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Maximizing the Wealth of Fictional Shareholders: Which Fiction Should Directors Embrace?

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ABSTRACT

Corporate directors are generally committed to the social norm of maximizing the wealth of their corporation's common shareholders. Their current practice is to simplify their investment decisions by positing a generic fictional shareholder who is undiversified in his investments as the person to whom they hold themselves accountable. In this Article I discuss this fictional undiversified shareholder concept and compare it with three alternative fictional characterizations that differ from it and among themselves only in the extent of assumed investor diversification, and which could each serve this same analytical function. These three alternatives are the fictional diversified shareholder, the fictional equity-only diversified shareholder, and the fictional corporation-specific diversified shareholder concepts. I also consider a hybrid characterization that would include both fictional undiversified shareholders and fictional diversified shareholders.

My conclusion is that despite its advantages of greatly simplifying directors' decision making we should discard the fictional undiversified shareholder concept for two reasons. First, it is highly unrealistic, more so than the other alternatives here considered. Second, it is indeterminate as to the degree of risk-aversion that should be ascribed to this fictional shareholder, and this degree of freedom completely undercuts ability of the shareholder wealth maximization norm to constrain director conduct.

I also conclude that if corporation investment decisions are best pursued through the use of a fictional shareholder concept, rather than through attempts by directors to ascertain and satisfy to the extent possible the conflicting preferences of their corporation's actual shareholders and perhaps other stakeholders as well—a question discussed but not resolved in this Article—then the fictional diversified shareholder concept, despite its significant implementation difficulties, is the preferred alternative among those here considered.

I. INTRODUCTION

In recent years corporate governance practices have come under close scrutiny.[1] In

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1. One need only think of the extensive publicity given to the Enron, WorldCom, Tyco, Adelphi and other major corporate scandals in recent years, and of the subsequent Congressional and securities industry self-regulatory organization responses imposing more stringent corporate governance requirements. The dramatic increases in recent years in the level of compensation paid to senior corporate officers, often in the absence of any discernable improvement in corporation performance attributable to those officers' actions, have also focused much attention on corporate governance issues. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

particular, there is currently a vigorous debate among leading corporation law scholars regarding whether legal changes that would enhance the ability of common shareholders of public corporations to nominate directors and initiate changes in key charter provisions would result in corporate boards being more responsive to shareholder interests.[2]

I believe that this debate is useful but somewhat misdirected. Even if governance reforms such as those that have been proposed are adopted, the severe collective action problems involved in coordinating the large and diverse population of public corporation shareholders will likely prevent these shareholders from effectively exercising these enhanced rights.[3] Nor are the courts likely to respond to calls to depart significantly from their traditional deferential business judgment rule standard of review that effectively shields directors from judicial accountability for their actions except for duty of loyalty violations involving fraud, illegality or self-dealing.[4] As a practical matter, the norm of shareholder wealth maximization—the widely shared understanding among directors that their main objective should be to maximize the wealth of their corporation's common shareholders—will likely remain the most effective constraint on director conduct in favor of those shareholders.

What is often overlooked, however, is that the conduct of directors seeking to maximize shareholder wealth depends critically upon their conception of who exactly is the "shareholder" to whom they hold themselves accountable. As Daniel Greenwood insightfully argued,[5] the corporate statutes and case law do not encourage the directors of public corporations to take referenda of the preferences of their many direct and indirect human shareholders[6]—who in general will have conflicting interests and preferences based on their differing attitudes, life circumstances, other asset holdings, etc.—before making decisions, and those directors rarely, if ever, do so.[7] The law instead allows

2. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1759 (2006) [hereinafter Bainbridge, *Director Primacy*] (responding to Bebchuk, *Increasing Shareholder Power*, *infra*); Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006) (responding to Bainbridge, *supra*, and Strine, *infra*); BEBCHUK & FRIED, *supra* note 1; Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) [hereinafter Bebchuk, *Increasing Shareholder Power*]; *see also* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006) [hereinafter Bainbridge, *Limited Shareholder Voting Rights*]; Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003); Leo E. Strine, Jr., *Towards a True Corporate Republic: A Traditionalist Response to Lucian's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006) (responding to Bebchuk, *Increasing Shareholder Power*, *supra*); Symposium, *Executive Compensation*: Pay Without Performance, 30 J. CORP. L. 647 (2005) (focusing almost entirely on BEBCHUK & FRIED, *supra* note 1).

3. STEPHEN A. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 202-03 (2002); Bainbridge, *Limited Shareholder Voting Rights*, *supra* note 2, at 622-23.

4. BAINBRIDGE, *supra* note 3, at 269-70.

5. Daniel J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996) [hereinafter Greenwood, *Fictional Shareholders*] (contending that the concept of a generic shareholder is a legal fiction, in many ways more problematic than the fiction of the corporation itself).

6. By "direct" human shareholders I mean to refer to individual people who directly own the common shares of the subject corporation, and by "indirect" human shareholders I mean the individual people who own the shares of (directly or indirectly through additional tiers of institutions) or otherwise have financial claims against the institutional shareholders of the subject corporation.

7. "[E]xamining the actual interests of the actual people behind the shares at some determinate point in time to see if they were in fact benefited or injured by the action . . . is never done; rather, inquiry is invariably

directors to greatly reduce the burden of discharging their fiduciary duties to this diverse group of shareholders by permitting them to consider only the impacts of their actions upon a generic "fictional shareholder" abstraction.[8] Moreover, the law does not impose any particular definition of this hypothetical shareholder, which leaves directors with the discretion to choose among a wide range of possible fictional shareholder characterizations to guide them in their investment decisions. The choice of characterization used may well have significant consequences for those decisions.[9]

It is certainly possible to offer an "external" critique of the use of any fictional shareholder characterization by directors to guide their investment decisions. Whether our society would be better off if directors were encouraged to assess the consequences of their actions for their actual shareholders, thereby importing into boardroom deliberations all of the complex and contentious political differences among shareholders that are now avoided through use of a unitary fictional shareholder concept, and requiring reassessment of decisions whenever a corporation's shareholder profile materially changes, is a difficult question whose full consideration goes well beyond the scope of this brief Article.[10] As I will later discuss, the conclusions that I reach in this Article suggest that this broad question should receive more attention, and I will offer some preliminary comments and suggestions in that regard. What I would like to primarily focus upon in this Article, however, are several related but somewhat narrower "internal" questions that arise if one accepts as a given the shareholder wealth maximization norm, and the need for the use of some fictional shareholder characterization to facilitate investment decisions in accordance with that norm. If directors are going to continue to

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restricted to the fictional shareholder." Greenwood, *Fictional Shareholders*, *supra* note 5, at 1062.

> [I]f the focus of interest were the actual people who own the shares . . . boards and courts would have to make detailed factual inquiries before they proceeded to analyze the interests of shareholders. From the absence of such inquiries, if nothing else, we can see the dominance of the fictional shareholder in our corporate law.

Id. at 1065 (footnote omitted).

8. "[I]n the eyes of the law and corporate management, shareholders are all the same. As a result, managers are given relatively clear direction without any need to pierce the cacophony of inconsistent demands from conflicted and conflicting individuals. Corporate management is therefore far easier than political management." *Id.* at 1026; *see also id.* at 1030-31.

9. "Which type of stockholder is the proverbial reasonable stockholder? To which type of stockholder does management owe its duty? . . . [D]ifferent formulations of management duty will often lead to very different outcomes in particular cases." Richard A. Booth, *Stockholders, Stakeholders, and the Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 442 (1998).

10. Greenwood clearly believes that the use of the fictional shareholder characterization as the focus of corporate fiduciary obligations creates an unacceptable divergence between managerial incentives and actual human welfare: "Corporate law succeeds because [decision making in accordance with the fictional shareholder characterization] is single-minded, and fails because it lacks a principle of moderation or any significant countervailing power . . . . The fiction of the one-sided shareholder hides the tradeoffs that must be made in life from the view of those who must make them." Greenwood, *Fictional Shareholders*, *supra* note 5, at 1029, 1032. He discusses at some length in this article the potential significance of directors abandoning altogether the use of a fictional shareholder concept, and attempting to instead assess and balance actual shareholder interests, but unfortunately does not discuss how this alternative approach could best be implemented. *See generally id.* at 1089-1104. In a subsequent 2004 article, however, Greenwood does offer an alternative "corporation as polis" director decision making framework that would require empirical assessment and political balancing. Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, 2004 COLUM. BUS. L. REV. 773, 841 (2004) [hereinafter Greenwood, *Enronitis*].

embrace this norm and implement it through the use of a fictional shareholder concept that obviously cannot be an accurate representation of the circumstances of every actual shareholder, what are the optimal contours of that concept?[11] What is the most plausible and operationally feasible characterization of the nature of that fictional shareholder, and what difference would it make as to which of the possible characterizations was embraced by directors to guide their conduct?

In Part II of this Article, I will first briefly discuss the shareholder wealth maximization norm, and will identify several different plausible fictional conceptions of the nature of public corporation shareholders that are each grounded to some extent in actual shareholder circumstances, and that could each provide an alternative frame of reference for making corporate decisions in accordance with that norm.[12] In Part III, I will attempt to demonstrate the significance of the differences among these characterizations for public corporation investment decisions.[13] I then will compare their relative implementation difficulties, and will offer my recommendations as to which of these characterizations would be most likely to lead to the maximization of actual

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11. There has been surprisingly little recognition by scholars of the seemingly obvious point that if directors are going to utilize a generic, fictional characterization of their shareholders, then a variety of potential alternative characterizations exist which may lead directors to different conclusions as to which actions to pursue to maximize shareholder wealth. Beyond Greenwood's article discussed earlier, Greenwood, *Fictional Shareholders*, *supra* note 5, this literature is rather sparse, and is essentially limited to articles comparing selected aspects of the fiction of an undiversified shareholder with the fiction of a fully diversified shareholder. Greenwood is of the opinion that this dearth of analysis of different possible generic fictional shareholder characterizations is "perhaps because they are so often viewed as unproblematically the same." *Id.* at 1057 n.83. *See generally id.*; Booth, *supra* note 9; Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991) [hereinafter Hu, *New Financial Products*]; Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277 (1990) [hereinafter Hu, *Risk, Time, and Fiduciary Principles*].

12. I will not in this Article explicitly address the question of how directors can best accomplish shareholder wealth maximization in the closely held corporation context where they could presumably without undue effort poll each individual shareholder as to their preferred corporation actions and then attempt to accommodate conflicting shareholder preferences. I will, however, address to some extent how directors might attempt to ascertain and balance actual shareholder preferences in the public corporation context. *See infra* Part IV.

13. Professor Greenwood is in full accord with my assessment that the nature of the characterization of the fictional shareholder is highly significant:

> Indeed, since corporate law and the market alike drive corporations to act in the interests of these fictional shareholders, the shareholder is the most important fiction of corporate law: The legally imputed characteristics of corporate shareholders are the power behind the throne of managerial autonomy, the driving force that determines the structure and functioning of our corporate system. For this reason, we need to examine the nature of our fictional shareholders more carefully: Both the successes and the failures of our system ultimately reflect the characteristics of the shareholder we have created.

Greenwood, *Fictional Shareholders*, *supra* note 5, at 1025. I will for the purposes of this Article implicitly make the simplifying assumption that the capital market is "efficient" in the sense that security prices accurately reflect the internalized consequences of corporation investment choices. The issue of whether and how directors should alter their investment choices that are based upon a fictional shareholder characterization to best promote shareholder wealth maximization if the capital market does not accurately price the consequences of investments, either only in the short term or over the longer term as well, is a complication that goes beyond the scope of this analysis but which does not materially affect my conclusions.

shareholders' wealth.[14] In Part IV, I will offer a few preliminary comments regarding why and how directors might attempt to assess and balance their actual shareholders' interests and preferences in making decisions rather than embrace any of the fictional shareholder characterizations. In Part V, I will offer a few preliminary concepts regarding whether the norm of shareholders' wealth maximization should be replaced by a broader norm of director loyalty to a more inclusive stakeholder constituency. Part VI of the Article will present a brief conclusion.

II. THE SHAREHOLDER WEALTH MAXIMIZATION NORM

A. The Widespread Embrace of the Shareholder Wealth Maximization Norm

Corporate directors generally regard themselves as subject to an overriding fiduciary duty to maximize the wealth of their common shareholders,[15] who they commonly regard in simple, straightforward terms as the "owners" of the corporation who therefore merit their fealty and prudence. This widely shared understanding, somewhat surprisingly, is not explicitly grounded in state corporation statutes.[16] Moreover, most of the state statutory frameworks include "constituency statutes" that explicitly permit (but do not require) directors to consider the impacts of their actions on various non-shareholder constituencies.[17] However, the judicial case law on balance clearly endorses this prevailing "shareholder primacy" conception of the proper directorial role,[18] as does most of the scholarly commentary.[19]

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14. For additional discussion regarding the comparative merits of different generalized conceptions of the shareholder for director decision making, see generally Booth, *supra* note 9; Greenwood, *Fictional Shareholders*, *supra* note 5; Hu, *New Financial Products*, *supra* note 11; Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11.

15. NAT'L ASSOC. OF CORP. DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR COMPENSATION: PURPOSES, PRINCIPLES, AND BEST PRACTICES 1 (1995) (stating that the primary objective of a corporation is to maximize shareholder gains); BAINBRIDGE, *supra* note 3, at 417 ("Although some claim that directors do not adhere to the shareholder wealth maximization norm, the weight of the evidence is to the contrary."); *see also* ROBERT C. CLARK, CORPORATE LAW 17, 678 (1986) ("Although corporation statutes do not answer this question explicitly, lawyers, judges, and economists usually assume that the more ultimate purpose of a business corporation is to make profits for its shareholders."); Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11, at 356 (noting in 1990 that while many corporation boards focused on other indicators of corporate performance such as earnings per share, return on net income, cash flow or sales growth, there was a trend towards greater focus on shareholder interests as a goal).

16. Lynn A. Stout & Margaret M. Blair, *Specific Investment and Corporate Law*, EUR. BUS. ORG. L. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=869010; *see also* CLARK, *supra* note 15.

17. Stephen Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 984-87 (1992).

18. CLARK, *supra* note 15, at 17.

19. "Shareholder primacy is the prevailing academic perspective on how corporations ought to be governed." Bainbridge, *Director Primacy*, *supra* note 2, at 1761 n.11 (with supporting citations); *see also* Henry Hansmann & Ranier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440-41 (2001).

> [I]t has become commonplace for modern observers to assume that for public corporations, maximizing share price is an important and indeed possibly the only legitimate business objective. . . . [T]he assumption that stock price reflects corporate performance is so deeply ingrained that for many it has become a mental habit, rarely subject to critical analysis.

There are scholars who have argued for replacement of the shareholder wealth maximization norm with aspirational norms that are more broadly inclusive of other stakeholder constituencies.[20] I am not aware of any evidence suggesting that corporate directors have embraced any of these suggested shifts in the focus of fiduciary duties that such academic writers have proposed. However, these proposals have stimulated discussion among academics and more reflective legal practitioners and directors. As a result, they may thereby have contributed to creating a more open boardroom environment conducive to reconsideration of the nature of the fictional shareholder who remains the focus of directors' continuing efforts to comply with the shareholder wealth maximization norm. Perhaps these proposals have even made the boardroom environment more conducive to reassessing whether directors should abandon fictional shareholder characterizations altogether and instead grapple directly with assessing and balancing actual shareholder preferences. This Article is intended to help inform both this narrower reconsideration and this broader reassessment.

B. Different Fictional Shareholder Characterizations

Consider a public corporation board of directors that is committed to shareholder wealth maximization and which is deliberating over a major investment decision. The choice has come down to two competing options. The first option involves the use of retained earnings to finance an expansion of the firm's existing production facilities that promises to pay only modest expected returns, but which poses very little downside risk (or upside potential). The second option is to supplement the internally available funds with external borrowing in order to invest heavily in a promising new business area that offers significantly higher expected returns, but that also poses substantial downside risks. If the downside risks of the second option subsequently materialized, they would lead to strained financial circumstances, probable employee layoffs, and even the possibility of default on the firm's bonds. How should this board proceed to determine which of these two options will maximize shareholder wealth, given the different expected return/risk tradeoffs that the two options present?

I will assume initially that the board has decided not to poll its many shareholders as

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Lynn A. Stout, *Share Price as a Poor Criterion for Good Corporate Law*, 3 BERK. BUS. L.J. 43, 46 (2006). Even a leading legal scholar who does not embrace this shareholder primacy view with regard to the operational accountability aspects of optimal corporate governance, but instead favors a "director primacy" governance regime that rests upon contractarian premises rather than upon an ownership model of corporate relationships, and who calls for sharply limiting the extent of shareholder control over director decisions, BAINBRIDGE, *supra* note 3, at 197-206, still regards shareholder wealth maximization as the appropriate guiding norm by which directors should exercise their substantial discretion. *Id.* at 417-24.

There are concededly other prominent legal scholars who favor not only sharply limiting shareholder control over directorial decisions, but also the abandonment of shareholder wealth maximization as the guiding norm for directors in favor of other norms that would include the interests of broader stakeholder constituencies. *See, e.g.*, David Millon, *New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993) (arguing for an embrace of a communitarian norm more inclusive of the interests of non-shareholder corporate stakeholders); Stout & Blair, *supra* note 16, at 27-30 (regarding directors as "mediating hierarchs" who should be free to allocate residual earnings to corporation stakeholders other than common shareholders when it is in the interest of the corporation to do so).

20. *See, e.g.*, Millon, *supra* note 19; Stout & Blair, *supra* note 16.

to their actual preferences regarding this choice. Instead I will assume the board has decided to simplify its analysis by first embracing a generic, fictional shareholder concept and then choosing the option that would be regarded as wealth-maximizing by that hypothetical shareholder.[21] What fictional characterizations of the nature of the public corporation shareholder are both sufficiently plausible and analytically tractable to be candidates for serving in this important instrumental role facilitating implementation of the shareholder wealth maximization norm?

I will first discuss the traditional fictional shareholder concept that is currently widely embraced by directors. I will label this concept, for reasons that will soon become obvious, the "fictional undiversified shareholder" concept. I will label a second characterization of the generic shareholder that also has considerable intuitive appeal the "fictional diversified shareholder" concept, again for reasons that will soon be apparent. Two other possible characterizations of the generic shareholder that I will also describe and discuss will be labeled the "fictional equity-only diversified shareholder" concept and the "fictional corporation-specific diversified shareholder" concept, respectively. For comparison's sake, I will also consider as another possible characterization a hybrid mixture of fictional undiversified shareholders and fictional diversified shareholders. Each of these alternative generic characterizations of the shareholder will differ from the basic fictional undiversified shareholder concept and from one another only with regard to the extent and nature of assumed shareholder diversification of their investment portfolios.

1. The Fictional Undiversified Shareholder

The fictional undiversified shareholder concept is simply the personification of shares of the corporation's common stock.[22] This characterization of the nature of the public corporation shareholder has been so widely accepted by directors for so long that its highly stylized and counterfactual features often pass unremarked. The reasons for the popularity of this characterization among directors are obvious. Fealty to such a fictional shareholder means that actual shareholder preferences need not be empirically assessed and then balanced against one another in some politically and philosophically defensible fashion, which would be quite a tall order indeed. Shareholder wealth maximization will instead simply require the monomaniacal maximization of the value of the corporation's common stock without regard to the other impacts of share price maximization efforts on real flesh-and-blood direct and indirect human shareholders. For example, corporate decisions may also impact shareholders in their other possible capacities as corporate officers or employees, corporate bondholders or other creditors, or as corporate pension recipients. They may also have impacts on the value of their other asset holdings, or upon them in their broader role as citizens who may be subject in other ways to beneficial or harmful consequences that are external to the corporation's financial calculus.[23]

A particular corporate action that increases the value of the common shares may nevertheless be regarded as undesirable by a majority of these direct and indirect human

21. For discussion of the alternative of directors actually polling their shareholders' preferences among investment options, see Greenwood, *Fictional Shareholders*, *supra* note 5, at 1089-1104.

22. *Id.* at 1030-31, 1058.

23. *Id.* at 1029-33.

shareholders, whether polled on a per-capita or per-share basis. Conceivably, the corporate action may even be so regarded by nearly *every* shareholder because of significant and widespread negative impacts that accompany the share price enhancement consequences. Such complications and the immense logistical and political difficulties of determining and accommodating intra-shareholder conflicts of interest can, however, be conveniently ignored by directors if the shareholders that are the focus of their fiduciary obligations can each be simply regarded as nothing more than reified holdings of shares of the corporation's common stock that are unaffected by these collateral consequences of corporation actions on actual human shareholders.

2. *The Fictional Diversified Shareholder*

Let me preface my discussion of the fictional diversified shareholder concept with a short digression on the portfolio theory aspects of modern finance theory. Portfolio theory has as one of its central principles the claim that through diversification of his investments across different risky[24] assets, an investor can reduce risk without sacrificing expected returns. A diversified portfolio of risky assets will yield returns that are more stable over time than the returns of the individual assets comprising the portfolio to the extent that the variability of returns of the individual assets is independent. Stated more technically, an investor can diversify away the "unsystematic" risk associated with holding individual risky assets by combining them into a portfolio of assets, and the variability of the overall portfolio returns will then only be that variability derived from the "systematic" variability of the asset returns. This systematic variability is simply the portion of the overall asset return variability that is correlated across the individual assets in the portfolio and with the variability of returns of the entire market of risky assets.[25] Rational, risk-averse investors will avail themselves of such diversification so as to reduce risk without sacrificing expected returns whenever they can do so at an acceptable transaction cost.[26] At the hypothetical zero transaction cost assumption extreme, a risk-averse investor would invest in a fully diversified portfolio that included holdings of all risky assets available in the capital market, each held in proportion to the total value of all holdings of each asset relative to the combined value of all risky assets, and then would, if necessary, adjust the expected return/systematic risk characteristics of that portfolio among the possible choices to reach that risk/return combination which that particular investor most favors. This can be accomplished either through adding riskless assets to the portfolio to reduce the portfolio variability (and thus reducing expected returns as well), or by leveraging the portfolio with additional assets purchased with borrowed funds to achieve higher expected returns (and thus increasing systematic risk as well).

Sophisticated modern investors have embraced this principle of risk reduction through diversification, and a substantial proportion of equity securities are held in

24. By a "risky" asset I mean an asset for which the amount of returns that will be paid to its owner in the future is uncertain, and where the potential returns in each future period can be represented by a probability distribution.

25. *See generally* RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 95-99 (1993) (explaining the value of diversification and its effect on risk and returns).

26. A "risk-averse" person is defined as a person who will prefer a certain sum over an actuarially fair gamble with the same expected value as that certain sum, and who will choose the gamble with the least variation in possible outcomes among a set of choices having equal expected values. *Id.* at 89.

diversified portfolios by either individual investors or institutional investors such as mutual funds, pension funds, hedge funds, bank trust funds, endowment funds, and insurance companies.[27] To the extent that the common shareholders of a corporation are diversified in their asset holdings, rather than holding exclusively the corporation's common shares, an assessment of their interests that takes into account the impacts of corporate actions on the value of their entire portfolio, rather than only on the value of their subject corporation common share holdings, would be a more accurate guide for maximizing their wealth than would be the fictional undiversified shareholder characterization. It would, however, still fail to reflect their other possible relationships with the subject corporation that go beyond holding financial assets that may be affected by its actions. In addition, any attempt by directors to actually measure the extent to which each of their shareholders were diversified investors, and to utilize that information in determining what corporate conduct would maximize the wealth of each shareholder in light of his degree of diversification, and then choose those corporate actions that would strike the appropriate balance among the conflicting interests of different shareholders would present the severe logistical and political difficulties discussed above. Once again a reified conception of the nature of the shareholder that now, however, reflects to some extent the reality of widespread investor diversification may come to the rescue to again make the shareholder wealth maximization norm a feasible aspirational standard.

The fictional diversified shareholder is another facilitating analytical abstraction, one that is at the opposite extreme along the degree of diversification dimension continuum as compared to the fictional undiversified shareholder who is assumed to hold only the subject corporation's common shares in his asset portfolio. The fictional diversified shareholder is simply the personification of a fully diversified portfolio of assets. This hypothetical portfolio would include not only the common stock of the subject corporation, but also holdings of the preferred stock and bonds of the subject corporation, as well as holdings of the common stock, preferred stock, and bonds of other corporations which are related to the subject corporation as either competitors, suppliers, customers, or in other ways, and holdings of all other risky assets that are available in the capital markets. All of these assets would be included in this portfolio in proportion to their share of overall risky asset market capitalization.

While this fictional diversified shareholder concept obviously does not accurately reflect the circumstances of each actual shareholder of a particular corporation, given the reality of widespread investor diversification, it is nevertheless likely to be a somewhat more accurate approximation to the actual circumstances of public corporation shareholders than is the fictional undiversified shareholder concept.[28] Whether it is not

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27. "The facts about the ownership of publicly traded stock in the United States are fairly well known. About half of the publicly held stock is held institutionally—principally by pension funds, insurance companies, mutual funds, bank trust funds and endowment funds." Greenwood, *Fictional Shareholders*, *supra* note 5, at 1033 (footnotes omitted). Frank Easterbrook and Daniel Fischel make an even stronger claim about the extent of modern investor diversification: "[T]he vast majority of investments are held by people with diversified portfolios." FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 30 (1991).

28. EASTERBROOK & FISCHEL, *supra* note 27. This is even more clearly the case when one realizes that some undiversified institutional investors—I am referring here primarily to hedge funds who may take large

only more descriptively accurate but also in other ways better suited to provide the underlying frame of reference for directors' efforts to maximize shareholder wealth is a key question which will be discussed later in this Article.

3. The Fictional Equity-Only Diversified Shareholder and the Fictional Corporation-Specific Diversified Shareholder

There are at least two other intermediate abstractions along this degree of diversification continuum, which each have some intuitive appeal as the focus of directors' fiduciary duties. One of these is the fictional equity-only diversified shareholder, which is the personification of an investment portfolio that is fully diversified across all common share equity claims available in the capital markets, holding each of these equity claims in proportion to their share of overall equity market capitalization, but which is not fully diversified in that it does not include any preferred stock or debt securities or other non-corporate financial assets. The intuitive appeal of this abstraction is that a number of actual investors do diversify broadly through mutual fund or pension fund equity investments or otherwise across equity securities but do not hold significant preferred stock or corporate bond positions in their portfolios, nor own significant holdings of options or other derivative instruments or other non-corporate assets. Another potentially useful conception of the shareholder is the fictional corporation-specific diversified shareholder, which is the personification of an investment portfolio that is diversified across the common stock, preferred stock, and bonds of the subject corporation, holding each of these securities in proportion to its share of the corporation's overall debt and equity capitalization, but that does not include any other risky assets. Such a concept also has some intuitive appeal as a personification of the overall investor interest in the combined cash flows to all financial claimants of the corporation.[29]

III. MAXIMIZING THE WEALTH OF FICTIONAL SHAREHOLDERS

Let me now discuss the different consequences of utilizing each of these four alternative generic conceptions of the public corporation shareholder for guidance in maximizing common shareholder wealth. I will also discuss the consequences of utilizing a hybrid combination of the fictional undiversified shareholder and fictional diversified shareholder concepts. As noted above, these five different variations on the generic fictional shareholder concept differ among themselves only with regard to the extent and nature of assumed shareholder diversification. I will then step back from this detailed analysis to take a broader perspective and compare the merits of directors embracing any generic fictional shareholder concept in their attempts to maximize the welfare of their shareholders with the alternative of attempting to measure and balance all of the impacts

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undiversified positions in the hope of reaping large gains—are best viewed as merely being part of larger and much more diversified portfolios held by their actual direct or indirect human shareholders.

29. For an elaboration of this idea of regarding the combined cash flows to all corporation financial claimants as in a sense being the wealth of "the corporation as a whole," see generally Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 217-21 (1998).

of their corporation's actions on their actual shareholders.[30]

A. Maximizing the Wealth of Fictional Undiversified Shareholders

Consider a board of directors committed to the norm of shareholder wealth maximization, and whose members each embrace a fictional undiversified shareholder concept of the shareholders to whom they hold themselves accountable. Those directors would then pursue those actions permitted by law[31] that would maximize the value of the corporation's common shares. They would do this regardless of any impacts upon their actual shareholders that occurred for reasons other than the share price effects, and regardless of any impacts on non-shareholders who may nevertheless have significant relationships to the corporation as its preferred shareholders, bondholders, employees, customers, or suppliers.[32]

One economically undesirable consequence of directors embracing the fictional undiversified shareholder concept, discussed in the academic literature[33] and addressed to a limited extent by the case law as well,[34] is that it may lead to corporations making inefficient investments that have very low or even negative overall expected returns when the corporation's preferred shareholders and bondholders, as well as the common shareholders, are taken into account. For some risky investments where at least one of the downside possibilities is a loss that would exceed total common shareholder equity, and thus be borne partially by the corporation's preferred shareholders and perhaps bondholders as well, the expected return of the investment to common shareholders viewed in isolation may nevertheless be quite attractive given their more modest potential losses. However, the overall expected return to common shareholders, preferred shareholders and bondholders taken together may be quite low or even negative.

Such inefficient investments are particularly likely to be pursued by thinly capitalized corporations existing in the "vicinity of insolvency" where the common shareholders have very little to lose and much to gain from risky investments, as is recognized by the case law.[35] However, modern capital markets offer a wide range of high-risk investment opportunities—such as large and uncovered short positions in out-of-the-money options or other derivative financial instruments—whose downside risks may be large enough to exceed the common shareholder equity capitalization of even very large, solvent corporations.[36] Such investment opportunities are particularly likely

30. For further consideration of this question, see generally Greenwood, *Fictional Shareholders*, *supra* note 5.

31. I will not consider in this Article the difficult questions as to whether directors who seek shareholder wealth maximization generally do (or should) regard the legality of their actions as an independent binding constraint, or whether they instead do (or should) should pursue illegal activities as well in those instances where to do so would maximize shareholder wealth.

32. Greenwood, *Fictional Shareholders*, *supra* note 5, at 1056-83.

33. *See generally* Gregory Scott Crespi, *Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm*, 46 SMU L. REV. 141 (2002) (discussing fiduciary duties in the corporate context); Smith, *supra* note 29; Stout, *supra* note 19, at 50-51.

34. *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'n Corp., No. 12150, 1991 WL 277613 (Del. Ch. 1991) (discussing the rights of a bank to remove members from the board of directors of a company that defaulted on a loan).

35. *Id.*

36. Smith, *supra* note 29, at 220, 223-24.

to materialize when persons are given the chance to engage in large transactions with corporations that are willing to make negative expected value investments in financial instrument transactions, i.e., willing (in a statistical sense) to give away their money! Even very solvent corporations pursuing shareholder wealth maximization on behalf of fictional undiversified shareholders may be presented with and inclined to approve such inefficient investments. This possibility has led to potential preferred shareholders and bondholders negotiating elaborate protective covenants in an attempt to prohibit those corporation investments that would "gamble with their money" on behalf of fictional undiversified shareholders. The burdens of negotiating such contractual protections are a social cost at least partially attributable to the embrace of the fictional undiversified shareholder concept.

Another and more serious difficulty with the fictional undiversified shareholder concept—one that has thus far received less attention in the literature and case law—is that it provides incomplete guidance for meaningfully constraining director decision making. This is because there is nothing inherent in this concept that gives directors any instructions on how risk-averse they are to regard this fictional shareholder to be. But without making some assumption as to the degree of risk-aversion attributable to this fictional shareholder there can be no determination made as to how to maximize common share values. A risk-averse undiversified shareholder would likely prefer that the corporation invest its funds in projects with relatively stable, expected returns rather than in far riskier projects with only slightly higher expected returns. This preference is particularly likely to be the case in instances where the higher expected return investments came with a significant risk of corporation insolvency that would be disastrous to the financial position of such an undiversified shareholder. But what is the wealth-maximizing risk/return combination that such a risk-averse fictional undiversified shareholder would most favor, and that would consequently maximize the share price in a market for the corporation's common shares that is implicitly assumed by the fictional undiversified shareholder concept to consist solely of such persons? How much in expected returns should this hypothetical person be assumed to be willing to sacrifice for a given amount of risk reduction; i.e., just how risk-averse should directors assume the fictional undiversified shareholder to be?

Real-world rational investors who are risk-averse will attempt to diversify their portfolios to eliminate unsystematic risk, and thus reduce their overall risk exposure. Given the ease of accomplishing such diversification in modern capital markets, the only investors who choose to hold undiversified portfolios are: those few persons who are either risk-neutral or risk-lovers; or who are for some reason forced against their wishes to hold undiversified portfolios;[37] or those persons who are not behaving in a rational, wealth-maximizing fashion. But the fact that a very small number of investors with

37. One example of such a shareholder might be an investor in a closely held corporation for which there is no liquid market in which the shareholder could sell some of his stock in order to diversify his portfolio more broadly. Another example would be where a shareholder has by shareholder agreement limited his freedom to transfer his shares, and cannot obtain the requisite consents for a sale. Yet another example would be where a shareholder must by law hold an undiversified portfolio. *See, e.g.*, Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11, at 365-66 (discussing that the Manville Personal Injury Settlement Trust is legally required to hold the majority of the shares of the Manville Corporation for asbestos exposure liability compensation purposes).

unusual attitudes towards risk or under special constraints may elect to hold undiversified portfolios is certainly an inadequate basis for directors to sweepingly ascribe a risk-neutral or risk-loving attitude to the fictional undiversified shareholder whose wealth is purportedly being maximized. If anything, it would be much more reasonable to impute extreme risk-aversion to this fictional undiversified shareholder given the likelihood that almost every actual common shareholder would respond in that fashion were his investment portfolio to be somehow transformed into an undiversified portfolio!

The fictional undiversified shareholder concept thus has a certain incompleteness and even weirdness to it with regard to providing guidance to directors as to how to weigh risk considerations against expected returns in their deliberations regarding how to maximize shareholder wealth. Since it does not posit any particular degree of risk-aversion on the part of this fictional shareholder, the concept essentially leaves directors with a degree of freedom to ascribe to this fictional shareholder whatever degree of risk-aversion is necessary to justify on shareholder wealth maximization grounds any particular level of sacrifice of expected returns purportedly done to adequately reduce risk. In other words, directors are not constrained from selecting, from the available investment options, those low expected return/low risk investments that would perhaps be most favored by their preferred shareholders and bondholders who are seeking primarily to avoid risks to their capital, or by their employees who are seeking primarily to avoid risks to their employment status, or in particular by their senior officers and directors who are seeking primarily to avoid risks to their lucrative corporate positions.[38] They could make this choice and still claim to be maximizing the wealth of their (here assumed to be highly risk averse) fictional undiversified shareholders, even in the face of possible opposition by many of their actual shareholders!

Use of the fictional undiversified shareholder concept to make the hypothetical investment choice presented at the beginning of Part II of this Article would, for example, allow the directors to justify choosing either of the options presented on shareholder wealth maximization grounds simply by ascribing the appropriate degree of risk-aversion to the hypothetical shareholder. The only real constraint that the fictional undiversified shareholder concept imposes on such investment choices is the rather trivial limitation that it cannot be used to justify those choices that are completely dominated by another choice; i.e., those choices that have both lower expected returns and greater risk than some feasible alternative. This degree of freedom with regard to attributing risk attitudes to the fictional undiversified shareholder essentially eliminates the constraining effect on directors of the shareholder wealth maximization norm, and allows them full discretion to choose investment options that may favor the interests of other corporate stakeholders—including themselves and their senior officers—over the interests of their actual shareholders. An approach to implementing the norm of shareholder wealth maximization that so completely eviscerates the ability of the norm to constrain investment decisions is obviously seriously flawed.

38. This risk-averse attitude on the part of senior corporate officers may upon occasion be reduced by the large gains they may obtain from share price appreciation due to a significant stock option component of their compensation.

B. Maximizing the Wealth of Fictional Diversified Shareholders

Consider now a board of directors again committed to the norm of shareholder wealth maximization, but whose members each embrace a fictional diversified shareholder conception of the shareholders to whom they hold themselves accountable. Those directors would then pursue the actions permitted by law[39] that would maximize the value of a fully diversified portfolio that included holdings of all of the corporation's securities, as well as holdings of all other risky assets, in proportion to their share of overall market capitalization. Again, this calculation would be carried out without regard for any possible impacts upon their actual shareholders other than the effect on the value of this portfolio.

It is immediately apparent that this changed conception of the fictional shareholder solves the vicinity of insolvency inefficient investment incentives problem that is inherent in the use of the fictional undiversified shareholder concept. Fully diversified shareholders would own the corporation's common shares, preferred shares and bonds in proportion to those securities' relative proportions of overall firm capitalization. Those shareholders would consequently want directors to take into account the combined effects on the expected returns on all of their investments. In other words, the low or even negative expected returns for preferred shareholders and bondholders of investments that presented a significant possibility of losses that exceeded total common shareholder equity should now be given equal consideration with the expected returns to common shareholders in the deliberations, rather than ignored as they would be when the fictional shareholders are assumed to be undiversified and thus not owners of any of the corporation's preferred stock or bonds.

The fictional diversified shareholder concept is also more complete than the fictional undiversified shareholder concept in that it implies that the shareholders are risk-neutral with regard to the unsystematic risks posed by various corporate investments, although it does also have some indeterminacy in that it does not specify any particular shareholder attitude towards systematic risk. A board of directors attempting to maximize the wealth of fictional diversified shareholders will therefore be far more constrained in their investment choices than if their focus is fictional undiversified shareholders. For example, the choice of an investment project that does not have the highest expected return of the various alternatives being considered could no longer be justified simply on the basis of the greater stability of its expected returns compared to those higher-yielding alternatives, since the posited shareholders are already assumed to be fully diversified against such investment return volatility. It would be justified only if, first of all, that greater stability of returns has its source in lesser systematic variability of the expected returns on the investment—i.e., a more attenuated linkage between the investment's performance and overall market performance than that of the alternative investments, rather than in a lesser sensitivity to unsystematic sources of variation—and, second, if the fictional diversified shareholders are assumed to be risk-averse enough with regard to systematic, non-diversifiable risk to justify the sacrifice of expected returns necessary to obtain this reduction in systematic risk.

For the hypothetical investment choice presented at the beginning of Part II.B of this

39. *See supra* note 31 and accompanying text.

Article, if the directors utilized the fictional diversified shareholder concept they would first have to determine what portion of the return variability associated with each of the two investment options was due to unsystematic factors, and what portion instead reflected a systematic correlation with overall market returns. If the higher expected return option was found to have lower systematic risk than the other option, it would dominate the other option on both counts and would be chosen as shareholder wealth maximizing. If, however, that higher expected return option was determined to have greater systematic variability of returns than the alternative choice, then the decision could not be made until a particular degree of risk-aversion with regard to systematic risk was attributed to the fictional diversified shareholder and incorporated into the weighing of the alternatives.

This freedom to postulate a particular attitude towards systematic risk on the part of the fictional diversified shareholder clearly has the potential to be a "fudge factor" that undercuts the constraining effect of the shareholder wealth maximization norm, and thus is comparable in some regards to the freedom to postulate the shareholder's attitude towards overall risk in applying the fictional undiversified shareholder concept. However, there is a significant difference in this regard between these two fictional shareholder characterizations. In my opinion it would be considerably more difficult for directors to manipulate this attribution of systematic risk attitudes to the fictional diversified shareholder so as to favor non-shareholder corporate stakeholders than it would be for them to manipulate the attribution of an attitude towards overall risk to the fictional undiversified shareholder to achieve this end. The reason for this difference is that it is extremely difficult, if not impossible, in most instances for directors to meaningfully differentiate between alternative investment possibilities with regard to their level of systematic risk, as opposed to the much simpler exercise of identifying only differences in their overall level of risk. The available data will usually not credibly support any definitive conclusions as to differences in the degree of systematic risk of various investment options, and under those circumstances of inadequate information, the systematic risk of the various choices can only be assumed to be equal.[40] In those instances their relative ranking will therefore depend only upon expected returns and be unaffected by the degree of systematic risk aversion attributed to the generic shareholder.

With the attribution of attitudes towards systematic risk probably not relevant to the choice in most instances, the use of the fictional diversified shareholder concept will therefore in practice generally support the choice of the investment alternative that will have the largest positive impact on the expected returns to a fully diversified shareholder's portfolio, without regard to the investment's degree of systematic risk. The fictional diversified shareholder concept would thus substantially reduce the ability of directors to justify on shareholder wealth maximization grounds the choice of lower expected return/lower risk investments that may well be preferred by the corporation's preferred shareholders, bondholders, and employees, and particularly by its directors and senior officers because of their often relatively undiversified overall portfolios that are

40. "Recent surveys of corporate capital budgeting practices often do not even provide information on what risk adjustments and discount rates are used on the company level, much less on the project-by-project level." Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11, at 317 (footnotes omitted). "Recent surveys of the capital budgeting techniques actually used by managers indicate that, when managers do consider risk, it tends to be total rather than systematic risk." *Id.* at 321 (footnote omitted).

dominated by the value of their expected future stream of compensation from the corporation.[41] It thus would provide a meaningful constraint that would better serve shareholder wealth maximization than does the fictional undiversified shareholder concept to the extent that the corporation's actual shareholders are diversified investors,[42] at least when the investment choices under consideration do not differ significantly in their degree of systematic risk, or when the actual shareholders are not very sensitive to systematic risk.

The major difficulty posed by use of the fictional diversified shareholder concept is of course the extraordinary breadth of the interests of such posited shareholders that would have to be considered in assessing the various investment alternatives. Shareholder wealth maximization decisions would essentially have to be made with regard to their industry-wide or even economy-wide implications, sometimes with relatively little attention paid to their local consequences for common share prices or for the various other stakeholder constituencies of the subject corporation.[43] This may not be a feasible framework of analysis for guiding directors who often are relatively familiar with the immediate circumstances of their corporation's business operations, but unequipped to make reasonably accurate assessments of the industry-wide and economy-wide consequences of their investment choices. In particular, directors would have to assess with some precision the likely consequences of their decisions for the value of their shareholders' securities holdings in other corporations that are competitors to or suppliers or customers of the subject corporation, since some investments may have very favorable impacts on the value of a corporation's common shares yet be much closer to break-even or even negative expected value propositions when the price effects on the financial claims against these other firms are also considered. Boardroom deliberations would increasingly come to resemble Federal Reserve Board macroeconomic policy deliberations rather than routine discussions of normal corporation product line and capital budgeting decisions, and informed consensus could be quite difficult or even impossible to achieve. However, as will be discussed in Part III.F below, even if the fictional diversified shareholder characterization can in practice only be applied in an approximate fashion that does not attempt to quantify these more diffuse impacts of investments, use of that characterization will still result in a better means of incorporating the overall risk characteristics of the various investment alternatives under consideration into the decision than would use of the fictional undiversified shareholder characterization.

41. *But see supra* note 38.

42. Stout & Blair, *supra* note 16.

43. EASTERBROOK & FISCHEL, *supra* note 27, at 29

> A person who holds a diversified portfolio has an investment in the economy as a whole and therefore wants whatever social or private governance rules maximize the value of all firms put together. He is not interested in maximizing one firm's value if that comes out of the hide of some other corporation.

Id; *see also* Greenwood, *Fictional Shareholders*, *supra* note 5, at 1080-81 (noting that "[t]he portfolio shareholder . . . is largely indifferent or hostile to changes in the division of the economic pie between different security holders").

C. Maximizing the Wealth of Fictional Equity-Only Diversified Shareholders

Assume now that this hypothetical shareholder wealth-maximizing board of directors is utilizing the fictional equity-only diversified shareholder concept as its yardstick. Under this approach, directors may choose inefficient vicinity of insolvency-type investments, which would be attractive to the corporation's common shareholders—who are here assumed not to hold any of the corporation's preferred shares or bonds—but which promise relatively low or even negative expected returns overall when the impacts on these other corporation equity securities are also considered. This result is similar to that which can occur when the fictional undiversified shareholder concept is used. But this approach would differ from the fictional undiversified shareholder approach in that the directors would now also have to consider the consequences of their decisions on the value of the common shares of other corporations, and thus would have to internalize the impact of their decisions upon the corporation's competitors, suppliers, and customers. Therefore, this approach would require, to a large extent, the same broad assessment of the industry-wide and even economy-wide consequences of investments—as does use of the fictional diversified shareholder concept—as well as impose the comparable requirements that the systematic component of the variability of returns on each investment option be isolated and a specific degree of risk-aversion be ascribed to this fictional shareholder. This assessment would be simplified somewhat in this instance, relative to the assessment required under the fictional diversified shareholder concept, since the directors at least would not have to consider the impacts of their choices upon the preferred shareholders and bondholders of their corporation or of those of other corporations.

D. Maximizing the Wealth of Fictional Corporation-Specific Diversified Shareholders

Finally, assume that this hypothetical board of directors is using the fictional corporation-specific diversified shareholder concept to make its decisions. This concept would prevent directors from engaging in those inefficient vicinity of insolvency-type investments that benefited the corporation's common shareholders, but which imposed large costs on the corporation's preferred shareholders and, perhaps, bondholders. In this regard it shares this advantage with the fictional diversified shareholder concept over either the fictional undiversified shareholder or the fictional equity-only diversified shareholder concepts. It also has a significant advantage over the fictional diversified shareholder concept of not requiring a Herculean assessment of the industry-wide or economy-wide consequences of investment choices, but only assessment of impacts on the corporation's own different securities.

On the other hand, the fictional corporation-specific diversified shareholder concept simply ignores the implications of the subject corporation's investments on the values of securities issued by other corporations, or on the values of other, non-corporate assets that its actual shareholders may own. Thus this concept is also vulnerable to the problem presented by the fictional undiversified shareholder approach of inaccurately reflecting the interests of the many actual shareholders who are diversified across different corporations and other non-corporate assets in their investment portfolios. It also shares with the fictional undiversified shareholder concept the very serious problem of providing no guidance as to the degree of risk-aversion to ascribe to this relatively undiversified generic shareholder, again leaving directors with a degree of freedom sufficient to justify either of the choices presented in the hypothetical at the beginning of Part II.B as being consistent with shareholder wealth maximization.

E. Choosing the Optimal Generic Fictional Shareholder Characterization

In the following Parts of this Article, I will first compare the features of the four alternative fictional shareholder characterizations discussed above. I will then consider the properties of a hybrid characterization that includes a mixture of fictional undiversified shareholders and fictional diversified shareholders. Finally, I will contrast the conclusions that I have reached with the work of several prior writers.

1. Comparison of the Four Alternative Fictional Shareholder Characterizations

All four of the alternative generic fictional shareholder characterizations discussed in this Article are "second-best" solutions relative to the theoretically preferable, but perhaps infeasible, approach of directors first attempting to assess the consequences of different investments for each of the corporation's actual shareholders, and then accommodating the conflicts of interests among those shareholders in some politically and philosophically defensible fashion.[44] All of these fictional shareholder characterizations are equally susceptible to the criticism that they ignore the personal circumstances of actual shareholders, except for the composition of their asset portfolios. Each is also vulnerable to the criticism that its particular assumptions about the extent of shareholder portfolio diversification do not accurately reflect the circumstances of all the corporation's shareholders, and that it is incomplete with regard to fully specifying the hypothetical shareholder's attitudes towards risk.

The main question of this Article is thereby posed: given that these four alternative fictional shareholder characterizations differ only in the nature of their partially inaccurate and incomplete assumptions regarding the extent of shareholder diversification and shareholder attitudes towards risk, and in the scope of director deliberations that would consequently be required to select the shareholder wealth-maximizing investment alternatives, which of these characterizations, if widely embraced by directors, would be most likely to promote the maximization of the wealth of actual public corporation shareholders?

The answer here is not immediately obvious because each of these four alternatives has its own advantages and disadvantages and no alternative clearly dominates the others on all of the relevant evaluative criteria. For example, the fictional diversified shareholder and the fictional corporation-specific diversified shareholder characterizations each avoid the problem of potentially endorsing inefficient investments as shareholder wealth maximizing under vicinity of insolvency circumstances.[45] This is an advantage they each have over the other two fictional shareholder characterizations. As another example, the fictional diversified shareholder and the fictional equity-only diversified shareholder

44. For discussion of this feasibility question, see *infra* Part IV.

45. Moreover, even very solvent corporations are now in the "vicinity of insolvency" at all times given the existence of relatively "perfect" capital markets that offer the opportunities for making very large and very risky investments. *See* Smith, *supra* note 29, at 224.

characterizations each better align director decisions with the interests of actual diversified shareholders than do either of the other two characterizations, though they are, of course, both inferior to the fictional undiversified shareholder approach for aligning director incentives with the interests of undiversified shareholders. Both are also inferior to the fictional corporation-specific shareholder concept in aligning director incentives with the interests of corporation-specific diversified shareholders.

The expected return properties of alternative investments are far easier to assess with regard to fictional undiversified shareholders than they are with regard to fictional diversified shareholders or fictional equity-only diversified shareholders. These latter shareholder characterizations would require essentially industry-wide or even economy-wide assessment of their impacts to ascertain the relevant expected portfolio return impacts. Alternative investments are at least a little easier to assess for fictional undiversified shareholders than they are with regard to fictional corporation-specific diversified shareholders, where the consequences for the corporation's preferred stock and bond values of investment projects will also need to be considered. However, the fictional undiversified shareholder and the fictional corporation-specific diversified shareholder concepts each provide no means of determining what degree of risk-aversion, if any, to ascribe to those generic shareholders. On the other hand, the fictional diversified shareholder and the fictional equity-only diversified shareholder concepts at least incorporate the assumption of shareholder risk-neutrality with regard to the unsystematic variability of investment returns. However, they each also have a degree of indeterminacy with regard to the posited generic shareholder's attitudes towards systematic risk.

A comparative assessment of the merits of the four alternatives is thus difficult because of the incomensurability of their different features. Nevertheless, I believe that some important generalizations can be made. My first conclusion is that two of these characterizations—the fictional undiversified shareholder concept and the fictional corporation-specific diversified shareholder concept—should each be discarded as unacceptable alternatives. Let me explain why I reject these two approaches.

The fictional undiversified shareholder concept, while it is the currently prevailing approach and is by far the easiest of the approaches to apply, should nevertheless be discarded for two reasons. First, it is very unrealistic with regards to the actual extent of public corporation shareholder diversification.[46] Second, perhaps even more importantly, it leaves the directors free to posit whatever degree of risk-aversion on the part of the fictional undiversified shareholder that is necessary to justify making low expected return/low risk investment choices that favor the interests of directors and senior managers, and/or other corporate stakeholders, over those of the actual common shareholders. This degree of freedom inherent in the use of the fictional undiversified shareholder concept totally undercuts the ability of the shareholder wealth maximization norm to constrain directors to favor the interests of shareholders over their own personal interests and those of senior officers or other corporation stakeholders. This constraint on director conduct is really the whole point of the shareholder wealth maximization norm in the first place, and the fictional undiversified shareholder concept is thus an unacceptable

46. "[T]he vast majority of investments are held by people with diversified portfolios." EASTERBROOK & FISCHEL, *supra* note 27, at 30.

approach for implementing that norm.

The fictional corporation-specific diversified shareholder concept also has the advantage of relative ease of application. It limits the need for the assessment of expected returns and risks to those impacts upon the corporation's own securities. However, once again, this approach has what I regard as the fatal flaw of leaving directors free to posit whatever degree of shareholder risk aversion is necessary to justify any (non-dominated) investment choice as shareholder wealth maximizing.

The bottom line is that despite the relatively greater ease of application of each of these two approaches compared to the other two alternatives, they are unacceptable. These two approaches simply do not provide a meaningful constraint on director conduct, and thus would rob the shareholder wealth maximization norm of any real power to further shareholder interests.

Turning to the remaining two candidates, the contest is close but I believe that the fictional diversified shareholder concept is to be slightly preferred over the fictional equity-only diversified shareholder concept. Neither of these two approaches suffers from the fatal indeterminacy flaw of the fictional undiversified shareholder and fictional corporation-specific diversified shareholder concepts with regard to shareholder risk attitudes, since each implicitly assumes shareholder risk-neutrality with regard to unsystematic risk. However, both of the approaches are subject to the criticism that they suffer from a lesser, but still somewhat troubling, indeterminacy problem with regard to specifying shareholder attitudes towards systematic risk. As I have discussed,[47] however, this indeterminacy presents less potential for manipulation adverse to shareholder interests because of the difficulty of differentiating among investment options as to their relative degrees of systematic risk.

The fictional diversified shareholder concept has one clear advantage over the fictional equity-only shareholder concept in that it is not subject to the vicinity of insolvency problem of potentially endorsing inefficient investments. The fictional diversified shareholder concept also has the slight advantage of being a somewhat more plausible characterization of actual shareholder diversification practices. The two approaches unfortunately share the rather serious operational disadvantage of requiring industry-wide or even economy-wide assessment of investment project impacts. However, this assessment may be at least slightly easier under the fictional equity-only diversified shareholder concept since only the impacts upon equity securities would need to be considered.

The fictional diversified shareholder concept, in my opinion, ultimately wins this contest because it better addresses the vicinity of insolvency inefficient investment incentives problem. In addition, this concept does not have any significant offsetting disadvantages relative to the fictional equity-only diversified shareholder concept. It is a qualified victory, however, because of the severe implementation difficulties presented by the broad assessments called for by this approach. Also, the nagging indeterminacy problem remains with regard to positing the generic shareholder's attitude toward systematic risk that would still present some opportunities for directors to justify, on shareholder wealth maximization grounds, investment projects undertaken primarily to further the interests of other stakeholder constituencies.

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47. *See supra* note 40 and accompanying text.

2. Maximizing the Wealth of a Mixture of Fictional Undiversified and Fictional Diversified Shareholders

Given the problems discussed above with each of the four alternative fictional shareholder characterizations, one might wish to consider the relative advantages and disadvantages of directors embracing a more complex fictional shareholder characterization that allows for some recognition of variation among shareholders as to the extent and nature of their portfolio diversification. Such an approach initially appears superior in some regards to the prior unitary fictional shareholder alternatives. It would provide directors with the opportunity to use a more accurate generalization as to the degree of diversification of a corporation's actual shareholders than would a simpler unitary approach that shoehorned all shareholders into one overly broad category. Unfortunately, further consideration reveals that such a hybrid approach does not really solve any of the difficulties that are inherent in the various unitary fictional shareholder characterizations. Moreover, it introduces at least two additional complications that make the application of this more complex fictional shareholder characterization even more difficult.

Let me illustrate this point by positing a slightly more complex fictional shareholder characterization for a public corporation that consists of a combination of undiversified shareholders and fully diversified shareholders. The choice of investment projects on shareholder wealth maximization grounds would then have to be done with regard to the combined effects on overall shareholder wealth of the (potentially different) impacts on each of these two subpopulations of fictional shareholders. One can immediately see that the various problems of each of these two fictional shareholder characterizations would now all be present; none would be avoided by this combined approach. The wealth impact of each investment alternative on the subpopulation of fictional, undiversified shareholders would still depend crucially on the degree of risk aversion imputed to those persons, and there would still be no constraint imposed upon the ability of directors to manipulate this imputation of risk attitudes to support the alternative that they may favor on grounds other than shareholder wealth maximization. Moreover, the investment alternative that most enhanced that subpopulation's wealth may be inefficient due to the vicinity of insolvency inefficient incentives problems. In addition, determination of the wealth impact of each alternative on the other subpopulation of fictional diversified shareholders would still require attribution of an attitude towards systematic risk on the part of the fictional diversified shareholder, as well as a very difficult assessment of its industry-wide or even economy-wide consequences.

Use of such a two-class combined fictional shareholder characterization also introduces two new difficulties not presented by the use of a unitary fictional shareholder characterization. The lesser problem created by this combined characterization is that a judgment must now be made as to the assumed distribution of shareholdings between fully undiversified portfolios and fully diversified portfolios that most accurately characterizes the corporation's actual investors. The relative proportions could perhaps be assigned generically based on an overall estimate of the proportion of overall corporate equity holdings that are held either by (presumably diversified) institutional investors[48]

48. I recognize that many hedge fund institutional investors deliberately choose to take concentrated positions in what they regard as promising ventures so as to potentially realize large gains. However, such

or by individuals that have chosen to hold diversified portfolios, or on the basis of a more corporation-specific assessment regarding the extent of portfolio diversification of a particular corporation's shareholders. Either of these choices would require an additional determination based upon empirical data that is not required by a single-class fictional shareholder characterization.

The more serious difficulty introduced by the use of a two-class characterization is that for each investment alternative the separate impacts on the wealth of each of the two classes of shareholders will then have to be combined in some fashion to determine which investment alternative will maximize overall shareholder wealth. This requirement will reintroduce the interpersonal welfare comparison problem that the unitary fictional shareholder concepts are intended to avoid. In those instances where the same alternative is determined to be wealth maximizing with regard to either subpopulation of posited shareholders, the need to combine the wealth impacts on each subpopulation before making the choice is mooted. However, it is entirely possible that the investment alternative that maximizes the wealth of fictional undiversified shareholders that are assumed to be risk-averse to some particular extent with regard to unsystematic investment risks, and that are unconcerned with the alternative's impacts upon the corporation's preferred shareholders or bondholders, or upon the holders of securities of other corporations, may not be the same investment alternative most favored by fully diversified shareholders who are risk-neutral with regard to those unsystematic risks and who are quite concerned about the consequences of the alternatives for the values of all of these other securities they own.

The choice of investment alternatives under these circumstances of conflicting shareholder preferences will necessarily involve sacrificing the interests of one subpopulation of the corporation's assumed shareholders to further the interests of the other subpopulation. How will this choice be made? On the basis of one shareholder, one vote, necessitating the determination of the corporation's actual shareholder profile? On the basis of one share, one vote, postulating hypothetical votes in accordance with the relevant fictional shareholder interests? On the basis of overall aggregate fictional shareholder wealth maximization? Does the norm of shareholder wealth maximization justify directors imposing uncompensated sacrifices on some fictional shareholders in order to benefit others, if overall fictional shareholder wealth is thereby maximized; i.e., does it implicitly embrace use of the Kaldor-Hicks efficiency criterion[49] applied to shareholder impacts alone, even if the subpopulation of fictional shareholders whose interests would be sacrificed own a majority of the shares and would thus prevail in a typical corporate election or policy referendum? These are exactly the difficult political and philosophical questions that the use of a fictional shareholder characterization is intended to finesse, and embracing even a still radically oversimplified two-class fictional shareholder characterization unfortunately reintroduces those issues into director deliberations.

My conclusion is that the use of such a hybrid characterization of the fictional

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hedge funds draw their capitalization essentially from diversified institutional or individual investors, so they are best regarded as aspects of larger diversified portfolios.

49. The Kaldor-Hicks criterion would call for aggregating the impacts on all affected shareholders, with the impact on each affected person measured by their willingness to pay for beneficial impacts, or to avoid adverse impacts. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 13 (6th ed. 2003).

shareholder, while allowing for a somewhat more realistic and accurate modeling of the degree of diversification exhibited by actual shareholders, is not only still subject to all of the various problems inherent in each of the single-class fictional shareholder characterizations—including the severe risk-attribution indeterminacy problem of the fictional undiversified shareholder concept—but now introduces an additional requirement of aggregating wealth impacts across differently situated shareholders that renders it incapable of serving as a means for directors to avoid addressing in their deliberations regarding shareholder wealth maximization any potential conflicts of interest among their corporation's shareholders. It thus defeats the whole purpose of using a fictional shareholder concept to facilitate those decisions, and thus also is inferior to the use of the fictional diversified shareholder concept.

3. Contrast with the Conclusions Reached by Other Analysts

I am not the first person to consider the consequences of alternative fictional shareholder characterizations for corporate investment decisions. However, the existing literature that addresses this question is surprisingly sparse[50] given that the choice of fictional shareholder characterization used by directors can lead to "dramatic differences" in the way corporations behave.[51] That literature is also quite limited in its scope of coverage and addresses only tangentially many of the theoretical and practical issues that are presented. Some of that work is in general accord with my conclusions, but at least one of the prior writers reaches a very different conclusion. Let me briefly discuss and compare with my conclusions the contributions that have been made by Richard Booth, Daniel Greenwood, and Henry Hu. I will address these prior scholarly efforts in chronological order.

Henry Hu's 1990 *UCLA Law Review* article[52] is the seminal work on this topic, and has provided a valuable jumping-off point for later researchers. In that analysis Hu began by recognizing the significant advantages for directors of utilizing a fictional shareholder concept to make their investment decisions, as compared to the difficulties of having to assess and balance actual shareholder preferences.[53] He then compared the fictional

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50. The only articles of which I am aware that directly address the questions that I consider in this Article are: Booth, *supra* note 9; Greenwood, *Fictional Shareholders*, *supra* note 5; Hu, *New Financial Products*, *supra* note 11; Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11.

51. Greenwood, *Fictional Shareholders*, *supra* note 5, at 1057. Greenwood speculates that the reason for there being so little scholarship addressing the implications of different fictional shareholder characterizations is because the fictional undiversified shareholder concept and the fictional diversified shareholder concept "are so often viewed as unproblematically the same." *Id.* at 1057 n.83.

52. Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11.

53.

> [M]anagers, especially those in publicly held corporations, would find it extremely difficult to ascertain the true time and risk preferences of existing shareholders, much less those of potential shareholders. At best, the managers may be able to determine the general income levels of its existing shareholders and the rough proportion of their wealth invested in the company and, on the basis of such facts, make some reasonable assumptions as to such preferences. Managers would prefer to make investment decisions that would not require the ascertainment of actual shareholder preferences.

Id. at 288 (footnotes omitted).

undiversified shareholder concept (which he labeled the "classic fiduciary principle"[54]) with two versions of the fictional diversified shareholder concept, one of which he called "pure shareholder wealth maximization"[55] and the other which he named "blissful shareholder wealth maximization."[56] These two versions differ only in their assumptions as to the pricing efficiency of capital markets. His blissful shareholder wealth maximization concept (which assumes an efficient capital market) corresponds most closely to my fictional diversified shareholder concept.[57]

Hu strongly endorsed the use of the fictional diversified shareholder concept, with some qualifications,[58] primarily on the basis that its underlying assumptions about the broad extent of shareholder diversification are more realistic than the assumptions underlying the fictional undiversified shareholder concept.[59] He argued, as do I, that use of the fictional undiversified shareholder concept will lead directors to be too sensitive to the unsystematic risks associated with investment choices, relative to actual diversified shareholder preferences.[60] His article also makes clear his understanding of the important point that when directors are choosing among investment options with different degrees of risk using a fictional undiversified shareholder concept, their choice will in general depend upon the degree of risk aversion attributed to the hypothetical shareholder, and that the fictional undiversified shareholder concept does not specify any particular

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54. *Id.* at 282.

55. *Id.* at 283.

56. *Id.* at 282.

57. Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11, at 282-83. It is not entirely clear whether Hu's blissful shareholder wealth maximization framework assumed that the hypothetical corporation shareholder was fully diversified across all asset categories, including the preferred shares and bonds of various corporations and other non-corporate assets, or whether that shareholder was assumed to be diversified only across the equity claims against different corporations.

58. Hu did not feel that use of this blissful shareholder wealth maximization framework for investment decisions was appropriate in the context of closely held corporations, thinly traded corporations, or under other special circumstances where corporations' shareholders were prevented from engaging in adequate diversification. *Id.* at 361-66.

59.

> [M]anagers of the typical, large, publicly held corporation should act consistently with 'blissful' shareholder wealth maximization. . . . [This approach] leads away from an undue concern with the health of the particular corporate entity and toward concern with the value of a share of that corporation to a shareholder who holds stakes in many different corporations. More shareholder wealth-enhancing risk taking would be warranted [than with use of the fictional undiversified shareholder concept].

Id. at 282-83.

60.

> If shareholders are diversified and the risk associated with a project can be diversified away, managers can concentrate on expected returns and pay relatively little attention to such "diversifiable," "unique," or "unsystematic" risk. Stated more generally, if shareholders hold diversified portfolios (as is usually presumed for publicly held corporations), corporate managers dedicated to acting consistently with shareholder optimality should pay relatively little attention to unsystematic risk in judging among investment alternatives.

Id. at 292-93 (footnotes omitted).

shareholder attitude towards risk.[61] While Hu also notes that directors are likely to be less diversified and therefore more risk-averse with regard to unsystematic risk than are their generally more fully diversified shareholders, he does not emphasize, as I do, the potential for directors to use the risk attitude indeterminacy of the fictional undiversified shareholder concept to undercut altogether the constraining effect of the shareholder wealth maximization norm and favor other corporate stakeholders (including themselves and senior corporate officers) over common shareholders while still paying lip service to that norm.

Hu's 1990 article reaches the same broad conclusion as I have, that the fictional diversified shareholder concept is to be preferred over the fictional undiversified shareholder concept as a means of implementing the shareholder wealth maximization norm. However, the scope of his analysis with regard to this question is much more limited.[62] Hu does not consider any of the several other variations of the fictional diversified shareholder concept that I have considered here,[63] nor does he consider the vicinity of insolvency inefficient investment incentives problem. His focus is almost exclusively upon the different treatments of unsystematic investment risk under the two approaches that he considers, and how use of the fictional diversified shareholder concept better serves shareholder wealth maximization under modern conditions of widespread investor diversification.[64] In addition, Hu qualifies somewhat his endorsement of the fictional diversified shareholder concept by calling for limiting its use to decision making for public corporations whose shareholders do not face special constraints on their diversification.[65] However, he does not adequately address the severe implementation problems that the directors of such corporations would face in making the broad industry-wide and economy-wide assessments necessary to determine the relative impacts of alternative investment options on such a hypothetical diversified shareholder. Hu does argue that board committees of independent outside directors be appointed with the mandate of assuring that decisions be made in accordance with that framework.[66] But the main thrust of his recommendation is to attempt to ensure director fealty to the fictional diversified shareholder concept rather than to facilitate the data collection and assessments needed to apply this concept.[67] Hu also notes that under the circumstances of closely held or otherwise thinly-traded corporations the lack of realism of the fictional

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> The choice between Project A and Project C is more difficult. . . . Project C is higher risk than Project A, but has a higher return. . . . The corporation's degree of risk-aversion will determine its choice. A corporation which is only slightly risk-averse will pick Project C, whereas a corporation which is highly risk-averse will pick Project A, the lower expected return project.

Id. at 285. "Classic fiduciary principles [i.e., the fictional undiversified shareholder concept] provide virtually no guidance on how quantitatively risk-sensitive . . . corporations should be." Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11, at 301.

62. *See id.* at 282 (discussing the advantages of particular diversified shareholder concepts).

63. These other alternatives that I have discussed include the fictional equity-only diversified shareholder concept, the fictional corporation-specific diversified shareholder concept, and the hybrid mixture of fictional undiversified shareholders and fictional diversified shareholders concept.

64. *Id.* at 355-66, 389.

65. *See supra* note 58.

66. Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11, at 366-73.

67. *Id.*

diversified shareholder concept would make it inappropriate for directors to apply this concept and ignore the circumstances of the corporation's actual shareholders.[68] However, he does not address how potential conflicts of interest among these shareholders are to be assessed and accommodated by the directors of these corporations.

In his subsequent 1991 *Texas Law Review* article, Hu again set forth his three alternative fictional shareholder characterizations.[69] The first concept, which corresponds to my fictional undiversified shareholder concept discussed in Part B.1, is formally labeled the "classic entity-oriented model."[70] The second and third concepts are again labeled the "pure shareholder wealth maximization model" and the "blissful shareholder wealth maximization model," and are defined in the same manner as in his earlier article.[71] The scope of his analysis is roughly the same as that of his earlier work, but somewhat surprisingly the conclusions he reaches are far more equivocal than those of his prior article that was published only a short time earlier.

In this latter article, Hu focuses primarily on the significance of the proliferation of new financial products, such as multiple classes of equity-like claims and new hedging instruments for the determination of whether the fictional undiversified shareholder concept or the fictional diversified shareholder concept provides the more appropriate framework for corporate investment decisions.[72] One important point he makes is that the increasingly widespread availability of a wide variety of hedging instruments makes the choice of fictional shareholder characterization more critical, because those instruments are essentially designed to reduce unsystematic risk.[73] Such hedging instruments may under some circumstances therefore be appropriate investments with regard to the interests of fictional undiversified shareholders. However, they are inappropriate investments for a corporation that is attempting to maximize the wealth of fictional diversified shareholders who are assumed to already be fully diversified against such unsystematic risks.[74] His second major point is that the proliferation of what he labels "interstitial securities"[75] that do not fit into conventional common stock/preferred stock/bonds categories—such as convertible exchangeable preferred stock, bonds with detachable warrant rights, separate internal tracking stocks, multiple classes of common stock with differing rights, etc.—make it problematic as to who is the hypothetical "shareholder" whose wealth is to be maximized, even apart from the issues presented by the appropriate degree of portfolio diversification assumed to be best characterizing that hypothetical shareholder.[76]

In the face of these new complexities, Hu essentially retracts his earlier qualified endorsement of the fictional diversified shareholder concept. He now declines to advance a definitive position on how the question should be resolved. He simply states in closing

68. *Id.* at 362-65. "When the disposition of shares is subject to limitation, ignoring the personal preferences of shareholders can hurt the welfare of shareholders." *Id.* at 362.

69. Hu, *New Financial Products*, *supra* note 11.

70. *Id.* at 1277-79.

71. *Id.* at 1277, 1282-86.

72. *Id.* at 1278-1317.

73. *Id.* at 1288.

74. Hu, *New Financial Products*, *supra* note 11 at 1306-09.

75. *Id.* at 1293.

76. Hu, *New Financial Products*, *supra* note 11, at 1292-97.

that his three conceptions of the shareholder now each "turn out to provide inappropriate or limited guidance" to directors given modern circumstances of widespread and significant financial innovation, and that he "does not purport to provide an answer" to the question of the appropriate decision making framework.[77]

I find Hu's sharp retreat from his earlier position somewhat puzzling. I agree wholeheartedly with his observation that the greater availability of hedging instruments that are tailored to allow corporations to reduce the unsystematic variability of their earnings increases the importance of determining the appropriate fictional shareholder characterization to guide directors' shareholder wealth maximization efforts. However, I fail to see how either the greater availability of hedging instruments or the proliferation of new equity-like claims in corporate capital structures undercuts in any way the arguments in favor of use of the fictional diversified shareholder concept to facilitate shareholder wealth maximization. Such a hypothetical shareholder would be assumed to already be fully diversified against unsystematic risk, rendering these hedging instruments superfluous. He would be holding each of these new equity-like claims in his portfolio in proportion to their share of the firm's overall capitalization, as well as holding comparable proportions of all other assets available in the capital markets, and would still want the directors to choose those investment options that maximized his overall portfolio value. The investment choice calculations thus required of directors, while obviously quite complex, would be no different in kind and not appreciably more difficult in practice than those that would be required of them if their firms had simpler capital structures and if hedging instruments were unavailable. The complexity of these calculations may render the fictional diversified shareholder concept infeasible, but that feasibility determination is essentially unaffected by the proliferation of hedging instruments or new forms of equity claims.

Daniel Greenwood's 1996 *Southern California Law Review* article[78] is without question the definitive discussion of the fictional shareholder concept and its implications for corporate behavior. The article makes it abundantly clear that director investment decisions purportedly intended to promote shareholder wealth maximization currently rest uneasily upon the fictional undiversified shareholder concept. However, while Greenwood's article demonstrates that he fully understands the significance for investment choices of the differences between the fictional undiversified shareholder and fictional diversified shareholder concepts,[79] he does not declare a clear preference for one or another of these fictional shareholder characterizations. Nor does he explore any of the other possible alternative fictional shareholder characterizations that I have discussed and that lie along the degree of diversification continuum. Rather, the thrust of his article is an "external" critique of the use of *any* fictional shareholder characterization.[80] He would prefer that directors grappled directly with the political and philosophical questions involved in maximizing not simply the financial wealth of actual corporate shareholders who may have conflicting financial interests based on their

77. *Id.* at 1317.

78. Greenwood, *Fictional Shareholders*, *supra* note 5.

79. *Id.* at 1056-89. Greenwood uses the phrase "corporate law fictional shareholder" to refer to what I call the "fictional undiversified shareholder" concept, and the phrase "portfolio investor shareholder" to refer to what I call the "fictional diversified shareholder" concept. *Id.* at 1056.

80. *Id.* at 1100-04.

different asset holdings, but instead their overall welfare inclusive of non-financial considerations that may create yet additional conflicts among the group.[81] I will revisit Greenwood's arguments in the next Part of this Article and I will address this external critique of the use of fictional shareholder characterizations.

Finally, Richard Booth in a *The Business Lawyer* article published in 1998[82] compared the merits of the fictional undiversified shareholder concept with the fictional diversified shareholder concept.[83] In sharp contrast to my conclusions and those reached by Hu in his initial 1990 article,[84] Booth came down strongly in favor of the use of the fictional *un*diversified shareholder concept.[85]

Booth goes beyond the earlier work of Hu in showing a clear awareness of the "vicinity of insolvency" inefficient investment incentives problem raised by each of these two fictional shareholder concepts.[86] He also goes beyond Hu's analysis to claim that defining directors' duties as running to fictional diversified shareholders would be "unworkable."[87] However, the major concern that Booth expresses for the feasibility of the use of the fictional diversified shareholder concept is not the extensive data requirements of that approach with regard to industry-wide and economy-wide impacts, but instead the difficulty that directors would have in determining the precise extent and

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81. *Id.* at 1098-1104.

82. Booth, *supra* note 9.

83. *Id.* at 429-30.

84. Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11.

85. "Most scholars who favor stockholder wealth as the measure of management duty have quite naturally assumed that management should manage with the interests of diversified stockholders in mind because rational investors diversify. . . . [However] management duty should be thought of as owed to an undiversified stockholder . . . ." Booth, *supra* note 9, at 434-35 (footnote omitted).

> In summary, although it is clear that rational investors diversify, and thus superficially arguable that management duty to the stockholders should be construed with diversified stockholders in mind, on closer analysis it is probably the better view that management duty should be interpreted as if it is owed to the corporation or to a reasonable undiversified stockholder. Such a conception of management duty makes sense even if in fact a given corporation's stock is owned predominantly by diversified shareholders.

Id. at 455-56.

86. Booth, *supra* note 9, at 454-56.

87. *Id.* at 435. Booth elaborates upon his basis for making this unworkability claim as follows:

> First, practically speaking, managers cannot be expected to make business decisions on the basis of what a diversified investor would prefer. For all management knows, there are many different kinds of diversified investors out there following very different models in making their investment decisions. What one investor might prefer management to do (in light of that investor's particular portfolio) might differ radically from what another investor might like to see. Second, several market phenomena seem to suggest that investors prefer managers who do their jobs single-mindedly and without attempting to anticipate preferences which individual investors have for company-level strategies designed to replicate similar strategies that investors can pursue more cheaply. For example, investors seem clearly to prefer that management refrain from conglomerate diversification over various lines of business as a way of smoothing out income, presumably because investors themselves can diversify their holdings virtually costlessly. . . . Third, because many stockholders also own bonds (at least at some time in their investing lives), and because all investors value predictability, investors in general will opt for a rule which prevents the intentional divergence of returns from one class of investment to another.

Id. at 435-36.

nature of their shareholders' diversification.[88] This indicates that the comparison he is actually undertaking in his article is between the fictional undiversified shareholder concept and attempting to empirically determine and then accommodate actual shareholder financial circumstances and preferences, rather than between two different fictional shareholder concepts.

It is not entirely clear whether Booth would still favor the fictional undiversified shareholder concept over the fictional diversified shareholder concept in the sort of direct fiction-to-fiction comparison that I have made, although my strong surmise is that he would because of the interesting reasons that he gives for his conclusions. My rejection of the fictional undiversified shareholder concept is primarily based upon the degree of freedom it allows as to the level of risk-aversion that is to be ascribed to fictional undiversified shareholders, which as I have emphasized, I regard as fatal to that concept as a means of implementing a director-constraining shareholder wealth maximization norm. However, this indeterminacy that I regard as a flaw in that concept, Booth regards as a virtue! While the focus of my analysis is the question of which fictional shareholder characterization will best further shareholder wealth maximization, Booth is apparently more interested in implementing the shareholder wealth maximization norm in a fashion that allows directors to also consider the interests of non-shareholder corporate stakeholders such as its bondholders and employees. He recognizes that the use of the fictional diversified shareholder concept will force directors to maximize profits even at the risk of bankrupting the firm, because of the indifference of such diversified investors to unsystematic risk.[89] If the directors instead utilize a fictional undiversified shareholder concept, however, they will as a result necessarily be concerned with minimizing the unsystematic risks associated with firm earnings as well as maximizing the expected value of those earnings.[90] If their investment choices are made partially with regard to these unsystematic risk consequences, the corporation-specific interests of non-shareholder corporate stakeholders—such as bondholders and employees—will be better protected than they would be if those consequences were ignored.[91] This property of the

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88. See the first portion of Booth's quotation above. Booth, *supra* note 9, at 435-36. Moreover, the second concern expressed above simply calls for managers seeking to maximize the wealth of fictional diversified shareholders to eschew company-level strategies that serve only to reduce unsystematic risk, which is an entirely "workable" principle to follow. Similarly, Booth's third concern expressed above simply calls for managers to consider the impacts of their actions upon their corporation's preferred shares and bonds as well as upon the common shares, again an entirely "workable" principle to apply. As I have discussed in this Article, the true practical difficulty posed by the fictional diversified shareholder concept is the breadth of analysis of investment policy impacts which it would require, which Booth does not address in his article.

89. *Id.* at 429-30.

90. *Id.* at 430.

91.

> If management duty is measured by the interest of an undiversified stockholder, the duty is to maximize profits *and* to minimize risk. An undiversified stockholder will likely prefer a merely adequate return to a high return with high risk. Such an investor cares very much about the survival of the firm. Thus, stakeholder interests are implicitly protected if fiduciary duty is seen as owed to an undiversified stockholder . . . .

Id. at 430;

> [T]he interests of undiversified stockholders . . . may be more akin to the interests of bondholders and employees than they are to diversified stockholders because such [undiversified] stockholders

fictional undiversified shareholder concept is the core underpinning of Booth's conclusion as to its preferability.

Booth in his article also offers the interesting and counter-intuitive claim in support of the use of the fictional undiversified shareholder concept that even diversified investors would prefer directors to act as though they owed their fiduciary duties solely to undiversified shareholders.[92] He rests this claim primarily upon the argument that the widespread use of stock option compensation for senior corporate management, which in most instances places those managers in the position of relatively undiversified corporate shareholders because of the large size of those stock option positions relative to the managers' overall wealth, evidences a desire on the part of the diversified shareholders that the managers behave in accordance with the interests of undiversified shareholders.[93]

I am unconvinced by this argument. While it is possible that the common use of corporation stock options for management compensation purposes—rather than the use of stock options on the shares of a diversified mutual fund—may reflect an implicit choice on behalf of diversified shareholders that they want to encourage their officers to maximize the wealth of undiversified shareholders rather than of diversified shareholders, it seems more likely that stock option compensation is currently utilized as a rather crude means to encourage management to generally favor shareholder interests (however defined) over their own personal interests. Furthermore, it does not reflect a considered choice regarding which of the possible fictional shareholder characterizations that diversified investors would want their directors and officers to embrace.[94]

Despite my disagreements with portions of Booth's analysis I regard it as a valuable contribution to this debate. It highlights the important point that the comparative assessment of the use of different fictional shareholder characterizations by directors can only be meaningfully carried out with regard to the particular objectives that one is attempting to facilitate those directors achieving. My preference for the fictional diversified shareholder concept is predicated upon the assumed goal of best facilitating the narrow objective of actual shareholder wealth maximization, and best constraining

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> may well prefer that the corporation simply chug along generating an adequate return. Thus, viewing management duty as a duty to undiversified stockholders or the corporation itself, rather than to diversified shareholders, has the effect of incorporating a duty to other constituencies.

Id. at 436 (footnote omitted).

92. "[D]iversified shareholders will, in any event, prefer management to behave as if it owes its duties to undiversified stockholders." Booth, *supra* note 9, at 430. "[I]t appears that diversified stockholders, who are supposedly risk-neutral, prefer management to behave as though they were not risk neutral. . . . In the end, it is at least possible that diversified stockholders prefer management to manage as if for the benefit of undiversified owners . . . ." *Id.* at 453-54.

93. Booth, *supra* note 9, at 453-54.

94. An alternative and much more plausible explanation for the failure of corporations to utilize stock options on the shares of diversified mutual funds as incentive compensation rather than stock options on the corporation's common stock is the fact that any connection between a particular corporate officer's actions and the performance of such a diversified mutual fund is likely to be extremely attenuated. In other words, it is not that diversified investors do not want managers to attempt to maximize those investors' wealth, rather than the wealth of undiversified shareholders, but simply that movements in mutual fund values, while likely to closely reflect changes in the wealth of diversified investors, are unfortunately not likely to be closely enough linked to particular corporate managers' performances to effectively provide incentive-linked compensation for those managers.

directors from favoring their own interests and the interests of non-shareholder corporate stakeholders at the expense of the shareholders. If the goal being sought is instead to confer discretion upon directors to give weight to non-shareholder interests at the possible expense of shareholders, and if one is not overly concerned with the potential for directors using this discretion primarily to favor themselves and the corporation's senior officers, then one may well, as has Booth, reach a different conclusion as to the optimal fictional shareholder characterization.[95] However, to the extent that Booth's article is viewed as an argument for the use of the fictional undiversified shareholder concept rather than the fictional diversified shareholder concept as the appropriate means of facilitating actual shareholder wealth maximization, I find that argument unconvincing.

F. Implementation of the Fictional Diversified Shareholder Characterization

In this Part of the Article, I will briefly discuss how directors might implement the fictional diversified shareholder characterization to make their investment choice decisions. The key aspects of the implementation of this concept are the recognition that, first, differences in the degree of volatility of the expected returns of different investment alternatives are now not a relevant consideration except under circumstances where they reflect differences in systematic risk rather than unsystematic risk, and second, significant impacts upon the value of the corporation's other securities and upon the value of other corporations' securities should be included to the extent possible in the comparative expected return calculations. I will present below a conceptual framework for applying this concept.

Initially, I would recommend that directors make the same basic determinations of the expected returns to common shareholders and potential volatility of each of the corporation's various investment alternatives as they now do when using the fictional undiversified shareholder characterization. Once they have made these determinations, they then need to engage in at least two and perhaps three additional calculations. Lastly, they should incorporate any adjustments to these various expected returns or any risk assessments, that are indicated by those additional calculations.

First of all, directors should estimate what additional impacts the announcement of the selection of each investment alternative would have: upon the value of the corporation's preferred shares, if any such shares exist; upon the value of the firm's other equity-like claims, if any such claims exist; and upon the value of the firm's bonds. There may well be differential impacts among the various investment alternatives on these other securities' values, given that the investment alternatives that present greater variability in their possible returns would likely have greater adverse impacts upon the values of these

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> Those who see managerialism [i.e., self-serving director behavior] as the greater threat will likely prefer a strict duty to maximize [share]holder wealth. Those who see other value (or values) at risk may not be as concerned about the loss of a clear duty of care. Instead they will likely prefer a duty of care which allows boards of directors to take into account the interests of other constituencies (such as workers who may lose their jobs), even if it means that management may use such excuses as a cover for preserving their own positions of influence.

Booth, *supra* note 9, at 442. My surmise is that Booth inadvertently used the phrase "duty of care" in the above quotation when he instead intended to refer to the "duty of loyalty."

other securities because of those securities' lesser participation in upside gains than for common shares, and their greater downside exposure. This is particularly likely to be the case if the corporation is in the vicinity of insolvency with regard to the most severe downside possibilities of a particular investment alternative. These impacts would then need to be aggregated with the anticipated common share price impacts to yield a broader assessment of the relative expected returns of each investment alternative for the overall investment portfolios of fictional diversified shareholders who would be assumed to hold all of these different corporation securities in proportion to their relative share of overall firm capitalization.

Second, directors should then estimate what impacts, if any, the announcement of the selection of each investment alternative would have upon the value of the various debt and equity securities of the firms most closely associated with the subject corporation either as its competitors, suppliers, or customers. There may well be differential impacts among the various investment alternatives in this regard. For example, some investments may be largely zero-sum in the overall industry sense that the corporation's gains from those investments would largely come at the expense of reduced profits for its direct competitors, while other investments may promise corporate gains through facilitating an overall industry expansion that does not prejudice those competitors. Similarly, some cost reducing-type investments may have significant adverse impacts on suppliers who formerly received those expenditures, and some marketing-type investments may result in gains that are largely due to higher prices charged to customers. Such investments would be disfavored by diversified shareholders relative to other investments promising comparable expected returns but whose gains were less likely to be accompanied by such partially or wholly offsetting losses to related firms. These impacts on other firms' securities would also need to be aggregated with the anticipated impacts on the prices of the subject corporation's securities to yield a comprehensive assessment of the relative expected returns of each investment alternative for fictional diversified shareholders who would be assumed to hold the various securities of all of these other firms in proportion to their relative shares of the overall capital market.

Third, if any expected impacts on the prices of the securities of other firms that have a less direct relationship to the subject corporation than as to its competitors, suppliers or customers can be identified for any of the investment alternatives under consideration, those impacts also need to be incorporated into the expected return calculations in comparable fashion, for similar reasons.

Finally, once these expected returns have been calculated in this broad, inclusive fashion for each of the investment alternatives under consideration, the final step in the decision making process would involve an assessment of the relevant risk considerations. An absolutely key point here is that differentials in the overall volatility of the expected returns of each investment alternative would *not* be a relevant consideration. If it is not possible to decompose the overall volatility of expected returns of each investment alternative into its unsystematic and systematic components, then the analysis is complete and the directors should simply choose the highest expected return alternative. If, however, it is possible to separate out the systematic volatility portion of the overall volatility of expected returns associated with each investment alternative,[96] and if there is also a significant difference among the degree of systematic volatility presented by the different alternatives,[97] then this difference may be a further relevant consideration in making the choice. To the extent that the highest expected return investment alternative is accompanied by larger systematic volatility of expected returns than are one or more of the lower expected return alternatives, a judgment will have to be made by the directors whether the fictional diversified shareholder should be regarded as sufficiently risk-averse with regard to systematic risk to favor the amount of sacrifice of expected returns necessary to achieve the indicated reduction in systematic volatility.

I expect that directors in most instances would be unable to obtain the detailed data necessary to make meaningful quantitative estimates of the impact of various investment alternatives on the values of their corporation's preferred stock, other equity-like securities or debt instruments, or on the values of the securities issued by other firms, even if they did have enough information to give them some qualitative sense of which investment alternatives might have such consequences. In addition, directors are unlikely as a general matter to be able to meaningfully decompose the variability of the overall expected returns of the various investment alternatives into their systematic and unsystematic components, particularly since this would require similarly decomposing not only the variability of returns to their corporation's common shares but also the variability of returns on the corporation's other securities and on the securities of other corporations that are impacted by their actions. Consequently, my approach would probably lead, in most instances, to directors choosing the investment alternative with the highest expected return to common shareholders without regard to its impacts on the values of other securities or its return variability. This may not be the case in those few instances where the expected returns to common shareholders of each of the leading alternatives was quite close, and where the investment alternative that promised the highest expected return to common shareholders would impose some significant losses upon the corporation's non-common stock securities, or upon the securities of other firms in the same or related industries, that the competing investment alternative would not.

Even if the fictional diversified shareholder characterization is in practice generally applied in this sort of approximate fashion that does not fully address the detailed implications of the assumed investor diversification, its use would still lead to significantly different investment choices, in many instances, from those that would result from the use of the fictional undiversified shareholder characterization. For that latter characterization the different volatility of returns of the various investment

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96. This may be possible in some instances. For example, a routine product enhancement-type investment with predictable consequences for the production or sales of a good or service whose sales tend to closely track the overall level of economic activity might present relatively little unsystematic risk, and its returns would be more subject to systematic variability. On the other hand, an "oil well" type of risky resource-extraction investment might present variability of returns that is largely grounded in unique, unsystematic factors, and its returns may be relatively less volatile with regard to overall market trends. In general, however, such decomposition of the return variability of investments into their unsystematic and systematic components would be quite difficult to do.

97. Once again, this determination would require separation of the predicted return volatility of investment alternatives for both the corporation's common shares and for other corporations' securities into their unsystematic and systematic components, which would in general be difficult or impossible to accomplish. *See* Booth, *supra* note 9, at 442.

alternatives is given weight in the decision, and can easily be outcome determinative for the choice if a sufficient degree of risk aversion is attributed to that posited undiversified shareholder. And, more importantly, not only would the investment choice made to maximize shareholder wealth on the basis of the fictional diversified shareholder concept often be different from the choice made on the basis of the fictional undiversified shareholder concept, it would also often be more in accord with the preferences of actual diversified corporation shareholders. The replacement of the fictional undiversified shareholder concept with the fictional diversified shareholder concept thus appears to be called for even given the more severe data problems presented by the implementation of that latter concept that would often limit it to being applied in an approximate fashion.

G. Summary

The analysis presented thus far in Part III of this Article has shed some light on the differing investment decision consequences of directors making various alternative generalizations about the extent of portfolio diversification engaged in by their shareholders. I have concluded by endorsing the fictional diversified shareholder concept as being the optimal fictional characterization for facilitating shareholder wealth maximization, as compared to each of the other alternative generic characterizations, and as compared to a hybrid characterization that assumed the existence of both undiversified and diversified shareholders. It is, however, a somewhat qualified endorsement because of lingering (though modest) indeterminacy concerns, and especially because of the severe implementation difficulties that would be presented by the need to make the very broad assessments of the impacts of investment alternatives that this concept would require for any precise application.

Henry Hu also reached this conclusion as to the superiority of the fictional diversified shareholder concept in his 1990 *UCLA Law Review* article,[98] although he shortly thereafter retracted that position in his 1991 *Texas Law Review* article.[99] Richard Booth, in his 1998 *The Business Lawyer* article,[100] reached a different conclusion favoring use of the fictional undiversified shareholder concept, although he was apparently primarily concerned with the relative ability of the various fictional shareholder characterizations to allow directors to give weight to the interests of non-shareholder corporate stakeholders, rather than their efficacy in promoting shareholder wealth maximization. Daniel Greenwood, in his influential 1996 *Southern California Law Review* article that initially popularized the fictional shareholder concept,[101] declined to opine regarding the relative merits of the two main alternative fictional shareholder characterizations, emphasizing instead their shared deficiencies as compared to directors attempting to assess and balance the actual social interests involved in their investment decisions.

The analysis that has led to my conclusions has particularly emphasized the significance of three related insights. First of all, the fictional undiversified shareholder characterization that is the predominant framework currently embraced by directors

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98. Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11.

99. Hu, *New Financial Products*, *supra* note 11.

100. Booth, *supra* note 9.

101. Greenwood, *Fictional Shareholders*, *supra* note 5.

leaves them with so much discretion as to the assumptions they wish to make about shareholder attitudes towards overall risk that it renders the shareholder wealth maximization norm ineffective as a constraint on self-serving or senior officer-favoring director conduct. This is an absolutely devastating shortcoming of this characterization,[102] and that concept therefore should be discarded and replaced either by the fictional diversified shareholder concept I have recommended in qualified terms or by some other fictional shareholder characterization that also imposes more of a constraint on directors in favor of shareholder interests, or by directors discarding the use of such analytical fictions altogether and instead attempting to assess and balance the preferences of their corporation's actual shareholders.

Second, this analysis not only makes clear that each of the alternative fictional shareholder concepts have their own drawbacks as a means of facilitating directors maximizing the wealth of their actual shareholders. It also demonstrates that any attempt to utilize even a slightly more nuanced and realistic hybrid model of public corporation shareholders—one that introduces greater realism only with regard to variations among shareholders in the extent of their investment diversification and not with regard to any of the other manifold and often more significant criteria that differentiate shareholders—immediately reintroduces the difficult political and philosophical questions that the fictional shareholder concept was designed to avoid.

Third, this analysis indicates that while the use of the fictional diversified shareholder characterization would in theory more closely align director decisions with the interests of actual diversified shareholders than would the use of the fictional undiversified shareholder concept, the major data gathering and analysis requirements implied by the industry-wide or even economy-wide assessments that would be needed to apply this concept with any real precision may simply be so extensive and difficult as to render the concept infeasible for any purpose beyond an approximate application that simply removes the differences in the overall variability of the returns associated with various investment alternatives as a criterion in the decision making process. However, this feature alone may well be a sufficient improvement to justify the use of that concept despite its implementation difficulties.

The choice to be made, though difficult, is thus clearly framed. The fictional undiversified shareholder concept, for the reasons discussed, is an unacceptable means of promoting actual shareholder wealth maximization. If shareholder wealth maximization is the norm that we wish to promote, then there are two alternatives. Either directors should embrace the fictional diversified shareholder concept—which because of its extensive data gathering and analysis requirements may ultimately not be a feasible means of facilitating their efforts beyond justifying their disregard of unsystematic investment risk in their decisions—or else boards of directors will have to become much more political bodies that will have to assess and balance the conflicting interests among their shareholders, and justify in some manner their decisions to sacrifice the interests of some of their shareholders to further the interests of other shareholders.

If this is indeed the Hobson's choice that we face in implementing the shareholder wealth maximization norm, then the latter alternative—of directors rolling up their

102. Assuming, of course, that the concept is judged by its ability to constrain directors to pursue shareholder wealth maximization, and not by its ability to facilitate achieving other objectives.

sleeves and delving into and responding to actual shareholder circumstances—merits a more sustained investigation before the choice of approach is made. It may well be a worthwhile effort to attempt to develop principles and procedures that would make it possible for directors to assess their actual shareholders' interests and preferences and then politically balance those conflicting objectives in some legitimate fashion. In the next Part of this Article I will offer a few preliminary comments along these lines.

IV. MAXIMIZING THE WEALTH OF ACTUAL SHAREHOLDERS

My analysis to this point has concluded that the fictional undiversified shareholder characterization that is currently widely embraced by directors is an unacceptable means of facilitating shareholder wealth maximization because the indeterminacy of the concept with regard to the level of risk aversion to be attributed to that hypothetical shareholder completely undercuts the ability of that norm to constrain directors to favor shareholder interests. I have also concluded that the fictional diversified shareholder concept is far superior to the fictional undiversified shareholder concept because it avoids this serious difficulty, and also avoids the vicinity of insolvency inefficient investment incentives problem. However, as I have discussed, the fictional diversified shareholder concept has its own shortcomings in that it also suffers from some indeterminacy as to the level of systematic risk aversion to be attributed to that hypothetical shareholder. It also presents serious implementation difficulties because of its extensive data requirements that go well beyond the modest data requirements of the fictional undiversified shareholder characterization approach due to the corporation-wide, industry-wide and sometimes even economy-wide assessments of impacts that it necessitates. It should be recognized, however, that even when the fictional diversified shareholder concept is applied in an approximate fashion in situations when such detailed impact assessments are not available it still has the significant advantage of treating unsystematic investment risk in a manner more appropriate to maximize the wealth of actual diversified investors.

There is, however, a larger concern that transcends these specific problems that I have identified that accompany each of these fictional shareholder characterizations. As Professor Greenwood has eloquently argued, *any* of the fictional shareholder characterizations that I have here considered are problematic means of promoting human welfare because of their failure to consider those "external" effects of corporate conduct on both shareholders and non-shareholders that are not fully captured by changes in securities prices.[103] Let me first briefly summarize Greenwood's broad critique of the use of any fictional shareholder characterization. I will then offer a few preliminary comments regarding whether fictional shareholder concepts should therefore be discarded and directors instead encouraged to assess and accommodate the conflicting interest of their actual human direct and indirect shareholders, and if so how this can best be accomplished.

The core premise of Greenwood's critique is that the apparent great simplification of director decision making made possible by the use of generic fictional shareholder concepts is an illusion. The conflicts of interest among actual shareholders, and the impacts of corporate actions on shareholders and non-shareholders alike that are not

103. Greenwood, *Fictional Shareholders*, *supra* note 5, at 1101.

reflected in relevant securities price changes, do not disappear merely because the law allows directors to ignore them.[104] Greenwood argues that because a fictional shareholder, whose interests are so narrowly characterized as limited to the value of his investment portfolio, is fundamentally different from any actual human being, a corporation guided by the interests of such a hypothetical monomaniacal figure may behave quite differently from how most or even all of its actual direct and indirect human shareholders would wish it to act.[105] It certainly is unlikely to satisfy the preferences of the non-shareholders who may be impacted by its actions, and whose interests are of course ignored in shareholder wealth maximization efforts regardless of the degree of diversification or attitudes towards risk ascribed to the fictional shareholders. If directors maximize shareholder wealth on the basis of a fictional shareholder characterization they are essentially putting their corporations on a "sort of automatic pilot"[106] with their actions guided only by one abstract indicator gauge. Their decisions reached through such a framework will fail to advance human welfare more broadly and inclusively defined because "it lacks a principle of moderation or any significant countervailing power."[107]

Greenwood insightfully analogizes the use of the fictional shareholder concept to facilitate the maximization of shareholder wealth to the liberal social contract philosophies of Thomas Hobbes, John Locke, John Rawls and other writers that each remove the most contentious issues from political debate by positing a hypothetical unanimous foundational agreement on first principles.[108] Once such a comparable narrow uniformity of shareholder objectives is postulated "then no actual discussions with actual people are necessary" for directors to make their investment decisions because those decisions can then be made simply by "applied logic"[109] in accordance with that hypothetical directive. However, since actual human shareholders have far broader goals than does any postulated fictional shareholder, the replacement of real political debate as to corporate policy by maximization of such a fictional shareholder's wealth is subject to the same legitimacy concerns and reductionist criticisms commonly leveled at those hypothetical social contract-based political theories.[110]

Greenwood notes that even the fictional diversified shareholder concept that I regard as the best of the fictional alternatives will exclude from director consideration those social impacts of corporation actions on both shareholders and non-shareholders that are not captured by movements in securities prices.[111] Maximizing the wealth of fictional

104. Greenwood, *Fictional Shareholders*, *supra* note 5, at 1026. The author also points out that "[t]he fiction of the one-sided shareholder hides the tradeoffs that must be made in life from the view of those who must make them." *Id.* at 1032.

105. *Id.* at 1028.

106. *Id.* at 1029.

107. *Id.*

108. "In the fictional shareholder we have, I believe, a clear application of this classic liberal methodology." Greenwood, *Fictional Shareholders*, *supra* note 5, at 1045.

109. *Id.* at 1049.

110. *Id.* at 1056.

111. Moreover, in a later 2004 article Greenwood notes that the use of the fictional diversified shareholder concept presents yet an additional problem beyond that presented by use of the fictional undiversified shareholder concept in that it promotes anti-competitive, collusive conduct by corporate directors. Greenwood, *Enronitis*, *supra* note 10, at 800.

shareholders will thus relentlessly push directors towards externalizing costs whenever possible to do so,[112] placing the rest of the social structure under extreme pressure to constrain such behavior, an effort made even more difficult by the powerful corporate political opposition to any constraints being imposed upon shareholder wealth maximization efforts.[113] Greenwood's overall conclusion as quoted at some length below is that the consequences of the use of a fictional shareholder concept to guide corporate decisions are socially unbalanced to the point of being almost pathological:

> In this great struggle between economic progress and social mobility, fictional shareholders have none of the ambivalence of the population. They do not hesitate between wealth and stability, between traditional values and new mobility, between the needs of the job and the needs of the family. The legally determined interests of the fictional shareholders include only one side of the struggle—so to the extent that corporations operate as they are designed to, corporations will be only on one side of the struggle. Corporate managements representing the interests of their fictional shareholders should push their institutions—and, if they are allowed, the broader political community—towards mobility, flexibility, change, novelty and other accommodations to the

112. Greenwood, *Fictional Shareholders*, *supra* note 5, at 1076-77. "[The fictional diversified shareholder concept] will consistently support the market's externalization of costs onto workers or the general public unless the [impacts on corporation security prices] of the internalized costs in employee morale are stupendous." *Id.* at 1077.

> [P]ortfolio investors [fictional diversified shareholders] view humans as pure objects of exploitation. For the portfolio investor a transfer from a nonsecuritized entity (such as most humans) to a securitized entity is a pure gain, even if total wealth diminishes as a result; for humans, at least in the aggregate, that is never true. Indeed, since the majority of citizens hold relatively little securitized wealth, a transfer of wealth to securities normally would cause more citizens harm than benefit even if the transfer were—in the aggregate—beneficial.

Id. at 1083.

113. In a subsequent 1998 article Greenwood called for restrictions to be placed upon corporate speech on the basis that such speech was made only on behalf of fictional shareholders and was not entitled to the free speech protections designed to protect actual individuals. Daniel J.H. Greenwood, *Essential Speech: Why Corporate Speech Is Not Free*, 83 IOWA L. REV. 995, 1003-05 (1998). He recognized in this article the distinction between the fictional undiversified shareholder and the fictional diversified shareholder, and that this distinction was important for some purposes including managers' view of the nature of their duties, although not with regard to his arguments for restricting corporate speech, which he argued applied equally in both instances:

> [S]ometimes the law (and nearly always the market) views the shareholder as a diversified investor with only a small part of its wealth invested in the securities of the particular firm, but more often the law (and nearly always the managers determining their role obligations) views the shareholder as undiversified, all of its wealth . . . tied up in the security in question. Sometimes the differences between the diversified and the undiversified shareholder are enormously important–indeed, they drive much of the litigated controversies in corporate law. Diversified and undiversified investors, the theories of corporate finance tells us, have radically different views of risk. Managers seeking to act in the interests of their shareholders will think quite differently about their role obligations depending on which of the two visions of the imaginary shareholder they have in mind. . . . However, for the purposes of this Article, the two versions of the fictional shareholders are more alike than dissimilar, and both are essentially inhuman.

Id. at 1042-43 (footnotes omitted).

> fungibility of capital without considering the finitude of humans and the implantedness of community, family and culture. And the law directs them to use corporate resources to pursue those aims, one-sidedly, to the extent that it appears profitable to do so, without regard for the ambivalence that the human beings involved no doubt have: Management is told it must put its feelings aside, and the people behind the shares have no voice at all. This is more than a finger tipping the balance. It is, instead, an institution out of its proper bounds.[114]
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> . . . [A]ll the fictional shareholders can agree that the redistribution of wealth from the unsecuritized sector (that is, ordinary individuals, whether in their role s as taxpayers, inhabitants of the public space, appreciators of culture or nature, pedestrians, students, nonbusiness consumers or employees) to the securitized sector (that is, stocks and bonds) is a good thing. And all the fictional shareholders agree that values that are not captured in the stock market are not values that need to be considered at all: If wealth requires mobility and that conflicts with child-rearing, the fictions all choose wealth. The people behind the fictions may have differing views on these issues; the fictions do not.[115]

Given his fervent conclusions as to the harm wrought by the use of fictional shareholder characterizations it is somewhat surprising that Greenwood's 1996 article does not offer even a broad sketch of a director decision making framework that might better address the concerns that he raises.[116] He notes in closing only that the "new task" of corporate law "must be to align the fictional shareholder more closely with us."[117] This recommendation implicitly suggests that he is of the view that the fictional shareholder characterization could somehow be expanded in scope to encompass more social interests, rather than discarded altogether. It also implicitly suggests that he favors retaining the shareholder wealth maximization norm as at least one source of guidance for directors rather than replacing it altogether with one or another of the more communitarian norms that some scholars favor.[118] Finally, Greenwood declares that the "greater shareholder democracy" that is currently being discussed by leading corporate law scholars as a means of addressing the executive compensation problem[119] will not solve the problems created by the use of a fictional shareholder concept because of the fact that the institutional investors that dominate corporate share ownership also hold themselves accountable to fictional rather than actual shareholders, and also because non-institutional diversified investors as well as institutional investors generally have too small a stake in any one corporation to justify participating in corporate decision

114. Greenwood, *Fictional Shareholders*, *supra* note 5, at 1098 (footnotes omitted).

115. *Id.* at 1101.

116. However, Greenwood does revisit these issues in a later 2004 article, Greenwood, *Enronitis*, *supra* note 10, that I will discuss *infra* in Part V of this Article.

117. Greenwood, *Fictional Shareholders*, *supra* note 5, at 1004 (footnote omitted).

118. *See* Bainbridge, *Limited Shareholder Voting Rights*, *supra* note 2.

119. *See generally* BEBCHUCK & FRIED, *supra* note 1.

making.[120]

Considering the severity of the implementation difficulties that would be involved in using the fictional diversified shareholder characterization with any real precision to guide investment choices, and given Greenwood's trenchant critique of the use of any fictional shareholder concept, might not society's overall interests be better served if the fictional shareholder approach was simply abandoned, and directors encouraged or even legally required to instead assess and accommodate the preferences of their actual direct and indirect human shareholders in determining what investment choices would maximize those shareholders' welfare more broadly defined? To a certain extent, this is not such a radical idea. Even those persons who favor the use by public corporation directors of a fictional shareholder concept to guide their decisions call for a more empirical and political approach in ascertaining and accommodating potentially conflicting shareholder preferences in the context of closely held corporations with a relatively small number of shareholders.[121] Thus, the basic idea of directors making such inquiries of their actual shareholders and then engaging in some political balancing of interests is not altogether novel. However, extending an obligation to directors of publicly held corporations with numerous shareholders to be more empirical and political would break new legal and policy ground.

What follows is some brief commentary regarding how public corporation directors might attempt to be more empirical and political with regard to ascertaining and satisfying the interests of their shareholders, and whether the obstacles that such efforts would encounter may be surmountable. One would think that the logical first step would be for the directors to assess the extent and nature of portfolio diversification engaged in by their actual shareholders. Even this initial step towards an empirical assessment of actual shareholder preferences makes it immediately apparent that it will probably be impossible to dispense altogether with the judicious use of at least some analytically simplifying categories of a fictional nature to guide director efforts. As discussed in Part III.E.2 above, it would be far simpler—and probably sufficiently accurate for the purpose of shareholder wealth maximization—if these directors were to make the broad simplifying assumption that the proportion of their shareholders that are diversified investors is identical to the proportion of overall equity holdings of all public companies taken together that are directly or indirectly owned by diversified investors, rather than attempt to determine and then subsequently monitor the extent of their actual shareholders' degree of diversification on a corporation-specific basis. Use of such an overall measure of the average extent of investor diversification as a proxy would significantly assist directors in determining the appropriate weight to give to the unsystematic risk aspects of various investment alternatives in making their decisions. As will be discussed below, however, giving any weight at all to unsystematic risk considerations would privilege the interests of undiversified shareholders over those of diversified shareholders.[122] This privileging of one group of shareholders over another

120. Greenwood, *Fictional Shareholders*, *supra* note 5, at 1104 n.163.

121. *See* Booth, *supra* note 9, at 470-72; Hu, *Risk, Time, and Fiduciary Principles*, *supra* note 11, at 361-66.

122. For that matter, giving no weight at all to unsystematic risk considerations would then privilege the interests of diversified shareholders over undiversified shareholders. Generally, once it is determined that various shareholders are differently situated with regard to the risk aspects of corporation investments there is

would have to be normatively justified on some basis.

A second and far more difficult empirical assessment that would have to be done on a corporation-specific basis would be to determine how many and which shareholders might be significantly affected by corporation investment decisions in ways unrelated to changes in the value of their investment portfolios. This would reveal which shareholders might favor an investment alternative that did not maximize their investment portfolio's value. One obvious such group of shareholders would be shareholder-employees, including the corporation's directors and officers, who often will generally prefer that the corporation make investments that will enhance corporation earnings stability, and indirectly enhance their own job security, rather than riskier investments that would promise larger expected share price appreciation, even if their investment portfolios are fully diversified, because of the often substantial fraction of their overall wealth that is comprised by the present value of their future stream of expected corporation salary payments that would be difficult or impossible for them to replace if their employment was terminated. Current and future corporation defined pension plan beneficiaries who are also corporation shareholders will likely also favor investments that promote the stability of corporation earnings over riskier investments that promise greater expected returns to their investment portfolios, given the overriding importance of continued corporation solvency for the security of their pension payments. Finally, all corporation shareholders may potentially be affected by the various "external" impacts of corporation investments that are not captured by movements in prices of the securities contained in their investment portfolios, and the differential impacts of various investment alternatives in this regard, when significant in magnitude, may lead to some shareholders preferring an investment alternative that does not maximize the value of their investment portfolio.

Identifying when the actual well-being of particular corporation shareholders might be best furthered by choosing investment alternatives that do not maximize the value of their investment portfolios, and measuring the magnitude of their resulting welfare gains if their preferred investments were chosen rather than the one that maximizes their portfolio gains, is thus obviously quite a complicated inquiry. This inquiry would of course necessitate the related and difficult job of measuring the losses that would necessarily be imposed on other corporation shareholders who are not subject to these "external" impacts in a significant fashion if any of the investment alternatives that do not maximize their portfolio wealth are selected. Any choice of an investment alternative that did not maximize overall aggregate portfolio wealth would generally create both winners and losers among the shareholders, relative to the consequences of the overall aggregate portfolio wealth maximizing alternative.[123]

Once the investment alternative that would maximize overall shareholder portfolio wealth is identified, and the winners and losers among shareholders that would result relative to this alternative from the choice of any other investment alternatives are identified, and their relative gains or losses from those other alternatives are quantified, the remaining questions facing directors in their decision making would then become

no way to avoid addressing the conflicts of interest that may arise.

123. In addition, even the choice of the investment alternative that maximized the aggregate portfolio wealth of all shareholders taken together might well differentially affect diversified and undiversified shareholders, and require the same "political" balancing of interests discussed in the text.

political and philosophical rather than empirical and technical. Since any investment choice that most enhanced the well-being of some shareholders would likely be disadvantageous to some other shareholders relative to one or more of the other alternatives, a balancing of shareholder interests would generally be required. When would it be appropriate to favor the interests of some corporation shareholders over others? Which of the many possible criteria for resolving such conflicts of interests should directors apply?[124] This question, of course, is the difficult one faced on a daily basis by political leaders seeking to promote both efficiency and equity and minimize discontent among their constituents, and is currently avoided by corporate directors through their use of a generic fictional shareholder concept that simply assumes away any such intra-shareholder conflicts of interest. This fictional shareholder approach obviously greatly simplifies corporate decision making and is therefore eagerly and rather unreflectively embraced by directors. But if Greenwood is at all correct in his critique, the social costs of directors swaddling themselves in comforting fictions and thus avoiding the reality of conflicting shareholder interests in making their investment decisions are manifold and are collectively so large, for both shareholders and non-shareholders alike, that we would perhaps be better served by discarding those fictions and importing all of the concededly cumbersome and expensive social mechanisms that we have developed over the centuries to promote effective political representation and broad accountability in our public institutions into the corporate boardrooms where these economically and socially critical resource allocation decisions are made.

What sorts of electoral procedures and other accountability mechanisms, and what kinds of "constitutional" discretion-limiting corporate charter provisions, would be appropriate for boards of directors to be subject to if they were to embrace this more explicitly political view of their shareholder wealth maximization role? What specific mechanisms would best facilitate the necessary dialogue among corporate directors and their shareholders in a cost-effective fashion? What role should the various levels of government play in facilitating and regulating such a corporate communication and decision making framework? Given all of these complications, would it ultimately prove unworkable to attempt to discard the use of unitary fictional shareholder concepts of one sort or another, despite their obvious shortcomings so well described by Professor Greenwood? In this Article, I have focused primarily upon alternative fictional shareholder characterizations, noted the important questions that would be raised by discarding such fictional characterizations, and do not offer any conclusions or recommendations in this regard. More research is obviously needed along all of these lines.

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124. Some of the more obvious alternatives for resolving such intra-shareholder conflicts include:

1) a one share, one vote resolution,

2) a one shareholder, one vote resolution,

3) the choice of the Kaldor-Hicks wealth maximizing (among shareholders alone) course of action, or

4) choosing to further overall economic efficiency defined more broadly to also include some categories of non-shareholders.

Of course a particular corporation's shareholders could proceed to adopt their preferred "constitutional" charter limitations on how directors were to make these choices.

V. MOVING BEYOND SHAREHOLDER WEALTH MAXIMIZATION

I have to this point in this Article taken the shareholder wealth maximization norm as a given, and have considered in some detail the use by public corporation directors of various fictional shareholder characterizations as a means to that end. I have also briefly considered how directors might alternatively attempt to maximize actual shareholder wealth without recourse to any such fictional characterizations. However, if one is willing to accept the politicization of corporate decision making that would necessarily result from directors attempting to empirically assess and balance actual shareholder preferences and interests, might one then not choose to go one step further and also rethink the social merits of the underlying shareholder wealth maximization norm, as opposed to other possible specifications of the nature of director duties that might if adopted more naturally and easily address some of Greenwood's concerns? Should directors perhaps also be somehow encouraged to give some consideration in this political process to the interests and preferences of the non-shareholders that would be significantly affected by corporate actions, extending perhaps even to the circumstances of those non-shareholders affected by corporation actions who are not preferred shareholder, bondholder or employee "stakeholders" of the corporation?

In a 2004 article considering the implications of the Enron scandal, Professor Greenwood revisited questions of corporate governance.[125] In this latter article he went well beyond his earlier criticisms, and no longer implicitly suggested that minor refurbishing of the fictional shareholder concept within the shareholder wealth maximization norm framework might suffice to address the problems.[126] He instead called for adoption of a specific new framework of fiduciary duties to replace altogether the shareholder wealth maximization norm.[127]

Greenwood proposed reconceptualizing the corporation as "a polis, a community of all of its human affiliates."[128] Corporate directors under this new polis framework should now regard themselves as "statesmen" accountable not only to their shareholders but also to other corporate stakeholders and more generally to all citizens affected by their actions.[129] They should treat the corporate surplus remaining after all contractual obligations have been met as something to be allocated through a political process, one responsive to the actual circumstances of all affected persons rather than to any fictional characterizations, with the common shareholders now having no special privileged

125. Greenwood, *Enronitis*, *supra* note 10.

126. See *supra* notes 116-17 and accompanying text.

127. Greenwood, *Enronitis*, *supra* note 10.

128. *Id.* at 841.

129.

> Corporate managers instead of conceiving themselves as selfless, unsituated rational maximizers could rather see themselves as statesmen, promoting the common good of all corporate participants, and, in our multi-sovereigned system, as participants in the American governance system required to promote the good of all citizens. . . . [G]iven the vague limits to "corporate stakeholders" in a firm that, understood as a nexus of contracts and externalities, lacks determinate or firm boundaries, the polis metaphor offers a rationale for managers to consider the public good generally, even beyond the narrower interests of corporate participants.

Id. at 841-42.

"ownership" claims to that surplus.[130] Greenwood also recommends as measures for helping facilitate the implementation of this new approach the clarification of director fiduciary duties as now running to all of the people impacted by corporation actions,[131] appointment of directors who are selected by the general public or its representatives and who are charged with promoting the interests of citizens at large rather than solely those of the corporation's shareholders, consumers or employees,[132] and appointment of a public official who will be directed to and able to enforce these broader fiduciary duties.[133] He recognizes the difficulties involved in directors discharging such a broad and diffuse duty of loyalty obligation, but nevertheless concludes that on balance this new framework would be socially preferable to shareholder wealth maximization done through the use of fictional shareholder concepts.[134]

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130. *Id.* at 843-45. This recommendation for director decision making is quite similar to the "mediating hierarch" role envisioned for directors by Margaret Blair and Lynn Stout in their advocacy of the "team production model" approach. *See* Stout & Blair, *supra* note 16; *see also* Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (offering the mediating hierarchy model as an alternative to the current shareholder's property model or shares of a corporation), reprinted in 24 J. CORP. L. 743 (1999); Gregory Scott Crespi, *Redefining the Fiduciary Duties of Corporate Directors in Accordance with the Team Production Model of Corporate Governance*, 36 CREIGHTON L. REV. 623 (2003) (evaluating the team production model at corporate governance as well as arguing that corporate directors have a broader duty to the community in addition to their fiduciary duty to the shareholders).

131. Greenwood refers to this large group as "the corporation as a whole," Greenwood, *Enronitis*, *supra* note 10, at 846, though by use of this phrase he is not referring only to the corporation's financial claimants, as does Thomas Smith when he uses that phrase, Smith, *supra* note 29, at 218, but also more broadly to employees and non-stakeholder members of impacted local communities as well.

132. Greenwood, *Enronitis*, *supra* note 10, at 846.

133. *Id.* at 846-47.

134.

> This broader conception of the managerial/director role is not an unmitigated good. Statesmanship is difficult. Many aspirants to the title have been cynical charlatans or self-interested deluders (even self-deluders). No doubt many managers will be able to explain to their own satisfaction why the common good requires precisely their private good. Moreover, the public good is often controversial, and there is no reason whatsoever to think that unelected corporate managers, or directors nominally elected on a "one-share, one-vote" basis, will reflect in their views the divisions of the citizenry as a whole. Managerialism is a poor substitute for democracy. Still, unlike the reigning share-centered ideology, working for the good of all corporate participants does not require managers to take inconsistent positions, play cynical double games, or deliberately lull people into trusting them when they know they will be required to take advantage of whatever trust they achieve.

Id. at 842. Professor Greenwood has recently published several additional articles in which he elaborates more fully his strong criticisms of the current structure of corporate law. *See, e.g.*, Daniel J.H. Greenwood, *Markets and Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41 (2005) (critiquing the view that corporations are citizens subject to law rather than power sources that help constitute the social governance system); Daniel J.H. Greenwood, *Linking Corporate Law with Progressive Social Movements: Introduction to the Metaphors of Corporate Law*, 4 SEATTLE J. SOC. JUST. 273 (2005) (critiquing the metaphors of corporations viewed as a form of property and corporations viewed as a market governed by contract law); Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL. REV. 381 (2005) (critiquing the internal affairs doctrine and the widespread state deference to Delaware law fostered by that doctrine). He also has in process a comprehensive critique of the claim that corporation shareholders have a special claim to the corporate surplus, and that the current distribution of that surplus to shareholders "is the result of a (possibly temporary) ideological victory in a political battle over economic rents." Daniel J.H. Greenwood, *The Dividend Problem: Are Shares Entitled to the Residual?*, 32 J. CORP. L. 103, 103 (2006).

A full response to this sweeping recommendation for a new model of corporate governance is beyond the scope of this Article, which largely accepts the shareholder wealth maximization norm as a given. In brief, let me first note in passing that there is no indication that corporate directors (or, for that matter, judges) have adopted or will in the near future embrace such a radical respecification of director fiduciary duties such as that which has been advocated by some other writers[135] and which is now articulated by Greenwood. Second, I will simply note also that this recommendation presents major questions of feasibility that go well beyond the considerable implementation difficulties that I have discussed would be involved in attempting merely to make directors more accountable to the interests and preferences of their actual shareholders in maximizing shareholder wealth by discarding the use of fictional shareholder characterizations. It is not at all clear that directors will be able to achieve even the narrow norm of shareholder wealth maximization, however the shareholder is defined, without the use of fictional shareholder concepts, given the severe measurement difficulties and contentious intra-shareholder political issues presented when the fictional shareholder characterization is discarded. To take yet another quantum leap and now include all members of society, in effect, among the persons to whom the duties of directors of public corporations run risks making it impossible to ever determine whether those duties have been met, and thus rendering the "polis" norm ineffective as a constraint on self-serving director behavior.

VI. CONCLUSION

Corporate directors are generally committed to the social norm of maximizing the wealth of their corporation's common shareholders. Their current practice is to simplify their investment decisions by positing a generic fictional shareholder who is undiversified in his investments as the person to whom they hold themselves accountable. I have discussed in this Article this fictional undiversified shareholder concept and contrasted it with three alternative characterizations of the hypothetical shareholder that differ from it and among themselves only in the extent of assumed investor diversification, and which might each serve this same analytical function: the fictional diversified shareholder, the fictional equity-only diversified shareholder, and the fictional corporation-specific diversified shareholder concepts. I have also considered the possibility of a hybrid characterization that would include both fictional undiversified shareholders and fictional diversified shareholders.

My conclusion is that despite its advantages of greatly facilitating the analysis of investment alternatives the fictional undiversified shareholder concept should be discarded for two reasons. First, it is highly unrealistic regarding actual shareholder circumstances, more so than the other alternatives here considered. Second, and perhaps more importantly, it is indeterminate as to the level of risk-aversion that should be imputed to this generic shareholder and this degree of freedom completely undercuts the director-constraining purpose of the shareholder wealth maximization norm. The hybrid characterization also proves to be fundamentally flawed for similar reasons. If shareholder wealth maximization is in fact best pursued through the use of a fictional shareholder concept, rather than through attempts by directors to ascertain and then

135. *See, e.g.*, Millon, *supra* note 19; Stout & Blair, *supra* note 16.

satisfy to the extent possible the conflicting preferences of a corporation's actual shareholders and perhaps other stakeholders as well, then the fictional diversified shareholder concept, despite its serious implementation difficulties, appears to be the preferred alternative among the ones here considered. Some but not all of the scholars who have previously considered this question are in accord with this conclusion.

Finally, the conceptual difficulties and operational shortcomings of even the preferred fictional diversified shareholder concept suggests that more thought should be given to the alternative of directors of public corporations attempting to maximize the wealth of their shareholders by assessing and balancing those shareholders' actual interests and preferences. Such an empirical approach would inevitably import into boardroom deliberations all of the political and philosophical issues that the fictional shareholder concept was designed to avoid, but this may nevertheless be the best course of action to promote overall social welfare. Consideration should also be given to the even more radical approach of broadening the scope of directors' fiduciary duty of loyalty to include the interests of a broader group of non-shareholder corporate stakeholders. More investigation of these questions is needed.