholder advocates and proponents of shareholder value maximization is its intractability. They disagree essentially over what preferences should be ascribed to bondholders. The mere ascription of preferences, however, is a notoriously weak foundation for economic explanation. Consider first the claim of proponents of shareholder value maximization. Their argument against any duty to bondholders rests on the claim that bondholders and shareholders would agree *ex ante* to terms that put the risk of loss from financial innovation on bondholders, because shareholders would demand a price higher for protection from such loss than bondholders would be willing to pay. This argument amounts to no more than an assertion about what prices, as a result of underlying preferences, would be. We cannot, however, know what relative preferences and therefore prices will be between bondholders and shareholders respecting financial innovation risk by looking at any deals shareholders and bondholders have actually struck. In practice, bondholders cannot contract into fiduciary or similar protection as a gap-filling rule that is superior to what shareholders get, whether or not they wanted to do so. Bondholders could not get a contractual term that says, "for all matters not addressed in this contract, the interests of bondholders are to be treated by corporate directors as equal to (or superior to) those of common shareholders." As interpreted by modern courts and academic commentators, such a provision would violate managers' fiduciary duty to shareholders.<sup>93</sup> If bondholders and shareholders were so free, then their failure to agree on such benefits for bondholders might be evidence that from their perspective the costs of this protection would outweigh the benefits. But as long as the governing rule is that shareholders benefit exclusively from a fiduciary duty and bondholders can get only express contractual protections, a contract term purporting to provide bondholders with something like gap-filling fiduciary protection would be unenforceable. Nothing consequently can be inferred from the present allocation of risks, not even underlying preferences.

Critics of shareholder value maximization, however, are in an equally untenable position. Millon imagines, in effect, a hypothetical bargain between bondholders and shareholders, resulting in a Pareto-optimality rule protecting bondholders; however, this result is based, as much as the argument above is based, on ungrounded assumptions about what bondholders would prefer. It simply assumes bondholders would value this protection by more than shareholders would charge for it. Millon on one side, and Easterbrook and Fischel on the other, are arguing over what is inside a black box.

Yet the exercise is useful because it makes one realize that once

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note 84, at 681; Stark et al., *supra* note 84, at 579.

93. See *supra* notes 3, 19, and 23.

one has imaginatively put bondholders and shareholders across the table to negotiate gap-filling rules, there is no determinate outcome, be it Pareto-optimality, or shareholder wealth maximization, or anything else (unless one begs the question by asserting that the parties' preferences will lead to one's preferred result). Framed as a hypothetical contract between shareholders and bondholders, the problem of settling on a gap-filling rule is intractable. This is a clue that the problem is incorrectly formulated. As I have argued in this Article, however, there is a way out. That way is to take the gap-filling rule as the result not of a hypothetical bargain among shareholders and bondholders (and other layers of the corporate capital structure), but as the result of a hypothetical bargain among the rational investors in the firm. They would settle on the maximization of firm value as the filler of gaps in the corporate contract. Cast this way, the problem is anything but intractable.

We can apply this gap-filling principle to cases in which bondholders have invoked a purported fiduciary duty owed to them. In *Metropolitan* and other cases,<sup>94</sup> the courts ruled that bondholders could not recover losses they suffered as a result of leveraged transactions that did not violate express contract terms. This result would be consistent with the rule rational investors would select as a gap-filling rule, but only if the transaction in question increased the value of stock by more than it decreased the value of the bonds. There is some evidence that LBOs by and large did have this firm-value-increasing effect.<sup>95</sup> Rationally diversified investors would approve transactions that increased firm value and would be indifferent toward distributional issues, for example the losses to bondholders. This principle would, of course, only be a gap-filling rule. If firms would be worth more with stronger or weaker bondholder protections than those implicit in this gap-filling rule, they

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94. See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1508 (S.D.N.Y. 1989); see also *Harris Trust & Sav. Bank v. E-II Holdings, Inc.*, 926 F.2d 636, 643-44 (7th Cir. 1991); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929 (5th Cir. 1981) (en banc); *Hartford Fire Ins. Co. v. Federated Dep't Stores*, 723 F. Supp. 976 (S.D.N.Y. 1989); *Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988); *Pittelman v. Pearce*, 8 Cal. Rptr. 2d 359 (Ct. App. 1992); *Katz v. Oak Indus. Inc.*, 508 A.2d 873 (Del. Ch. 1986); *Hazzard v. Chase Nat'l Bank*, 287 N.Y.S. 541, 566-67 Sup. Ct. (1936), *aff'd mem.*, 14 N.Y.S.2d 147 (App. Div. 1939), *aff'd mem.*, 26 N.E.2d 801 (N.Y. 1940).

95. See Paul Asquith & Thierry A. Wizman, *Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts*, 27 J. FIN. ECON. 195 (1990); Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 818-19 (1987); Kenneth Lehn & Annette Poulsen, *Free Cash Flow and Stockholder Gains in Going Private Transactions*, 44 J. FIN. 771 (1989); Laurentius Marais et al., *Wealth Effects of Going Private for Senior Securities*, 23 J. FIN. ECON. 155 (1989); Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207 (1988); Krishna G. Palepu, *Consequences of Leveraged Buyouts*, 27 J. FIN. ECON. 247 (1990).



should be able to provide for that by contract. Absent such express provisions, however, if an LBO were to decrease total firm value by reducing the value of bonds by more than it increased the value of stock, a court applying the fiduciary duty principle I propose should rule that the transaction breached a fiduciary duty that the managers owed not to bondholders, but to the target corporation.<sup>96</sup>

Cases such as *Metropolitan* would thus probably come out the same way under the neotraditional version of the fiduciary duty I propose as they did under the analysis courts actually employed. This convergence may constitute some weak support for my view, in the sense that it is consistent with these judicial results. LBO cases might also be taken as support for the general view that courts applying fiduciary duty analysis to public corporations accord little weight to purely distributional concerns in filling gaps in the public corporate contract. This emphasis on maximizing firm value is consistent with the neotraditional approach.

### B. Targeted Share Repurchases and Auctions — Unocal and Revlon

In targeted share repurchases (“TSRs”), corporations buy back stock from some shareholders but not others. TSRs typically involve the purchase of a large block of shares from a potential acquirer of the company at a significant premium over their market value and their purchase price.<sup>97</sup> Though stigmatized as “greenmail,” evidence suggests that TSRs may actually increase, on average, the total value of companies that engage in them.<sup>98</sup> Yet TSRs probably also distribute gains disproportionately from some shareholders to others.

TSRs typically involve shares of public corporations. They represent a relatively clear instance in which shareholders are not treated with horizontal equality but in which the transaction in question in-

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96. See Schwarcz, *supra* note 84, at 685-86.

97. See Michael Bradley & Michael Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377 (1986); Michael Bradley & L. Macdonald Wakeman, *The Wealth Effects of Targeted Share Repurchases*, 11 J. FIN. ECON. 301, 306-07 (1983); Larry Y. Dann, *Common Stock Repurchases: An Analysis of Returns to Bondholders and Stockholders*, 9 J. FIN. ECON. 113 (1981); Larry Y. Dann & Harry DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 J. FIN. ECON. 275, 285-88 (1983).

98. See Bradley & Wakeman, *supra* note 97, at 312-13; William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 398; Dann & DeAngelo, *supra* note 97, at 295; Clifford G. Holder-ness & Dennis P. Sheehan, *Raiders or Saviors? The Evidence on Six Controversial Investors*, 14 J. FIN. ECON. 555 (1985); Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185, 208-09 (1993); Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985); Wayne H. Mikkelson & Richard S. Ruback, *Targeted Share Repurchases and Common Stock Returns*, 22 RAND J. ECON. 544 (1991); A. Schliefer & R.W. Vishny, *Greenmail, White Knights, and Shareholders Interest*, 17 RAND J. ECON. 293 (1986).

creases the total value of all financial claims on the company. Permissive treatment of TSRs by courts is consistent with the idea that the corporate law norm mandates maximization of firm value but is relatively indifferent to distributional consequences even within a single class of claimants, unless distributions violate express corporate contractual terms.

TSRs are restricted, however, when there is substantial reason to doubt that their use will maximize firm value. *Unocal* involved a TSR formulated to protect against a tender offer hostile to the firm's incumbent management.<sup>99</sup> The Delaware court imposed the restrictions of what became known as the *Unocal* standard.<sup>100</sup> This standard is sometimes construed as permitting TSRs calculated to increase firm value, by fending off low bids, for example, but not those merely intended to entrench management.

The landmark *Revlon* case,<sup>101</sup> often cited as support for shareholder primacy, deserves special attention. It made explicit a fiduciary duty to maximize the value of the winning bid in the context of a firm sale.<sup>102</sup> In *Revlon*, management's attempted friendly deal with the white knight Forstmann-Little stopped the auction of the firm in exchange for the white knight's supporting the price of notes whose poison-pill-like covenants had to be removed for the friendly deal to go forward. The white knight's promise to support note prices was apparently calculated to reduce the exposure of target directors to personal liability from suits by disaffected note holders.<sup>103</sup> *Revlon* could be taken to stand for the proposition that a bidder could do nothing to accommodate vulnerable note holders or other claimants, if it meant shareholders would get one penny less.<sup>104</sup>

This is, however, exactly the sort of shareholder primacy an efficient corporate law norm should eschew. Under my theory, *Revlon* management should have been allowed to accept, after a firm-value-maximizing auction, a bid that offered the most in total value for the firm, even if it offered less than another bid for stock. Would one really want courts to compel *Revlon* management to accept, with the company on the auction block, a *lower* bid, just because it offered

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99. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

100. See *Unocal*, 493 A.2d at 955; Eric A. Chiappinelli, *The Life and Adventures of Unocal — Part I: Moore the Marrier*, 23 DEL. J. CORP. L. 85 (1998); Janet E. Kerr, *Delaware Goes Shopping for a "New" Interpretation of the Revlon Standard: The Effect of the QVC Decision on Strategic Mergers*, 58 ALB. L. REV. 609, 616-20 (1995).

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

102. See *Revlon*, 506 A.2d at 182.

103. See *Revlon*, 506 A.2d at 184.

104. See *Revlon*, 506 A.2d at 182 (chastising *Revlon* management for accepting buyout terms that benefited subordinated note holders at the expense of shareholders).

more per share than another bid that offered to buy both Revlon stock and notes, and offered more in total for securities of the company? To insist on such a result would make a fetish of shareholder value maximization. The neotraditional approach I propose is entirely consistent with a rational version of the *Revlon* duty that would require managers, when auctioning off the company, to sell it to the highest bidder. My approach merely insists that the size of the bid be measured by the sum of amounts offered for all of the target's securities, not merely its common stock. In any event, it seems unlikely that the sum Forstman-Little actually offered for Revlon notes, even if taken into account, would have made its bid the highest. If, however, it would have, then Revlon management would have acted consistently with their fiduciary duty, in my view, in selling Revlon to Forstman-Little. Indeed, one can imagine that in a case like *Revlon*, a white knight and incumbent management might want to budget part of the total expense of acquiring control of the target firm toward relief of noteholders or other financial claimants who would otherwise suffer losses from the transaction and therefore oppose it. It would be arbitrary to refuse to count these payments as part of the value the bidder was offering to pay for the target firm.

### C. Recapitalizations Affecting Preferred Stock

Although not residual claimants, preferred stockholders are equity claimants on their firm and, traditionally, beneficiaries of a fiduciary duty.<sup>105</sup> Yet a series of celebrated corporate law cases shows the notorious indifference of corporate law toward managerial decisions that allocate corporate value away from preferred stockholders and toward common stockholders.<sup>106</sup> In these recapitalizations, accumulated preferred dividends were extinguished and replaced with newly issued common or preferred stock. As a first approximation, this sort of re-

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105. See *Great W. Producers Co-op. v. Great W. United Corp.*, 613 P.2d 873, 875 (Colo. 1980); *Kirschner Bros. Oil v. Natomas Co.*, 185 Cal. App. 3d 784, 788 (Cal. Ct. App. 1986); *Security Nat'l Bank v. Peters, Writer & Christensen, Inc.*, 569 P.2d 875, 881 (Colo. Ct. App. 1977); *Jedwab v. MGM Grand Hotels*, 509 A.2d 584, 594 (Del. Ch. 1986); Susan A. Barrett, *Fiduciary Duties and Stock Warrants: A Fine Distinction Between Shareholder Rights and Contract Rights*, 21 STETSON L. REV. 253, 260 (1991); Brudney, *Contract and Fiduciary Duty*, *supra* note 45, at 651; Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (and Why We Should Care About It)*, 51 BUS. LAW. 443, 454 (1996); Robert B. Robbins & Barton Clark, *The Board's Fiduciary Duty to Preferred Stockholders*, 7 INSIGHTS, No. 11, at 18, 21-22 (1993).

106. See *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944); *Bove v. Community Hotel Corp.*, 249 A.2d 89 (R.I. 1969); *Western Foundry Co. v. Wicker*, 85 N.E.2d 722 (Ill. 1949); *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949); *Iowa ex rel. Weede v. Bechtel*, 31 N.W.2d 853 (Iowa 1948); *Johnson v. Fuller*, 121 F.2d 618 (3d Cir. 1941); *Wessel v. Guantanamo Sugar Co.*, 35 A.2d 215 (N.J. Ch. 1944), *aff'd*, 39 A.2d 431 (N.J. 1944); *Buckley v. Cuban American Sugar Co.*, 19 A.2d 820 (N.J. Ch. 1940); *HB Korenvaes Invs., L.P. v. Marriott Corp.*, 19 DEL. J. CORP. L. 748 (1993); *Johnson v. Lamprecht*, 15 N.E.2d 127 (Ohio 1938).

capitalization should have, under the Miller-Modigliani irrelevance theorem, only distributional consequences and leave the total value of the firm unaffected.<sup>107</sup>

Courts addressed these cases with contract-style analysis. They read the corporate contract as containing an implicit term that the chartering authority, the state legislature, could change the rules by passing merger statutes that allowed the sort of recapitalization statute in question to proceed.<sup>108</sup> Another slightly narrower and perhaps preferable interpretation of these cases would be to take courts as filling gaps in corporate contracts. The contracts were silent on the rights and duties of various classes of equity claimants in the face of legal innovation. The courts might be seen as applying a hypothetical contract term that rational investors proportionally invested in common and preferred stock would prefer, namely that transactions that might increase the value of the firm, even while distributing gains from one equity class to another, be permitted, unless specifically prohibited by other terms in the corporate contract. If this is the correct gap-filling principle, the courts' seemingly cold treatment of preferred stockholders is unobjectionable. The decisions are consistent with a default rule to which rational investors would agree *ex ante*.

#### D. *Close Corporations*

As D. Gordon Smith recently argued, the history of the shareholder primacy doctrine bears out the idea that it historically dealt mainly with horizontal equity among shareholders in the context of the close, not public, corporation.<sup>109</sup> The famous *Dodge v. Ford Motor Co.*<sup>110</sup> case, often cited as a landmark statement of the shareholder primacy norm,<sup>111</sup> far from "enunciating a meta-principle of corporate law," as Smith points out, "was merely deciding a dispute between majority and minority shareholders in a closely held corporation in the same way courts had decided such disputes for nearly a century."<sup>112</sup> As Smith explains, the shareholder primacy norm grew out of the older idea that the corporation was a trust for those interested in it, namely shareholders. Controlling shareholders had a fiduciary duty to

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107. See RICHARD A. BREALEY & STEWART C. MEYERS, *PRINCIPLES OF CORPORATE FINANCE* 376 (4th ed. 1991).

108. See *Bove*, 249 A.2d at 97-98 (stating that "the stockholder's contractual rights have been altered, but in each instance the alterations are permitted by the stockholder's contract into which the law reads the reserved power to amend or repeal. That power is a part of the charter or articles of association of every Rhode Island corporation").

109. See Smith, *supra* note 3, at 322-23.

110. 170 N.W. 668 (Mich. 1919).

111. See Bainbridge, *supra* note 3, at 1423-24.

112. Smith, *supra* note 3, at 320.

all shareholders. This idea matured into the modern doctrine of minority oppression. The idea behind the doctrine lingered on in phrases in the case law, such as the oft-quoted language of *Ford* and of *Miner v. Belle Isle Ice Co.*: “[T]he ultimate object of every ordinary trading corporation is the pecuniary gain of its stockholders.”<sup>113</sup>

For purposes of the neotraditional formulation of the corporate norm, however, corporations with publicly traded securities and closely held corporations should be clearly distinguished. This is because the logic of the neotraditional formulation is driven by the choices of rational investors in the capital markets. While there is a strong warrant for treating diversified investors as complying with the full mandate of CAPM, treating part owners of close corporations, who are more akin to partners in an enterprise, in the same way would not be justifiable. This does not mean that analysts would not profit from taking a contractual approach to understanding the law of close corporations, as some scholars have done.<sup>114</sup> It merely means that the conclusions that follow from the diversification of rational CAPM investors do not apply directly to the close corporation context.

#### IV. THE CORPORATE LAW NORM AND “DERIVATIVE REALITY”

I have argued that the corporate law norm of “maximizing shareholder value” is inefficient. I began with the problem of *Credit Lyonnais* and used the omnipresence of the “vicinity of insolvency”<sup>115</sup> to suggest the depth of the problem. The neotraditional corporate law norm, I argue, is the way out of this conundrum: rational investors would choose in a hypothetical bargain to maximize firm, not shareholder, value.

One might argue that the difference between the shareholder value maximization and the neotraditional formulation of fiduciary duty is not that important. In most garden-variety firms, one might say, both norms would point managers in the right direction, and the practical problem will always be pushing managers the right way. Arguing about whether the fiduciary duty should require maximizing firm value, instead of shareholder value, one might say, is arguing about the details of a utopia no one will ever actually see. This criticism, however, would be shortsighted, as I argue below.

Shifting to the neotraditional norm would make a significant difference to corporate law practice and judicial opinions but, under current conditions, not a radical one. I suggested above two immediate implications of my proposal. First, under the neotraditional formula-

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113. 53 N.W. 218, 223 (Mich. 1892); see also Smith, *supra* note 3, at 314 (relating *Miner* to the nineteenth century shift to protection of minority shareholders).

114. See EASTERBROOK & FISCHER, *supra* note 3, at 228-52.

115. See *supra* Section I.A.2.

tion of the fiduciary duty, the *Revlon* duty would have to change: target managers should be able to accept a friendly bid, if that bid totaled more than another bid that offered more for the target's common stock.<sup>116</sup> Second, transactions that reduced the total value of the firm, even though they increased the value of the target's common stock, as a leveraged buyout could conceivably do, should be seen as violating managers' fiduciary duty to the corporation, unless the transaction was expressly permitted by the "corporate contract" — in the corporate articles or bond indentures, for example. Leveraged transactions that are inefficient in this way, I grant, would probably be extreme and unusual.<sup>117</sup>

The most important difference that a shift would make, however, stems from the tendency of economic evolution to subject our legal infrastructure to stress, turning relatively harmless doctrinal incoherencies into embarrassing errors. In the next few decades, it seems likely, as Professor Hu has argued, that financial innovation, in particular the development of various equity derivatives, will test current conceptions of fiduciary duty.<sup>118</sup> It is already obvious that the shareholder value maximization norm will not be up to these tests. As capital markets grow more complete, the problems with the shareholder value maximization norm will be difficult to limit to merely academic discussions.

## A. *Disaggregating Equity*

### 1. *Residual Claims*

Financial products can be quite complicated,<sup>119</sup> but for our purposes the theoretical problems raised by equity derivatives can be described simply and schematically. Modern financial theory explains that options are the building blocks of all financial instruments and provides precise models of how options are priced.<sup>120</sup> "Financial engi-

116. See *supra* text accompanying notes 97-98.

117. See *supra* note 97 and accompanying text.

118. See sources cited *supra* notes 13-17 and accompanying text.

119. For general discussions of different derivatives, see Hu, *supra* note 15; Karol, *supra* note 17; Kleinbard, *supra* note 16; Joseph L. Motes III, *A Primer on the Trade and Regulation of Derivative Instruments*, 49 SMU L. REV. 579 (1996); Barbara Donnelly Granito, *Common Terms in the Derivatives Market*, WALL ST. J., Aug. 10, 1993, at A6; Cathy E. Minehan & Katerina Simons, *Managing Risk in the '90s: What Should You Be Asking About Derivatives?*, NEW ENG. ECON. REV., Sept. 19, 1995, at 3; Balvinder S. Sangha, *Financial Derivatives: Applications and Policy Issues*, BUS. ECON., Jan. 1 1995, at 46.

120. Options are the building blocks of more complex derivatives. See Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 216 (1997); Kenneth A. Froot et al., *A Framework for Risk Management*, HARV. BUS. REV., Nov.-Dec. 1994, at 91, 99; Donald L. Horwitz, *Derivatives, I: The Basics on Terms and Risks*, 5 BUS. L.

neers," who design new security products, can therefore disaggregate common stock into its component financial parts, including options. Equity can be disaggregated in different ways, but for our purposes we can imagine this process as being analogous to the slicing of a cake; but unlike the usual practice of cutting perpendicularly to the bottom of the cake, imagine slicing along a horizontal plane, parallel to the bottom of the cake. Slicing common stock horizontally, in this picture, divides it into different call-option-like claims that have different exercise prices. I call this "horizontal" because these divisions are like the horizontal divisions between different layers of financing on the right side of the corporate balance sheet. These layers of conventional financing are, after all, like call options that have increasingly high exercise prices as one moves down the right side of the balance sheet (through horizontal layers) from senior debt to common stock. Thus the senior-most debt has an exercise price of zero. The first dollars of the firm's value must go to those who hold the senior-most claims. These claims are capped at the total amount due on the senior debt, and this line marks the beginning, or exercise price, of the next layer of firm financing. This layer in turn has a cap equal to the exercise price of the next layer, and so forth, until one reaches the junior-most claims on the firm.

In a conventional capital structure, the bottommost layer would be common stock of the familiar sort. These are the residual claimants in whom the standard view of corporate law would vest control rights and the exclusive right to benefit from the fiduciary duty, because of their supposed incentives to maximize the value of the firm. What advances in financial technology make it possible to do, among other things, is to slice the distribution of risks and returns depicted on the conventional corporate balance sheet into thinner layers. To take one example, some investment bankers once proposed that firms sell "unbundled stock units."<sup>121</sup> The proposed transaction would have divided up common stock into several components, including a security representing the expectation that firms would continue to pay dividends at historical rates, and also a call-option-like security representing a claim to appreciation of the firm's value above its current value. Of course, one would not have to stop there. One could disaggregate

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TODAY, Sept.-Oct. 1995, at 38; Sangha, *supra* note 119, at 46.

121. For the story of unbundled stock units, see, for example, Alan J. Berkeley & Jean E. Minarick, *Disclosure and Developments in Financing Instruments and Techniques*, 703 PLI/CORP 335, 349 (1990); John D. Finnerty & Victor M. Borun, *An Analysis of Unbundled Stock Units*, 1 GLOBAL FIN. J. 47-69 (1989); Hu, *supra* note 15, at 1299; Raymond W. Wagner, *Unbundled Stock Units*, 662 PLI/CORP 175 (1989); Report, *Sixth Annual Review of Developments in Business Financing*, 45 BUS. LAW. 441, 446-49 (1989) (describing unbundled stock units); George Anders & Steve Swartz, *Some Big Firms to Break up Stock into New Securities*, WALL ST. J., Dec. 5, 1988, at C1; Floyd Norris, *Shearson's Financial Alchemy*, N.Y. TIMES, Dec. 11, 1988, at F1; and William E. Sheeline, *Unbundled Stocks: How They Work*, FORTUNE, Jan. 2, 1989, at 11.

common stock into any number of call-option-like claims, each class of which would give the holder a claim to the value of the firm at increasingly larger amounts above its current value. These "horizontal" call option slices of the value of firm, being further and further "out of the money," would represent increasingly "residual" and increasingly leveraged claims on the value of the firm.<sup>122</sup>

Using new financial products to disaggregate equity horizontally does not achieve anything fundamentally different from what financiers could do with more familiar tools. Simply by borrowing more money, for example, managers could make the firm more highly leveraged, and this would, in effect, increase the exercise price of the call options we quaintly call the common stock. For lawyers thinking about fiduciary duty, what the new instruments can do, however, is to force one to confront doctrinal difficulties. Thus, for example, if managers borrow for the first time, so that the firm goes from an all-equity capital structure to one in which debt equals equity, under the conventional view this makes no difference to either the object or content of the fiduciary duty. Managers still owe common shareholders a duty to maximize the value of their shares. Yet if the firm sells financially equivalent call options (as firms increasingly do<sup>123</sup>), they owe presumably no such duty to the holders of those options, who are in a financially equivalent position to holders of common stock in a leveraged firm. As firms begin to offer more and different slices of what would traditionally have been included in the common equity of a firm's capital structure, what can the standard view tell us about the object and content of the corporate fiduciary duty? Very little, I think, that is satisfying.

One could begin with the principle Easterbrook and Fischel suggest, that common shareholders benefit from the fiduciary duty because they are the *residual* claimants, and infer that those with the most residual claims should be the exclusive beneficiaries of the duty. This principle, however, is clearly unsatisfactory. Suppose a firm slices up its equity into very thin slices, including call-option-like claims that are very far out-of-the-money.<sup>124</sup> Surely we do not want to place man-

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122. See Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 420-21 (1986).

123. See, e.g., *Interneuron Pharmaceuticals Announces Call Option Arrangements*, BUS. WIRE, May 5, 1997; *New Deals - IDEC Pharmaceutical Corp.*, BIOVENTURE VIEW, Oct. 1, 1997; *A Twist for Issuers and Buyers, the Detachable Call Option Debuts in \$67 Million Las Vegas Deal*, BOND BUYER, Apr. 9, 1992, at 5 (call options used in municipal finance).

124. An option is "out-of-the-money" when its exercise price is greater than the current market value of the underlying security, such as stock. Thus an option to buy stock in Amazon.com at a price of \$175 would be out-of-the-money if Amazon.com were currently trading at \$150. Options that are out-of-the-money at their expiration or maturity date are worthless. No one would pay anything for the right to buy for \$175 a stock selling on the market for only \$150. The more the price of the underlying security is below the exercise price of the option, the more the option is out-of-the-money.



agers under a duty to maximize the value of those claims, irrespective of the effects those actions would have on the value of other slices of the value of the firm. The incentives of holders of far-out-of-the-money call options are equivalent to those of shareholders of very highly leveraged firms. They would both have managers choose risky but inefficient projects that would increase the value of their options, even if they would decrease the total value of the firm. It may seem reasonable to say that a highly leveraged firm has entered the “vicinity of insolvency,” but this mysterious region becomes more magical still if we suppose the firm enters it as well by dividing up its equity into its financial component parts. It is hard to see how the solvency of the firm has changed by restructuring its equity, yet the troubling effect on the incentives of its most residual claimants is exactly the same as if the firm had leveraged itself to the hilt.

Alternative arguments for the standard view are difficult to formulate. If the most residual slices of equity are not those whose value should be maximized, then what should be maximized? In fact, there is no justification in finance theory for maximizing the value of any one horizontal slice of the value of the firm. If one does not include the interests of the most residual claim holders, for instance, in the calculus of fiduciary duty, managers will not have the correct incentives to pursue projects that are quite risky but nevertheless efficient. If one includes only the residual slice, the incentives are the opposite, but potentially just as inefficient.

The only “slice” of the value of the firm the maximization of which it would be efficient for managers to pursue as a matter of duty is a *vertical* slice, one that includes a proportional amount of every layer of the firm’s capital structure. And this, as it happens, is precisely the slice that CAPM mandates — for completely independent reasons, that the rational investor should hold. This important convergence of efficient portfolio theory and the modeling of efficient corporate governance and corporate norms has been unjustifiably neglected in contemporary discussions of corporate law, and obscured by the emphasis, dating back to Berle and Mean’s profoundly premodern<sup>125</sup> theories of finance, on the “shareholders.” No version of the standard account, but only the neotraditional account of corporate fiduciary duty, yields efficient managerial incentives.

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Applying the options analysis to corporate capital structure, stock of a corporation is like a call option in the sense that stockholders can be imagined as having the option to buy the firm by paying off creditors and keeping any residual for themselves. If a company were so highly leveraged that if it were to liquidate, not all creditors could be paid off in full, and stockholders would get nothing, the “options” represented by common stock could be said to be out-of-the-money.

125. See BERLE & PEDERSON, *supra* note 56.

## 2. Letter Stock Puzzles

Another type of new equity product illustrates yet another conundrum-producing quality of the shareholder value maximization norm. It is now fairly common for large firms such as General Motors to issue equity claims not on the value of the whole corporation but on some part of the firm's business. GM pioneered the use of this "letter stock" — so called because the first of its kind, General Motors E stock, was tied to GM's Electronic Data Systems (EDS) division, which it purchased from H. Ross Perot. As Hu explains, by 1991 GM had three kinds of common stock: ordinary common, Class E common stock, and Class H common stock.<sup>126</sup> Thus GM has multiple classes of common stock, one of which is a residual claim on the firm as a whole, the others being tied to the economic performance of divisions of the firm. The influential investment newsletter *Value Line*, in fact, treats GM as consisting of different firms, with the letter stock being the common stock of the firms-within-the-firm.<sup>127</sup>

Under the shareholder value maximization norm, managers should maximize the value of which of these classes of stock? There is no reason to believe they can simultaneously maximize the value of each of them. Furthermore, picking one class of stock as the "true" common stock to be maximized would be merely arbitrary. Even if there were some reason for doing so in the case of GM, it is easy to imagine a case in which a firm had different classes of common stock tied to different divisions of the company and whose unlettered common stock represented only a trivial part of the firm's capitalization. When the bottom layer of the traditional capital structure is cut into pieces in this way, the shareholder value maximization norm tells managers nothing about what share values they should maximize.

### B. Resolving Equity Puzzles

Option-like equity derivatives and letter stock are just two of the new products that Hu rightly suggests present difficult, and I would argue impossible, puzzles for traditional conceptions of fiduciary duty. Hu's paradoxes, however, are less difficult than they might seem, if one is willing to espouse the "neotraditional" reformulation of fiduciary duty that I propose.

#### 1. Maximization Rights

Hu correctly notes the impossibility of nonarbitrarily enforcing multiple "maximization rights" to several classes of equity holders, all

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126. See *supra* note 15.

127. See *supra* text accompanying notes 100-101.

of whose claims cannot be maximized simultaneously. This problem is intractable as a matter of financial theory, since if equity shares are of different priority in their claims to firm value, their value will respond differently to the riskiness of the firm's underlying business. None of these classes of claimants will have efficient incentives across all magnitudes of risk. Similarly, particular business decisions are bound to affect the value of the different lines of business of the firm differently. Shareholder value maximization provides no guidance to firms with letter stock if it cannot specify which shares the norm targets. Indeed, it is intuitively obvious that as financial innovation carves up the risk-and-return stream that firms produce into ever more specialized pieces, a norm that calls for the maximization of the value of any one sort of piece at the expense of others will diverge increasingly from efficiency. The source of this problem should be faced squarely: the insistence that the object of the duty be concrete holders of financial claims, rather than the abstract entity against which those claims are held.

In the neotraditional approach I propose, the default norm for managers would be to maximize the value of the firm. Thus in a firm that had any number of horizontal slices of equity, the duty of managers would be to maximize the sum of the value of the various securities issued by the firm. If a firm had letter stock, managers would be duty bound to make the decisions that maximized the value of the firm. They would be violating the norm if they took decisions that increased the value of one class of letter stock by less than it decreased the value of another. Actual investors might well want to contract around these duties. An efficient corporate law would allow them to do so. But the efficient default rule to which hypothetical rational investors would agree is to maximize firm value.

The neotraditional norm is very simple, yet it reduces the otherwise daunting conundrums of equity derivatives to almost trivial proportions. The more perverse the incentives of far-out-of-the-money option holders were in a firm with thinly sliced equity, the less weight they would have under the neotraditional norm. The misguided notion that most residual claimants are specially situated to promote optimal managerial decisionmaking is simply abandoned, as it should be. Managers of firms with letter stock would equally know what to do. Common stock value would not be favored because it is more residual, nor would managers be forced to make Solomonic choices among claimants with equal and inconsistent claims. The managers would just try to maximize the value of the firm. If claimants wanted more than that, they would have to negotiate for it *ex ante*.

## 2. *Enforcing the Neotraditional Norm*

Because the content of the neotraditional norm is the maximiza-

tion of firm value, all securities holders could be beneficiaries of it simultaneously. One might want to conceive of the rights that shareholders, and perhaps others, would have under the neotraditional approach as being derivative in nature — that is, as belonging first to the corporate entity and second, and only indirectly, to the shareholders or other security holders. Because the right would be to have managers maximize firm value, at the level of the default rule, the rights of particular classes of security holders could not come into conflict. The maximization of firm value might have distributional consequences that particular classes of security holders might not like in particular cases, but this would be matter that they should resolve *ex ante* by negotiating provisions in the corporate contract. For example, bondholders could negotiate, as they sometimes do now, for covenants that protect them against the risk of leveraged transactions that decrease the value of bonds even if they increase the total value of the firm.<sup>128</sup>

Throughout this Article, I have deliberately spoken in terms of a corporate law “norm.” A norm is not necessarily a rule that one can enforce in court. Its authority more usually would take the form of a persuasive guide that only occasionally acquires legal force. Thus, the ability of shareholders to force firm managers to maximize shareholder value is quite limited — the sale of the firm as in *Revlon* presents the clearest case. The business judgment rule permits much rationalization of managerial self-seeking.<sup>129</sup> Nevertheless, the idea that it is for the shareholders that the managers ultimately manage firms, and that what they are trying to do for the shareholders is maximize the value of their shares, permeates both American corporate culture and the influential economically oriented academic discussions of corporate law and policy. While shifting to a norm that makes more economic sense might not make a sudden and predictable practical difference, it would still have a beneficial influence over time, especially in an era of rapid financial change.

Implementing a new conception of fiduciary duty, especially one at variance with much corporate law doctrine, would present many practical problems that are beyond the scope of this Article, the purpose of which is merely to begin discussion. It is worth noting, however, that the neotraditional conception offers, at an idealized level, another ap-

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128. See Richard G. Clemens, *Poison Debt: The New Takeover Defense*, 42 BUS. LAW. 747, 750 (1987); Hurst & McGuinness, *supra* note 42, at 197-200; Kahan & Klausner, *Anti-takeover Provisions in Bonds*, *supra* note 50; Stark et al., *supra* note 84, at 566-68; *Credit-policy: Event Risk Covenant Rankings*, STANDARD & POOR'S CREDITWEEK, July 24, 1989, at 17; Daniel Hertzberg, “Poison-Put” Bonds Are Latest Weapon in Companies' Anti-Takeover Strategy, WALL ST. J., Feb. 13, 1986, at A5.

129. See *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 180 (Del. 1986); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); Carol Seidler, Comment, *Assessing the Wisdom of the Business Judgment Rule in Corporate Control Contests: Is It Time to Make Shareholders' Interests Paramount?*, 23 LOY. L.A. L. REV. 919 (1990).

peeling feature, and one that helps motivate an entity-based approach. To explain this, let us return to the CAPM rational investor. If it were the case that all investors in truth held the market portfolio, then in a sense it would matter less what the content of the corporate law norm was. If the norm were to "maximize the value of residual claims," the CAPM rational investor would not press to enforce this norm, since doing so would not maximize the value of his diversified portfolio. So one might suppose that such a norm, though not finely tuned, would do little harm. It would seem better, however, if we could formulate a model that actually worked, at least at an idealized level, to push managers toward the efficient managerial decision, if it were perfectly enforced.

To that end, consider the following idealized enforcement scenario. Imagine that security holders could costlessly monitor managerial decisions, and that some enforcement agency, such as a court, could accurately determine when managerial decisions had departed from the norm. What norm, and enforced by whom, would have the effect of always correcting managerial departures from efficient decisionmaking? The unique answer to this question is the neotraditional norm I propose, enforced by holders of all classes of securities. This norm works because its enforcement mechanism would produce an equilibrium at the efficient managerial decision. For example, imagine that managers decide to undertake a risky, but inefficient, project that will increase the value of residual claims but decrease the total value of the firm. If residual claimants are the only ones who can invoke the norm and enforce it, managers will proceed with their inefficient plan. But if nonresidual claimants could invoke and enforce the norm, they would prevent the inefficient project. But could these nonresidual claimants also prevent managers from undertaking some very risky but efficient project that decreased the value of their nonresidual claims but increased the value of residual claims by more? They could not, if the norm were not the maximization of the value of their particular claims, but the maximization of the sum of the value of all claims, that is, the maximization of firm value. This is why efficiency demands that the object of the duty be the corporation: no particular class of claims can efficiently have a maximization right, but all classes of claimants can have the right to demand that the value of the firm be maximized. It is easy to see that, if this were the case, whenever managers undertook an inefficient project, some class of claimants would have the incentive to challenge it. Managers could defend actions that reduced the value of a class of claims only by showing that other classes gained more than the challenging class lost. Thus only actions that increased firm value would be immune from challenge from all classes of claimants. Maximization of firm value would thus be the equilibrium of the enforcement mechanism. If we then relax the assumption that all investors are CAPM rational investors, this equilib-

rium survives. Investors specializing in residual or nonresidual claims would have incentives to challenge inefficient projects, but invocation of the norm would not allow them to push managers to make inefficient decisions.

### C. *Capital Market Imperfections*

Hu stresses the difficulties capital market imperfections, information asymmetry, and the timing of firm cash flows can cause for conceptions of fiduciary duty.<sup>130</sup> These problems, however, do not seem any more insuperable for the neotraditional conception of fiduciary duty than for the traditional one.

Financial research, it is true, has uncovered numerous apparent imperfections in capital markets.<sup>131</sup> Whether markets are perfect or not, however, the relevant question is whether a better alternative for valuation of the firm exists. Under Hu's "blissful shareholder wealth maximization" duty, managers would be obliged to maximize the true value of shares, blissfully ignoring inaccurate valuation by the stock market. This approach implies a greater distrust in market valuation than in managers' ability to value future cash flows themselves and to rein in their natural human tendencies to self-service and optimism. If shares can be valued blissfully, however, so can firms. Market imperfections create no worse problems for valuing all of firm's financial claims than they do for merely valuing its stock.

Of particular concern to Hu is the timing of cash flows. If markets cannot perfectly anticipate the timing of cash flows, and managers have information about the timing of flows superior to the market, then they will face decisions that in effect force them to choose among "generations" of shareholders. One investment might yield immediate benefits, while another might pay off only years hence — a payoff that, if we assume imperfect markets, might not reflect in the current price. If managers choose the investment with the later payoff, future shareholders will gain at the expense of present shareholders.<sup>132</sup> Timing creates a conflict of fiduciary duty similar to that of having multiple stock classes with conflicting maximization rights.

Yet if we assume that managers really do have information better than the market's, the efficient result must be for managers to make the investment that the market has undervalued. In due course, the market will see its mistake, and share prices will rise to incorporate better information about the project's cash flow. The problem, it may

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130. See Hu, *supra* note 15; *supra* text accompanying notes 15-19.

131. See, e.g., RICHARD H. THALER, *THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE*, ch. 12 (1992).

132. See Hu, *supra* note 15, at 1300-05.

seem, is that this correction will come too late for earlier generations of shareholders, who will have already sold by this time.

This problem, however, like Hu's other paradoxes, may be unraveled with the help of hypothetical bargain theory using rational investors. Rational investors are widely diversified. If they are diversified across all firms, it seems likely they will be holding securities of firms whose projects are at all stages of their life cycles. They will own some stock in firms investing in projects that will not be correctly valued currently and some stock in firms whose stock is rising only now to correct previously mistaken valuations. Thus, rationally diversified investors should not choose a rule that would have firms do anything other than choose the value maximizing project, even if it did postpone the realization of gains. Diversified shareholders should expect to garner as many windfalls as they lose out on realizations of projects. If the fiduciary rule required intergenerational shareholder equity, however, this would reduce the total value of their portfolios. Their holdings in companies with early maturing but factually less valuable projects would not increase in value enough to make up for their losses in firms with late-maturing but, by hypothesis, more valuable projects. This leads to an interesting result. Rational investors in a hypothetical bargain setting would not choose a fiduciary rule that required some sort of equity across time. Rather, they would elect a rule that required managers to maximize firm value, even if this value were reflected in the price of securities only in the long run. (This only assumes, as seems plausible, that in the large sample of firms in the market portfolio, the maturity of projects would be normally distributed.) Once again, rational investors choose an efficient fiduciary rule, and paradoxes are avoided.

#### D. *Time and the Corporate Entity*

Finally, Hu argues that if directors owe a fiduciary duty to "the corporation," they may be obligated to avoid undertaking risky projects that might lead to the demise of the corporation, even if diversified shareholders would prefer that managers take these risks.<sup>133</sup> This criticism, however, attacks only a straw man. A duty to the corporation could take several forms, and even a naively formulated duty would not necessarily require a duty to maximize the duration of a corporation's "life." In any event, the neotraditional formulation would require, as a gap filler, that the sum of the values of financial claims on the corporation be maximized. Managers conforming to this duty would adopt risky projects to the extent that their adoption would maximize the value of the firm, which might or might not be

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133. See Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 295-306 (1990).

consistent with maximizing the duration of the corporation's "life." In fact, critics of a duty running to the corporation should notice the beam in their own eye. It is *not possible* to formulate an efficient version of corporate fiduciary duty in terms of only one class of financial claimants; it is *necessary* to invoke some proxy for the sum of the values of claims against the corporation, such as the concept of the corporate entity, to formulate an ideally efficient corporate fiduciary duty. The best argument that could be made for a duty running exclusively to shareholders would be that it is the best practical approximation of an ideally efficient duty, such as that proposed by the neotraditional formulation.

## V. CONCLUSION

The efficient norm for corporate law is simply: Maximize the value of the corporation, that is, the sum of the values of all the claims the corporation has issued on its value. This is just a default rule, around which one would expect much contracting, especially as contracting costs diminish over time. But it is the rule to which rationally diversified investors would agree *ex ante*, and a rule that can survive the disaggregation of traditional equity that seems likely as financial markets continue to evolve. Until that time, to say the primary corporate norm is to "maximize shareholder value" perhaps will do, as long as we are sure not to mean exactly what we say.

To shareholder value maximization, this Article offers an alternative — a duty to the corporation to maximize firm value. Firm value maximization is the efficient default rule. Hypothetical investors, modeled according to the most highly developed relevant theory of rational choice, would choose it. The proposed rule avoids problems that are theoretically clear now and will become increasingly pressing in practice.

More compelling as a theoretical matter is the convergence of rational portfolio theory and a theory of an efficient version of the corporate law norm. For reasons independent of corporate law norms, rational investors will hold a certain portfolio. This portfolio also gives these investors the correct incentives to maximize the value of the firm. The default rule chosen by investors of this sort will be the efficient default rule for filling gaps in the corporate contract. This bridge between the neotraditional corporate law norm and efficient portfolio theory strongly recommends my approach.