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Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited

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FICTIONAL SHAREHOLDERS: FOR WHOM ARE CORPORATE MANAGERS TRUSTEES, REVISITED*

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I. INTRODUCTION

It is a commonplace of American law that corporations are fictional. The U.S. Supreme Court said so, in the first important corporate law case to come before it, *Bank of the United States v. Deveaux*,[1] and repeated it in the next, the famous contract case of *Dartmouth College v. Woodward*:[2] The corporation is simply a convenient, though misleading, way to refer to its shareholders or members.

1. Bank of the United States v. Deveaux, 9 U.S. (5 Cranch) 61 (1809).
2. Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

Many modern theorists agree that the corporation is a metaphor, though they have different visions of what it "really" is.[3]

But despite this ancient and sophisticated discourse regarding the corporation, the literature and cases have relatively little discussion of the shareholders. This omission is particularly glaring in light of the dominant paradigm of corporate law, which holds that the central task of corporate law is to lessen or eliminate the potential conflict between shareholders and corporate managers—the so-called problem of separation of ownership and control identified in Berle and Means' seminal work[4] and put into its modern form by Jensen and Meckling.[5]

Modern cases and theory, like the older ones, assume that shareholders, unlike corporations, are not problematic. Corporations may be legal fictions, mere metaphors for underlying—and quite different—realities. But shareholders, it is generally assumed, are not problematic at all. They are widows in Iowa, profit-maximizing investors or—more recently—institutional investors, and little further discussion is needed. After all, whatever else shareholders may or may not want, every shareholder wants to make a profit and that is all that is really important for the operation of corporate law and, indeed, the corporation itself.

Virtually all the major groups of corporate law scholars today agree on the centrality of the shareholder to corporate law; all but the communitarians agree that virtually the sole task of corporate law is to ensure that managers act as agents for the shareholder owners.[6] This Article directly challenges the almost universally held assumption that

3. *See, e.g.*, Scandia Down Corp. v. Euroquilt, Inc., 772 F.2d 1423, 1427 (7th Cir. 1985) ("The corporation is just a convenient name for a complex web of contracts among managers, workers, and suppliers of equity and debt capital."). Even the legal realists believed that corporations are "really" something else. *See, e.g.*, Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 811 (1935) ("Nobody has ever seen a corporation. What right have we to believe in corporations if we don't believe in angels?"). It seems to me, however, that if "nobody" has ever seen a corporation, then "nobody" has not been looking in the right place. *See* LEWIS CARROLL, THROUGH THE LOOKING GLASS AND WHAT ALICE FOUND THERE 68 (Selwyn H. Goodacre ed., 1983) (" 'If you can *see* whether I'm singing or not, you've sharper eyes than most,' Humpty Dumpty remarked severely."); MEIR DAN-COHEN, RIGHTS, PERSONS, AND ORGANIZATIONS (1986) (emphasizing the importance of taking seriously the organizational reality of corporations).

4. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

5. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structures*, 3 J. FIN. ECON. 305 (1976).

6. For a history of the classic schools of corporate law, see William W. Bratton, Jr., *The New Economic Theory of the Firm*, 41 STAN. L. REV. 1471 (1989); Morton J. Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173 (1985). The

shareholders, in the form understood by the law, are a group of

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contract and agency cost schools are reviewed in William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989) [hereinafter Bratton, *Nexus*]. Many of the more recent articles are cited and summarized in Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 WASH. & LEE L. REV. 1565, 1567-1569 (1993). Although the theory presented here has implications for the debate regarding the nature of the corporation, I will not engage it directly: If, as I contend, shareholders are best viewed as legal fictions, many of the dichotomous categories of the classic debate must be reconfigured. *See also* DAN-COHEN, *supra* note 3 (arguing that entity/aggregate and natural/artificial categories fail to capture corporate behavior or characteristics); John Dewey, *The Historical Background of Corporate Legal Personality*, 35 YALE L.J. 655 (1926) (arguing that entity/aggregate and natural/artificial dichotomies fail to drive actual legal results); Horwitz, *supra* (contesting Dewey's conclusions).

For simplicity of exposition, most of this Article works within (or against) the loose collection of models that appear to be the current paradigm: a shareholder-centered version of the nexus of contracts approach that views the corporation as "really" a private contract between shareholders (as principals) and directors/managers (as agents or trustees), and sees the central issue of corporate theory as reducing the resulting agency costs. I define this paradigm broadly, to include all those who, following Berle and Means, *supra* note 4, agree that the central problem of corporate law is the separation of ownership and control, regardless of their otherwise large disagreements. Thus, I include both those who see the agency cost problem as largely solved or solvable by market forces, leaving little room for law, *see, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Jensen & Meckling, *supra* note 5; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); or, for the *reductio ad absurdum*, HENRY N. BUTLER & LARRY E. RIBSTEIN, THE CORPORATION AND THE CONSTITUTION (1995) (contending that the U.S. Constitution enacts a theory of market perfection that, in turn, bars all interference with corporate participants' ability to create their own law); and those who see the problem of managerial action against shareholder interests as requiring far greater legal intervention, *see, e.g.*, RALPH NADER, MARK GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION (1976); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); or who emphasize the difficulty rather than the ease of contractual solutions to organizational issues, *see, e.g.*, OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); Oscar Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984). I also mean to include both proponents and opponents of the nexus of contracts approach, to the extent that both proponents and opponents share the view that corporations exist for the benefit of their shareholders. *Compare* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) [hereinafter Black, *Agents*] *with* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986) [hereinafter Coffee, *Shareholders*]; John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449 (1989).

For my purposes, these scholars share a key commitment: Each accepts the central Berle and Means claim that managers should work on behalf of shareholders and that the task of corporate law is to align their interests. It is to that claim that this Article is addressed.

A few scholars dissent from the central metaphor of managers as shareholders' agents. Most prominently, the "communitarians" seek to create a vision of the corporation as a community extending beyond shareholders. *See, e.g.*, David Millon, *Redefining Corporate Law*, 24 IND.

human beings entitled to respect and consideration and having interests that exist independent of corporate law. I contend, rather, that corporate law theorists have missed the critical point that an agency (or trust) relationship has quite a different significance when the "principal" (or beneficiary) is a set of legally defined interests that are not under the control of any individual or group of individual human beings who could choose to redefine or act in opposition to those interests.

This Article, then, is an attempt at a careful look at the role of shareholders in corporate legal theory. Shareholders, I contend, are a legal fiction, and in many ways a far more problematic fiction than the corporation itself. 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.

Specifically, I contend that the fictional shareholder is fundamentally different from the human beings who ultimately stand behind the fiction. The law and the legally created structure of corporation and market filter out all the complexity of conflicted, committed, particularly situated, deeply embedded and multi-faceted human beings, leaving only simple, one-sided monomaniacs. Human beings have short lives, spent in particular places with particular relationships to other human beings; they constantly confront the problems of finitude and commitment. Shareholders, in contrast, are in significant senses immortal, uncommitted and universal: They are indifferent as to time and place, language and religion. They are indifferent between projects and personalities. They are understood to care deeply about one important and vital human aim—profit maximization—but not at

L. REV. 223 (1991); Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry Into the Causes of Corporate Immorality*, 73 TEX. L. REV. 477 (1995) [hereinafter Mitchell, *Cooperation*]. The "communitarian" vision, however, appears to be normative and aspirational; even these theorists seem not to challenge the empirical assertion that as currently structured, the modern corporation is (largely) shareholder-centered. Others have begun to exploit the potential challenge to shareholder supremacy inherent in the nexus of contracts approach. *See, e.g.*, Bratton, *Nexus*, *supra*; *infra* note 24.

all about numerous others. While the ultimate owners of the shares are specific, situated, conflicted and committed human beings, shareholders in most instances may be thought of more appropriately as a "large, fluid, changeable and changing market."[7]

These differences between fictional shareholders and human beings can be grouped into two broad categories, each with a distinctive impact on the society and economy we use them to create. First, like classical utilitarians and the market itself, shareholders do not take the distinction between persons seriously.[8] That is, in many important situations they are indifferent to distributional issues that are critical to ordinary human beings. Second, they are fundamentally inhuman because they have only one goal, profit maximization—and, thus, need not make the compromises among conflicting goals that are the essence of human politics and life.

The consequences for corporate law are also twofold: First, in 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. This simplicity, however, is based on an illusion—the conflicts do not disappear merely because the law presumes that shareholders are above them.

Second, the actual owners of the shares are irrelevant to corporate law: Neither the interests nor the desires of the people behind the shares count. Because managers manage on behalf of a fictional principle rather than a human principal, corporations are a strange, driven

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7. *See, e.g.*, Arnold v. Society For Savings Bancorp, Inc., 650 A.2d 1270, 1290 (Del. 1994). The phrase originated in Paramount Communications, Inc. v. Time Inc., 1989 WL 79880, at *23 (Del. Ch. 1989) and was used by the Delaware Supreme Court in Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 47 (Del. 1994). *Cf.* Marcel Kahan, Paramount *or Paradox*, 19 J. CORP. L. 583, 595 (1995). Professor Hu has provided us with sophisticated discussions of the implications of the market theory of the shareholder for classical notions of fiduciary duty. *See, e.g.*, Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1277, 1285 (1991) [hereinafter Hu, *New Financial Products*] (discussing whether managers should maximize some entity-level accounting concept, the actual share price or the price at which shares "would" trade if the stock market were perfectly rational and omniscient); Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 295-306, 355-66 (1990) [hereinafter Hu, *Risk*].

8. *See* JOHN RAWLS, A THEORY OF JUSTICE 29 (1971) (objecting that utilitarians do not take the distinction between persons seriously).

kind of institution—neither managers nor anyone alse has the ultimate authority to stop the institution from acting out its logic to the fullest.

This Article proceeds as follows. First, I explain what I mean by calling shareholders fictional and outline in more detail the basic characteristics of the legally determined fictional entity. Second, I illustrate some ways in which the fictional shareholder imposes its will on the corporation—here, I follow the current consensus that the conflict between managers and shareholders has been resolved in favor of shareholder control, but with a twist, since I view the corporations not as controlled by human owners but rather as run in the largely legally defined interests of fictional creations. Neither those legally defined interests nor their fictional holders can be mapped in any simple way onto an underlying group of human beings. Finally, I explore the consequences of having our largest institutions run in the interests of a legal fiction and offer some preliminary suggestions regarding areas in which an institution run in the interests of fictional shareholders will be similar to, or different from, one run by or in the interests of human beings.

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Berle and Means' classical corporate theory and their leading contemporary critics agree that corporate law should strive to organize corporations so that managers act in the interests of shareholders. In the modern jargon, corporate law should seek to reduce the agency costs inherent in the separation of ownership and control. In contrast, this Article's analysis suggests that the agency metaphor is deeply misleading. Since shareholders are a legal fiction rather than living, breathing human beings in their full richness, they are not principals in any ordinary sense. The corporation, then, is not usefully understood as a more or less perfect agent acting more or less responsibly on behalf of its principal. Rather, corporate law creates a corporate entity that may behave distinctly differently from the ways in which any (or all) of the human participants would behave were they free from legal constraint.

For corporate theory, this shift in perspective is of enormous importance. If the corporation's shareholders cannot be identified with human citizens of the political community, then even the most sophisticated proof that the "genius" of American law forces corporations to act in shareholder interests[9] cannot demonstrate that corporate actions reflect the will or interest of any citizen or group of citizens. Rather, the corporation becomes an *independent* actor in our polity and economy.[10] Because the fictional shareholder is fundamentally different from any human being—even human beings who own shares—a corporation acting in shareholder interests will act quite differently from the way its supposed principals would have it act.

Corporate freedom, it follows, need not necessarily promote human freedom, as most theorists have assumed;[11] nor can corporations easily be assimilated to the private side of the great public/private divide in liberal theory.[12] Rather, corporations—even when the market and law work as they are supposed to, even without considering deviations from the norms of shareholder control or competitive markets—belong closer to the governmental side, as elaborate human

9. *See generally* ROMANO, *supra* note 6.

10. An earlier generation of corporate personality theorists argued that independent action by corporations was a basis for granting them political rights. *See generally* Bratton, *Nexus*, *supra* note 6; Horwitz, *supra* note 6. A somewhat similar conclusion is reached in DAN-COHEN, *supra* note 3, at 102-13 (asserting that corporations should have First Amendment speech rights deriving from their listener's rights precisely because corporate speech cannot be reduced to speech of any particular corporate participant) and Meir Dan-Cohen, *Freedoms of Collective Speech: A Theory of Protected Communications by Organizations, Communities, and the State*, 79 CAL. L. REV. 1229 (1991). Although my analysis shares the conclusion of the earlier corporate personality theories that corporate actions cannot be understood as mere agency-projections of the will of an identifiable principal, I do not agree that this is a basis for political rights. Thus, in a future article, I will argue that the fact that corporate speech is distinctive is the reason why it should not be protected; corporate speech, like governmental speech, should be inherently suspect in a democratic polity.

In contrast to the general view of corporate personality theorists that corporations are values in themselves (but in accordance with the contemporary agency cost theorists), I see corporations as a purely utilitarian device for promoting human wealth and, ultimately, freedom and happiness. If I am right that the corporate shareholder is not identifiable with people who own shares, so that the corporation is an agent without a principal, corporate actions do not necessarily or simply reflect the needs or desires of an identifiable group of humans. The consequence is that neither the corporate personality nor the agency defense of corporate rights can stand. Corporate actions that are neither a source of value in themselves nor reflections of freely acting citizens are entitled to no presumption of validity or special respect. Instead, the corporate system and particular corporate actions must be subject to constant critique to determine whether and when they serve the purposes of the political community. The presumption in favor of market-generated results simply falls away; the notion of corporations as being entitled to set up rights against political action of the citizenry becomes as odd as the long-discarded notion of the sovereign as a rights-bearer against his subjects.

11. See generally Horwitz, *supra* note 6, for an account of the long history of disparate theories of corporate personality all leading to a similar conclusion that corporations should be granted rights as if they were citizens.

12. On the current state of the public/private distinction, see, for example, Frederick Schauer, *Acts, Omissions, and Constitutionalism*, 105 ETHICS 916 (1995) (reviewing CASS SUNSTEIN, THE PARTIAL CONSTITUTION (1993)).

creations, meant to promote human happiness but potentially taking on a life and mission of their own.[13]

The corporate system we have created generates a conflict that is not reducible to either of the classic conceptions: It is not a class conflict, as that term is understood in either the Marxist or sociological traditions, and it is not the agency conflict with which so much of corporate law is concerned. It is, instead, more closely related to the problem of government as understood by the classic liberal theorists: a human institution which may often and in predictable ways cease to serve the limited (if essential) purposes for which it was formed.

In short, we have created an institution for a specific purpose and put it on a sort of automatic pilot, so that it continues to pursue the preset goals whether or not they continue to be useful. Corporate law succeeds because it is single-minded, and fails because it lacks a principle of moderation or any significant countervailing power.

II. UNDERSTANDING SHAREHOLDERS: THE THEORY OF THE FICTIONAL SHAREHOLDER

A. Distinguishing People Who Own Shares From Shareholders

Shareholders are a convenient and sometimes extremely misleading metaphor that can prevent us from seeing the real rights and responsibilities at issue. Plenty of people own shares—indirectly,

13. The assimilation of corporations to government as objects of suspicion is not, of course, new to American history. Indeed, the vision of large organizations, rather than government per se, as the threat to liberty is probably the older one, with roots in Jefferson's celebration of the independent small farmer, the Jacksonian attack on the Second Bank of the United States and populist hostility to the railroads. *See, e.g.*, Richard Hofstadter, The Paranoid Style in American Politics 194-96, 205-08 (1965); *President Jackson's Veto Message Regarding the Rechartering of the Second Bank, July 10, 1852, reprinted in* Jacksonian America 1815-1840, at 139 (Frank O. Gatell & John M. McFaul eds., 1970). Mark Roe has recently argued that this political hostility to large centralized organizations, particularly Eastern banks, accounts for much of our current corporate regime. *See* Mark J. Roe, Strong Managers, Weak Owners (1994); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10 (1991). In most cases, however, this suspicion has been motivated by a fear of a class of elites using both government and corporation as tools to manipulate the "common people." In contrast, while there may well be a strong overlap between the agenda of the fictional shareholder and that of certain economic classes or political elites, my argument is not based on a conspiracy theory of political domination. I contend, rather, that corporations, acting according to their own internal logic, may end up acting in ways that none of their participants would endorse; rather than supporting any particular elite or class agenda, they will contend for a particular version of a rapidly changing market economy regardless of whether that helps or hurts any particular group of people.

virtually every American with a pension plan or an insurance policy (which is to say virtually every American with any assets at all) is the beneficial owner of some stock.[14] But shareholders as understood by the law are neither a class or social group in our society nor a random collection of people who happen to own shares.

Rather, shareholders are treated as if their entire identity were their shareownership, as if their sole goal in life were to maximize the risk-adjusted present value of the future income stream represented by those shares and as if they had no competing interests that might, even occasionally, warrant taking an action not designed to improve "shareholder" value.[15] The world is a wide and diverse place, and I imagine such single-minded people must be out there somewhere. But they are a scarce and mysterious species, as hard to find as gremlins in caves or golems in old shuls.

Shareholders are a legal fiction in a very precise sense. The law[16] demands that corporate directors and managers manage the corporation in the interests of the shareholders and the corporation. But by "shareholder interests" the law does not mean the interests—let alone the will—of the actual people who are the beneficial owners of the shares (or, in our increasingly institutional stock market, the people who are the ultimate beneficiaries of the legal entities that own the shares). The actual people are not consulted; they have only primitive, indirect and ineffective means of letting their perceived interests or actual will be known. No owner of shares ever negotiates a contract with or submits instructions to the directors or managers. Nor does the board act like a sort of Benthamite neutral observer examining the life situations of the actual people out there and determining that, whether they know it or not, their interests require some action or other.

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14. *See infra* part II.B.

15. The standard term, shareholder value, itself presents this confusion. Humans who own shares may have their net worth increased by corporate actions that increase the return to corporate shares (or they may not, depending on their other investments and financial interests), but it is highly unlikely that their "value" will be affected one way or the other. The term refers not to the value of the shareholder but rather of the share. That writers are not bothered by the distinction between a share (a bundle of legal rights) and a shareholder demonstrates the power of the paradigm of the fictional shareholder I discuss in the text.

16. The law of the business community as well as the law of the state. *Cf.* Robert M. Cover, *The Supreme Court, 1982 Term— Foreword: Nomos and Narrative*, 97 HARV. L. REV. 1 (1983) (discussing varieties of non-state law).

Rather, the law creates a simplified and fundamentally inaccurate image of a hypothetical shareholder and then requires that the interests of this nonexistent person be the focus of corporate efforts.[17] It is the interests of a fictional person whose sole interest is the shares it owns that is the focus of legal and corporate efforts to promote "shareholder" interests—in effect, the shareholder is reduced to the shares.

I call this shareholder fictional because it is a coherent story, an essentially complete and unified being, lacking the complexity and contrasting commitments of real, human, people. When corporations are seen as owned by the fictional shareholder, the struggles of the corporate world seem to be a simple novel about a central character with one driving force, one story to tell and—although this has not often enough been remarked—one fatal flaw.

The fictional shareholder is also fictional because of a specific falsehood: the ideological belief that shareholders, as they are understood in the law and the marketplace, can be identified with specific individual human beings, and therefore, that defending shareholder rights is the same as defending human rights. I hope to show, in contrast, that while shareholder rights may often promote human rights and that while shareholder gains are often human gains, the correlation is by no means complete or automatic. In this sense, shareholders are fictions in precisely the same way that corporations are called legal fictions: Sometimes one must look through or around the legally visible entity to understand the human relations that are affected by it.

It is fictional, also, because this one-sidedness means that the shareholder's story can be written by outsiders; unlike true stories, it need not be written by or with the participation of the participants themselves.[18] We—whoever we are—can know what the shareholder wants, without knowing anything about the person behind the shareholder. The Fischer Separation Theorem tells us that shareholder risk preferences do not matter; the simplification of the fiction excludes almost every other value. Like Thomas Hobbes' man in the state of nature, shareholders have no names, no particular needs, no specific individuality, place or generation. But if the life of man in the state of

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17. *Cf.* Karen Engle, *Female Subjects of Public International Law: Human Rights and the Exotic Other Female*, 26 New Eng. L. Rev. 1509 (1992).

18. *See, e.g.*, Ronald Dworkin, Life's Dominion: An Argument About Abortion, Euthanasia, and Individual Freedom (1993); Daniel J.H. Greenwood, *Beyond Dworkin's Dominions: Investments, Memberships, the Tree of Life, and the Abortion Question*, 72 Tex. L. Rev. 559, 566-67 & n.34, 570 n.43, 623 n.280, 626-28 & n.299 (1994).

nature is "solitary, nasty, poore, brutish and short," and primarily motivated by a drive to power and glory,[19] the life of the fictional shareholder is an endless pursuit of present discounted future returns; a "life" that is indeed solitary, and nasty on many understandings, but thin rather than poore, and eternal rather than short. The similarity is that all shareholders are alike, and philosophers (or business managers) may argue about how best to serve their interests without ever needing to consult with the subject of the debate.

I do not mean to suggest that the shareholder is fictional in the sense of nonexistent. On the contrary; shareholders are legally created entities that exist in the strong sense that they determine much of our lives. Indeed, one variant of the fictional shareholder—the portfolio investor—is among the most powerful influences in the economic marketplace, and in some sense can be understood as the financial market itself. For both better and worse, fictional shareholders control much of the direction of our economy.

Nor do I mean to suggest that the motivations of fictional shareholders are entirely different from those of the underlying owners. After all, presumably most owners of shares would prefer that their shares be worth more rather than less, *ceteris paribus*. This Article is concerned with those instances where *ceteris* is not *paribus*. The problem is not that fictional shareholders always or even often make the wrong decision, but that they make no decision at all: 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.

This Article, then, is about the separation of the shareholder from the owners of the shares. For the law and the market, the shareholders are simple, unidimensional, time-indifferent, fungible, uninterested and disinterested—uncommitted to any particular place, project or community. The fictional shareholder is truly cosmopolitan (in the negative sense of the word): deracinated, lacking religion, language, nation or civilization. It is fully mobile, able to leap regional and, as the Mexicans have discovered recently, national boundaries in a single bound. In many ways, the fictional shareholder resembles the "homo economicus" of the economists more than any human being. Putting our economy in the hands of the fictional shareholder has many of the positive and negative effects of unbridled capitalism: the tremendous

19. THOMAS HOBBES, LEVIATHAN 185-86 (C.B. Macpherson ed., 1977) (1651).

creativity of constant change and the tremendous unsettlingness of constant change.

B. The Owners of the Shares

The facts about the ownership of publicly traded stock in the United States are fairly well known. About half the publicly held stock is held institutionally—principally by pension funds, insurance companies, mutual funds, bank trust funds and endowment funds.[20] Most of this institutional ownership is, in turn, on behalf of identifiable individual human beings: the beneficiaries of pension funds, the policy holders of mutual insurance companies, the stockholders of mutual funds. Some of it is more difficult to see as held on behalf of specific people: Who is, for example, the ultimate beneficiary of Harvard University's endowment?[21]

The indirect ownership of this institutionally owned stock is fairly broad. Virtually all American households own a car and carry automobile insurance. A large percentage of Americans own their own homes and carry homeowners insurance. Many Americans hold life insurance. Virtually all of these people—clearly the ones who hold their insurance through mutual companies, and arguably the rest as well—are indirect beneficiaries of insurance company stock holdings. In addition, a significant number of Americans have pension plans or 401(k) plans; all of the former and most of the latter group are also indirect holders of stocks. Finally, about twenty percent of American

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20. In 1990, institutions held about 45% of the publicly traded stock. Carolyn Brancato, *The Columbia Institutional Investor Project Report*, *in* PLI Institutional Investors: Passive Fiduciaries to Activist Owners 406, 424, 434, 441 (1990). Most observers think the figure has increased since then. Pension funds apparently held about 30% of all publicly traded stock in 1988. *Id.* at 81, 178 (listing inconsistent numbers—30% of total, or 44% of 43% [19%]). Mutual funds held about 10% of the outstanding domestic equity securities issues in 1992—$429.9 billion worth. Investment Company Institute, Mutual Fund Fact Book 37, 39 (33d ed. 1993). Over one third in value of the mutual fund shares are held, in turn, by other institutions (often pension fund fiduciaries), *id.* at 62, thus moving the ultimate human beings even further away from the corporation. Several authors have explored the implications of this shift to largely institutional shareholdings. *See, e.g.*, Black, *Agents*, *supra* note 6, at 827-29; John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277 (1991) [hereinafter Coffee, *Liquidity*] (institutions are little involved in corporate management); John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 Cardozo L. Rev. 837 (1994); Hu, *New Financial Products*, *supra* note 7, at 1277, 1285 (discussing whether managers should maximize some entity-level accounting concept, the actual share price or the price at which shares "would" trade if the stock market were perfectly rational and omniscient); Hu, *Risk*, *supra* note 7, at 295-306, 355-66.

21. *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835 (1980).

households hold stock mutual funds.[22] Thus, it seems safe to assert that a significant proportion of Americans are indirect stockholders or closely related to such stockholders.[23]

Indirect ownership of stock, however, has few of the attributes of common law fee simple property: Berle and Means' claim that shareholders have few rights and little control of the publicly held corporation is even more true with respect to the indirect ownership of stock. Direct stockholders in publicly owned corporations retain three basic rights of ownership: the right to sell the stock (and thus, acting collectively, the company), the right to vote for directors and on certain narrowly defined issues presented to them by the directors, and the right to receive a proportional share of any dividend issued by the directors. Indirect shareholders generally have even fewer ownership rights. Pension beneficiaries, for example, generally lack all three of the basic shareholder rights: As a rule, they are barred by law from making decisions regarding the sale or voting of the stock held by their fund and have no right to (present) distribution of the dividends declared by the board of the indirectly "owned" corporation.[24] Similarly, open-ended mutual fund shareholders lack even a legal right to annual elections to the mutual fund's board of directors or to sell the fund to another manager (although they do have the right, absent in

22. *See* Investment Company Institute, *supra* note 20, at 13, 89-90 (27% of U.S. households held mutual funds in 1992; 72% of those were equity funds).

23. Adolf A. Berle, writing in 1930, estimated that roughly half of Americans were direct or indirect stockholders at that time. Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931). Some of the subsequent increase is due to changing patterns of insurance company and pension fund investment: Those institutions appear to be more heavily invested in stocks than a few decades ago. In any event, it does not appear to be the result of any decrease in the skewedness of the distributions of income or wealth. *See, e.g.*, Paul Krugman, Peddling Prosperity 130-50 (1994) (income gains since 1973 have gone disproportionately to the very rich).

24. The use of the word "ownership" in this context—and, indeed, in the original Berle and Means context—is thus deeply inaccurate as a description of the current state of the law. Neither direct nor indirect shareholders own the corporation in the sense in which a fee simple owner owns property: As Berle and Means pointed out, the shareholders have only limited control over corporate assets. *See* Berle & Means, *supra* note 4.

Furthermore, the Berle and Means terminology serves a deceptive ideological function in the debate over what I view as the key issue in corporate law: Who should have what elements of control over corporate assets. By asserting, rather than arguing, that shareholders "own" the firm, it suggests an easy answer—shareholders own the firm, therefore they should control it. Within this framework, then, it is possible to answer every argument regarding the proper role of shareholders in the firm by asking rhetorically, "Whose money is it anyway?" *See* Charles D. Watts, Jr., *Corporate Legal Theory Under the First Amendment:* Bellotti *and* Austin, 46 U. Miami L. Rev. 317, 358 n.176 (1991) (quoting Judge Frank Easterbrook's response "whenever public policy is argued as a justification for limiting the range of action available to corporate decisionmakers").

corporations, to withdraw their capital), and have essentially no rights with respect to the firms whose shares are held by the fund, other than to a pro rata share of any dividend distribution the firm may make.[25]

Direct individual ownership of stock in the United States is quite concentrated, in the sense that a very small number of individuals holds an extremely high percentage of the individually owned stock,[26] but quite dispersed, in the sense that close to half of Americans own some stock directly. Since the typical direct stock owner has an extremely small stock holding, it appears that most stock owners (direct and indirect) hold only tiny amounts of stock, and even tinier amounts

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Without the a priori premise that shareholders own the firm, Judge Easterbrook's question is anything but rhetorical. Shareholders have few of the usual moral, economic or legal attributes of owners. If the corporation is basically contractual, there is no inherent reason to deem the shareholders the owners or the natural recipients of residual return; rather, one could conclude that shareholders—who, after all, are selling only the most fungible of all commodities (capital and risk-bearing services)—are hired by management for a market rate of return, and have no particular claim to any surplus the corporation creates.

Indeed, in most modern, publicly traded corporations, shareholders contributed only an infinitesimal portion of the corporate capital—and virtually none of its other resources. Rather, the largest part of corporate assets is internally generated; that is, created by corporate action. Much of the rest is borrowed. Thus, the shareholder contribution to this common enterprise is not only fungible but rather small as well.

As an economic matter, it is not at all obvious why we should assume that perfectly fungible suppliers of a perfectly fungible commodity that, in many instances, appears not to be centrally important, would be able to trade that commodity for ownership—particularly when we do not actually see anything that looks like conventional notions of ownership in the market.

For these reasons, it is probably dangerously deceptive to refer to the shareholders as owning the firm. However, further exploration of this theoretical mother lode lies beyond the scope of this Article. In order to ease reading and writing, I will use the conventional terminology—hoping that my readers will remember that the issue of who owns the firm is, in my mind, at least an open question. (Actually, I think it is more likely a wrong question, like asking who owns the U.S. government—corporations are not sufficiently similar to real estate to be usefully described in property terms.)

25. John Nuveen & Co., Inc., SEC No-Action Letter, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,383, at 77,198 (Jan. 28, 1987) (annual election not required). Open-ended funds typically are managed by a separate corporation; the fund's directors nominally hire the management company (realistically, the sponsoring management company picks the directors). Shareholders in an open-ended fund sell their shares to the fund rather than to other shareholders; thus there seems to be no possibility of a "hostile takeover" or sale of the company. If the fund does not perform to shareholder expectations it will shrink (rather than suffering a reduced share price, as in a conventional corporation or closed-end fund).

26. The high proportion of institutionally held stock confuses this analysis. Institutionally held stock will be seen as highly concentrated for some purposes, *see, e.g.*, ROE, *supra* note 13, at 223. But holdings of pensions, mutual insurance policies and even mutual funds are far less concentrated than direct stock holdings: Increased institutional ownership, thus, may suggest that indirect stockholdings are less concentrated in the extreme upper class than are direct holdings.

of any particular corporation's stock, whether measured absolutely or in comparison to the stock owner's total wealth and earning capacity.

People who own shares, directly or indirectly, then, look like most of us: Indeed, they are most of us. Their interest in the corporations whose stock they own is likely to be quite limited. It is limited economically, in that their interest in any one corporation, or even in the stock market as a whole, is likely to be a limited part of their total wealth (for most Americans, even in the upper half of the wealth distribution, earned income—wages and salary—is vastly more important than all financial assets combined, let alone any particular indirectly held stock investment). It is limited, too, in that they are unlikely to know much about the investment—in the case of institutional stock holdings, now the largest part of the market, the ultimate human beneficiaries of those stock holdings are unlikely even to know which corporations' stock they indirectly "own." The interest of owners of stock in the underlying corporations is limited in other senses as well: People have interests other than in the maximization of their wealth, many of which are likely to be more salient at any given time than any particular stock holding.

C. Fictional Shareholders

The shareholder encountered in the law and practice of business organizations is quite different from this picture of the actual "owners."

1. *The Puzzle of the Uniform Shareholder*

Here is the puzzle. If shares are held directly or indirectly by half the American population, and corporations act as agents of their shareholders, then we should expect two things: First, that corporate America would reflect the full diversity of human America, and second, that shareholder elections and other methods of determining what exactly it is that the shareholders are directing their agents to do would reflect in some fashion the wide range of human American politics.

We should see publicly held corporations that are as deeply dedicated to particular projects, or products, or places, or ideologies, or religions, or ways of working and lifestyles as many Americans are. We should see Berle and Means corporations that decide that profits are not the most important thing—just as many Americans put other values ahead of wealth maximization, some corporations should reduce their income in order to better serve needs of children, family, art, leisure time, status or religion. We should see Democratic corporations, Republican corporations, stamp collector corporations and the like.

We do not. Instead, public corporations have a rather narrow range of styles and interests. Few of them even claim to have Time Inc.'s dedication to a particular corporate culture, and even those that do seem able to throw it off—generally in the direction of corporate normality—as easily as IBM abandoned lifetime employment or the American Can Company abandoned the can business.

There are some importantly idiosyncratic corporations out there. But by and large the idiosyncratic ones are the ones that do not fit the Berle and Means model. Either they are privately held, and thus able to vary all the basic structures of corporate law,[27] or they are dominated by founders who exploit the looseness of corporate law to treat a public company as if it were still private. We do not see public companies dropping their blandness to reflect the diversity of America.[28]

Similarly, we do not see the hotly contested shareholder elections one might expect if corporations were reflecting a diverse shareholder body. Americans, after all, have radically different views on issues such as the proper place of religion or art in public spaces, the relative importance of working conditions as opposed to, say, quality control,

27. Even privately held ideological corporations tend to take large mushy positions with overwhelming support; for instance, saving the rain forests or not putting poisons in the eyes of cute animals. *See, e.g.*, Udayan Gupta, *Four Companies Hope to Turn Customers Into Activists*, WALL ST. J., Jan. 21, 1993, at B2 (describing difficulties of specific political activism by privately held companies); Udayan Gupta, *Keeping the Faith*, WALL ST. J., Nov. 22, 1991, at R16 (describing more general positions of The Body Shop and Ben & Jerry's). These broad positions suggest that the corporate ideology may be as much advertising as charity. *Compare* A.P. Smith Mfg. v. Barlow, 98 A.2d 581 (N.J. 1953) (corporation defended charitable contributions on the ground that they were profit-motivated advertising).

Conversely, however, both publicly and privately held corporations take highly controversial stands on hotly contested political issues that are directly related to their pursuit of profit. *See, e.g.*, First Nat'l Bank v. Bellotti, 435 U.S. 765 (1977); Edward Felsenthal, *EPA Report Sparks Antismoking Plans*, WALL ST. J., Jan. 7, 1993, at B1 (describing how tobacco companies encourage smoking in their offices in contrast to the general trend in corporate America); parts III B.5 and IV, *infra*. Fictional shareholders deemed to be interested only in maximizing profit from this shareholding would, of course, support such activism unanimously. Real people, in contrast, probably would have some disagreements.

28. Agency theory suggests that firm political and charitable acts will reflect shareholder views, perhaps by shareholders sorting themselves out according to publicly announced corporate positions. The model presented in this Article demonstrates the falsity of this suggestion. *See infra* part IV.A.

the proper approach to environmental quality, the proper relationship between stability and progress, the importance of growth versus the importance of economic equality, the degree to which public goods, such as education, culture or urban spaces, should be publicly financed and other issues that corporations must confront in their everyday management. So there ought to be battles among the shareholders to determine what the corporation will look like, just as there are such battles in every political unit in our country.

Far from the battles of the Kulturkampf one sees in elections to the House of Representatives or local school boards, however, corporate elections look like something out of the former Soviet Union. If management nominees or positions in a publicly held corporation's shareholders meeting win by less than eighty-five percent, it is front-page news for the Wall Street Journal, generally followed shortly thereafter by a palace revolt among the very directors management nominated. Shareholders, unlike American citizens, appear to have a general will in John Jacques Rousseau's sense: Without debate or discussion, by independent voting, they agree on what is best for the collectivity, consistently arriving at a single answer. Or perhaps the better metaphor is the Leninist one: Like Lenin's proletariat, shareholders follow the leadership of the vanguard that knows, without false consciousness, what their true interests are.

2. *The Puzzle of the Missing Agency Rights*

Another set of oddities seems to challenge the very notion of shareholders as principals of the corporation: Shareholders have few or none of the rights that agency law grants to principals. This is no secret; why, then, do courts and scholars continue to use the agency metaphor?

The Restatement states that an agency relationship is characterized by two special traits. The agent, who acts on behalf of the principal, is subject to the principal's control.[29] And the principal has an unlimited right to terminate the agent at any time.[30]

In sharp contrast, Delaware courts never tire of repeating that the board of a Delaware corporation has original, undelegated power to

29. RESTATEMENT (SECOND) OF AGENCY §§ 1, 14 (1984).

30. RESTATEMENT (SECOND) OF AGENCY § 118 & cmt. b (1984) ("The principal has power to revoke . . . although doing so is in violation of a contract between the parties and although the authority is expressed to be irrevocable. A statement in a contract that the authority cannot be terminated by either party is effective only to create liability for its wrongful termination.").

manage the corporation.[31] The board may make virtually every decision on its own authority; only a few decisions must be ratified by the shareholders. Even in those relatively unusual circumstances where shareholder approval is required, shareholders generally have no right to initiate action. They can vote only at specified times for specified purposes; subject to a few exceptions, the board controls their agenda.[32] Shareholders, to be sure, have the right to present proper proposals at the annual meeting.[33] But state law generally bars most proposals ordering the directors to take particular actions: That would be a breach of the directors' fiduciary duty to act in the best interests of all shareholders.[34] Federal law has been even more restrictive, denying even to purely advisory proposals access to the proxy machinery necessary to make proposals meaningful if, inter alia, the "proposal deals with a matter relating to the conduct of the ordinary business operations of the registrant"; this rule has been applied—though not consistently—to bar shareholders from expressing to management their opinions regarding employee health benefits, compensation policies, workplace management, racial discrimination, hiring and firing practices, labor relations, conditions of employment, EEO compliance, affirmative action, a company policy discriminating against homosexuals and so on.[35]

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31. In doing so they are only slightly paraphrasing the statute. DEL. CODE ANN. tit. 8, § 141(a) (1991). *See, e.g.*, Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989) ("[T]he contention [that shareholders might have a right to accept a tender offer] stems, we believe, from a fundamental misunderstanding of where the power of corporate governance lies."); *see also* People *ex rel.* Manice v. Powell, 94 N.E. 634, 637 (N.Y. 1911) ("[T]he powers of the board of directors are, in a very important sense, original and undelegated.").

32. Boards also largely control their own composition, despite formal election by shareholders. *See, e.g.*, BERLE & MEANS, *supra* note 4; *Paramount*, 571 A.2d at 1140, 1146 (stating the fact that Time Inc. sought to structure the initial merger to assure that Time would be the dominant corporation and its board would control the combined corporation; to assure this it was—paradoxically—prepared to pay a premium leaving Warner shareholders with 62% of the votes in the combined firm); Paramount Communications, Inc. v. Time Inc., 1989 WL 79880, at *23 (Del. Ch. 1989) (stating that the fact that 62% of Time stock would be held by Warner shareholders was "irrelevant" in determining whether the transaction involved a change in control).

33. DEL. CODE ANN. tit. 8, § 211(b) (1991).

34. *See infra* notes 38, 43-47 and accompanying text.

35. Rule 14a-8, 17 C.F.R. § 240.14a-8 (1995) sets out the conditions under which management must include a shareholder proposal in its proxy materials: The shareholder must own at least one percent or $1,000 in market value of the stock eligible to vote, the shareholder may make only one proposal (and a subject matter need be the subject of a proposal only once in five years under some conditions); the supporting statement (which management must include) may be no more than 500 words (this footnote alone has over 200); the proposal must be proper for shareholder action under state and federal law (thus excluding most directive proposals); it must affect more than five percent of the registrant's total assets or five percent of its net earnings or gross sales, or be otherwise "significantly related" to its business (note that this might exclude

Even the most important decision from a shareholder perspective—whether to sell the corporation as a whole—must be made in the first instance by the board. Merger agreements, sales of all assets, dissolution of the corporation and even amendments to its articles of incorporation must all be initiated and approved by the board prior to shareholder action.[36] As the board in the famous case *Smith v. Van Gorkum*[37] found to its discomfort, a board may not simply delegate these decisions to the shareholders.[38]

Similarly, tender offers in practice are subject to board decisions regardless of shareholder desires. Formally, to be sure, tender offers do not require board action, presumably because they are understood as individual shareholder actions with respect to individual holdings rather than as corporate actions.[39] However, with the emergence and judicial approval of the "poison pill"[40] and the " 'just say no' defense,"[41] it is virtually impossible to consummate an uninvited tender offer without board acquiescence. The constituency statutes—which effectively preclude judicial review of board resistance to hostile tender offers by allowing boards to invoke the interests of virtually any corporate participant to justify a board decision—surely are mere icing on the poison pill cake.[42]

extremely large expenditures from the point of view of the recipient); and so on. *See* New York City Employees' Retirement Sys. v. SEC, 45 F.3d 7 (2d Cir. 1995) (upholding SEC "Cracker Barrel" ruling that companies may omit shareholder resolutions on "social" issues such as the issuer's "employment policies and practices," including an alleged practice of racial discrimination); *see also* Amalgamated Clothing & Textile Workers Union v. Wal-Mart Stores, Inc., 821 F. Supp. 877, 882-83 (S.D.N.Y. 1993) (reviewing prior cases and SEC actions).

36. *See* DEL. CODE ANN. tit 8, §§ 251 (merger), 271 (sale of all assets), 275 (dissolution), 242 (amendment) (1991).

37. 488 A.2d 858 (Del. 1985).

38. *See also* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1149-50, 1154 (Del. 1989) (framing the question as "Did Time's board . . . come under a fiduciary duty to . . . put the corporation's future in the hands of its shareholders?" and emphasizing the "duty" of the board to manage the corporation, which "duty may not be delegated to the stockholders"); Rule 14d-9(e)-(f), 17 C.F.R. § 240.14d-9(e)-(f) (1995).

39. T.W. Services v. SWT Acquisition Corp., Fed. Sec. L. Rep. (CCH) ¶94,334 (Del. Ch. 1989).

40. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

41. *See, e.g.*, Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931 (1991).

42. *But see* John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003, 1038-46 (1993) (arguing that the demise of the hostile takeover is accompanied by an increase in shareholder voice, particularly of large institutional shareholders through informal mechanisms); Coffee, *Liquidity*, *supra* note 20, at 1336-66 (arguing that institutional investors make poor corporate monitors and rationally prefer "exit" over "voice"). In this Article, I seek to avoid entering into the debate regarding the degree to which

Furthermore, shareholders, unlike ordinary principals, may not issue binding instructions to their "agents." The general rule is that directors would be in breach of the law if they accepted such instructions.[43] Like Edmund Burke's statesman,[44] but unlike the Populist legislative model of direction, initiative and referendum,[45] directors are required to exercise independent judgment, not simply to follow their constituents'—let alone principals'—orders.[46] Indeed, in the precise opposite of the agency law rule, directors are not necessarily protected in their decisions by turning a matter over to shareholders for decision, and may not defend a shareholder suit on the ground that they were doing no more than they were instructed to do or that they pledged to do prior to their appointment.[47] Unlike agents, in short, directors are not viewed as mere emanations of their principals' personalities.

The fundamental agency right of termination is also missing. Agency law holds that an agent may always be terminated, regardless of prior agreements. An agent wrongfully terminated may have an action for damages, but never has a right to continue as the principal's

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seemingly powerless shareholders may influence the firm through market power (exit) or internal pressure (voice). My point here is, rather, that that power looks quite different from the power a principal has over its agent. In Parts III and IV, I discuss the assumption in most academic corporate law theory that an effective increase in shareholder power is simply a good thing.

43. Many courts will now enforce shareholders' agreements binding the directors in close corporations, especially if all the shareholders are party to the agreement. *See, e.g.*, Galler v. Galler, 203 N.E.2d 577 (Ill. 1964). The continuing strength of the basic rule as stated in the text is shown by the difficulty courts have in making an exception even in close corporations where the shareholders effectively are the directors and where no third party is concerned.

44. "Your representative owes you, not his industry only, but his judgment; and he betrays, instead of serving you, if he sacrifices it to your opinion." EDMUND BURKE, II WORKS 95-96 (Boston 1866). For further discussion, see EDMUND S. MORGAN, INVENTING THE PEOPLE: THE RISE OF POPULAR SOVEREIGNTY IN ENGLAND AND AMERICA 216-19 (1988).

45. *See, e.g.*, CAL. CONST. art. iv, § 1 (providing for legislation by popular referendum); THE OMAHA PLATFORM (1892), *in* THE POPULIST MIND 59, 65 (Norman Pollack ed., 1967) (calling for initiative and referendum); JAMES MADISON, THE DEBATES IN THE FEDERAL CONVENTION OF 1787 (Gallard Hunt & James Brown Scott eds., 1920) (objecting to the policy of binding legislators to their constituents' specific directions); GORDON S. WOOD, THE CREATION OF THE AMERICAN REPUBLIC 1776-1787 (1969); GORDON S. WOOD, THE RADICALISM OF THE AMERICAN REVOLUTION (1992).

46. *See, e.g.*, Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947) (director represents all shareholders, not just those who elected him).

47. *See* Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985).

agent. Partnership law follows the agency model, allowing for wrongful dissolution of the partnership at any time by any partner.[48] Corporate law, however, is quite different.

First, individual shareholders never have the right to dissolve the relationship between the shareholders as a group and the board: Ordinarily, the shareholders may never manage their own affairs.[49] Furthermore, the corporation may be dissolved only by vote of the board followed by vote of the shareholders.[50] A shareholder may, of course, transfer its interest to another person, but the shareholder/director relationship continues unchanged.

Second, shareholders have only limited rights—even acting collectively—to replace the directors. Unlike agents, directors are appointed for a term and may be terminated during the course of that term only by following the procedures set out in the statute; there is no equivalent to the agency concept of wrongfnl termination. Thus, a shareholder agreement to elect certain individuals directors is generally binding and enforceable.[51]

Furthermore, even in the absence of an agreement, shareholders may remove directors only by majority vote at a meeting duly called

48. UNIF. PARTNERSHIP ACT § 31 & Official Comment (1914), 6 U.L.A. 771-72 (partnership is an agency relationship; one partner may dissolve the partnership at any time); REV. UNIF. PARTNERSHIP ACT §§ 602, 603 (1994), 6 U.L.A. 77-79 (limiting the effect of a partner's disassociation but preserving the principle that a partner's right to end an agency relationship may not be eliminated by contract).

49. DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."); REV. MODEL BUSINESS CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors . . . ."). Both the Delaware statute and the Revised Model Business Corporation Act provide for certain exceptions if they are listed in the articles of incorporation, and provide for direct management of statutory close corporations by their shareholders. Significantly, however, amendment of the articles of incorporation or reincorporation as a close corporation would require board permission. REV. MODEL BUSINESS CORP. ACT § 10.03 (1984). A principal, in contrast, never needs its agent's permission to dispense with the principal/agent relationship.

50. REV. MODEL BUSINESS CORP. ACT § 14.02 (1984); DEL. CODE ANN. tit. 8, § 275 (1991). While shareholders may dissolve the corporation by unanimous written consent without board action, *id.* § 275 (c), this exception is meaningless in the public corporation context with which we are concerned. Shareholders may also bring an action to dissolve the corporation for a limited set of stated reasons, REV. MODEL BUSINESS CORP. ACT § 14.30 (1984); clearly, this too is quite different from the ordinary agency rule.

51. Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 53 A.2d 441 (Del. 1947).

for that purpose.[52] Calling such a meeting requires fulfilling statutory requirements that often cannot be met on short notice. Moreover, if the corporation has a staggered board, the shareholders may be barred completely from removing directors during their term except on a showing of good cause; some of the older statutes required this showing of cause in all cases.[53] A stronger contrast to the agency rule cannot be imagined: While agents serve only at the pleasure of the principal, regardless of agreements to the contrary, directors serve for a fixed term and may not be removed except by prescribed procedures.

3. *A Different Kind of Principal*

We have seen, then, that shareholders do not have the kinds of disputes one would expect if they were a diverse group of Americans engaged in a struggle to make corporations in their images, and that as a matter of law, shareholders, even taken as a collectivity, lack the control over directors that characterizes an ordinary agency relationship. The facts are no surprise: Every reader of the Wall Street Journal knows that corporate elections are generally won by margins not seen in democratic politics. The law is no surprise, either: Virtually all my citations in Parts II.C.1 and II.C.2 above are taken from a leading casebook used to teach basic corporate law to second-year law students.[54]

One might conclude from this that the agency metaphor is simply wrong; that in fact directors are not agents of the shareholders and the shareholders are not the principals, or owners, of the firm.[55] Directors, after all, are explicitly authorized by statute in over half the states and by case law in Delaware[56] to consider the interests of corporate participants other than the shareholders. Thus, the law of directors defies even the remaining aspect of agency law, that the agent

52. REV. MODEL BUSINESS CORP. ACT § 8.08(d) (1984); DEL. CODE ANN. tit. 8, § 141(k) (1991).

53. DEL. CODE ANN. tit. 8, § 141(k)(I) (1991). For the older rule, see, for example, Frank v. Anthony, 107 So.2d 136 (Fla. Dist. Ct. App. 1958) (shareholders may not remove a director without cause). The New York statute allows removal for cause only if the certificate of incorporation so provides. N.Y. BUS. CORP. LAW § 706(b) (Consol. 1988).

54. WILLIAM L. CARY & MELVIN ARON EISENBERG, CORPORATIONS: CASES AND MATERIALS (6th ed. 1988) and its statutory supplement.

55. *See supra* discussion part II.C.1-2.

56. This is seen most prominently in Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1989) (distinguishing between interests of the corporation and those of shareholders, and holding that in most instances the board may prefer the former to the latter)

acts on behalf of the principal.[57] Taking these "constituency statutes" and the agency metaphor seriously, one might come to view the corporation as a coalition of bargaining groups with the shareholders as one among equals,[58] or as a quasi-state that has (presumptively wrongfully) limited the franchise to but one subsection of the governed,[59] or as a more amorphous kind of community.[60]

The persistence of the notion that the directors are agents for shareholders, in the face of well-known facts and law to the contrary, however, suggests that the metaphor should not be dismissed so easily. The fictional shareholder solves the puzzle and rescues the agency metaphor from otherwise hopeless obscurity.

The key to the puzzle, in my view, is that in a sense directors often do view themselves as acting on behalf of shareholders, and the shareholders do control the corporation, despite the law and appearances to the contrary. But the shareholders on behalf of which the directors act and the shareholders that control the corporation are not the owners of the shares. Rather, they are a kind of personification of the shares themselves, almost imaginary creatures driven by only one goal: to maximize the value of their shares.

I claim, then, that the agency picture of the corporation is right in this sense: The people who make corporate decisions—directors and managers—do so and are required to view themselves as doing so in an agency role. Their job, as they see it, is to put aside their own interests and views and act on behalf of someone else's views and interests.[61] In that strong sense, they are agents, regardless of whether the law gives that someone else the technical rights of a principal under agency law. But the someone whom the corporate agents represent, in whose behalf they must act, is not a full human being in all

(citing the seminal case, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (board may consider "the impact on 'constituencies' other than shareholders")).

57. RESTATEMENT (SECOND) OF AGENCY § 39 (1957).

58. The nexus of contracts theory does this in some varieties. *See generally* Bratton, *Nexus*, *supra* note 6.

59. This critique is implicit in the German system of employee representation on the board and the standard kibbutz defense of their system of having important corporate decisions made by vote of the entire kibbutz. *See also* Daniel J.H. Greenwood, Corporation as Polis: A Political Theory of Shares (forthcoming work in progress).

60. *See e.g.*, Mitchell, *Cooperation*, *supra* note 6; Millon, *supra* note 6, at 240-46; Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992).

61. *See* DAN-COHEN, *supra* note 3; Meir Dan-Cohen, *Between Selves and Collectivities: Toward a Jurisprudence of Identity*, 61 U. CHI. L. REV. 1213, 1218-20 (1994).

its complexity, much less a collection of half the citizens of the United States of America. Rather, it is the fictional simplification we call a shareholder.

4. *Hypothetical Politics of Imagined Monads: Hobbes Meets the Fictional Shareholder*

The fictional principal solves many of the puzzles of the agency metaphor. First, it explains the startling absence of intra-shareholder conflict and actual agency rules[62] in corporate law noted in the prior two sections. Second, it justifies an extraordinary level of deference to the professional managers of the corporation.

Fictional shareholders, unlike real ones, do not have strong conflicts in their attachments or ideologies. They are not Democrats and Republicans, religious and atheist, committed to New York or Iowa, tied to a job or a family or encumbered by the life stages of a real human being. They do not have a multiplicity of plans for a too-short life: They have one, to maximize the value of their shares. As a result, they are all the same (or almost all the same, as we shall see in a moment).

Now, timeless, ageless, familyless, unencumbered imaginary people with unified goals getting together and deciding what to do are a familiar image to students of Western political philosophy. That is a crude, one-sentence description of persons in the state of nature of the liberal political theory tradition of John Locke and Thomas Hobbes.

Liberal theory has long attempted to deal with the problem of contentious politics through the device of imagining such participants in politics. In the fictional shareholder we have, I believe, a clear application of this classic liberal methodology. The fictional shareholder does not need actual messy politics or, for that matter, the actual rights of a principal under agency law, for the same reason that Hobbes, Locke and John Rawls can base their political philosophies on imaginary agreements. In the simplified world of liberal theory—and fictional shareholders—expertise of the philosophers and the managers replaces actual politics. To see why this is so will require a short excursus into the arcana of liberal theory and back.

a. *Liberal theory and the abolition of politics:* A central issue for liberal theory is the majoritarian difficulty: put most crudely, that

62. Or, for that matter, actual contract negotiations.

might does not make right. The mere fact that a majority has approved a law, without more, does not make a law just, and does not explain why the losers should view the law as legitimate, rather than as simple brute force to be obeyed in necessity and evaded where possible. In the particular American context, one of the oldest examples is the battle for religious freedom: We long ago agreed that mere majority vote does not justify an established church, let alone exiling or burning dissenters. An equally old and obvious example is slavery: The general consensus is that a majority vote to reinstate slavery or the apartheid system of Jim Crow would not be enough to justify it morally. Thus, few, if any, have ever tried to distinguish between the American version of apartheid and its South African variant on the ground that the former, but not the latter, was imposed by a majority on a minority. Such laws are unjust and illegitimate regardless of the procedures used to adopt them.[63]

The project of the Western liberal theories since at least Hobbes has been to explain why or when the law is legitimate—when, that is, it has a claim beyond that of mere force, whether the force of arms or the force of numbers.[64] There are a number of approaches to this problem, but I will concentrate on only one—the one I call "hypothetical politics." I deliberately ignore other solutions that seem less relevant to the problem of the fictional shareholder, and I discuss the hypothetical politics theory at a level of generality that is sure to offend the living authors and serious students of all concerned: My purpose here is not a philosophic examination but a broad picture of a general method that seems to have important implications for our understanding of corporate law.

63. The majoritarian difficulty that stands at the core of most liberal theory, then, stands in the strongest possible contrast to Alexander Bickel's countermajoritarian difficulty, which concentrated on the apparent anomaly of a law-driven court enforcing minority rights in a supposedly democratic (majoritarian) system. *See* ALEXANDER BICKEL, THE LEAST DANGEROUS BRANCH (1962).

64. This problem is not limited to the Western political tradition. Thus, for example, the Talmud thought so highly of majority vote (of the qualified) as a decisionmaking method that it held that divinely mandated majority rule prevails even over a direct revelation from Heaven regarding a point of law. B.T. BABA METZIA 59b (Oven of Achnai). Nonetheless, Talmudic law also recognizes the majoritarian difficulty, in the principle, "Because they are many, may they be thieves?" (that is, a majority vote does not make wrong into right). B.T. BABA BATRA 100b. For further discussion, see, for example, Menachem Elon, *The Legal System of Jewish Law*, 17 N.Y.U. J. INT'L L. & POL. 221, 237 (1985); Suzanne Last Stone, *In Pursuit of the Counter-Text: The Turn to the Jewish Legal Model in Contemporary American Legal Theory*, 106 HARV. L. REV. 813, 840-42 (1993); Greenwood, *supra* note 18, at 562 n.15.

The hypothetical politics story runs something like this. Real politics offers little or no guidance to the requirements of justice: Force too easily prevails. The majoritarian difficulty suggests that even if we could complete the John Hart Ely/Footnote Four[65] project—that is, create a procedurally perfect majoritarian system—we would still not have solved the problem of justice. Majority oppression of minorities is still oppression. Instead, justice seems to require some form of fair proportionality: taking turns, or equal distributions, or distributions appropriate to the nature of the thing in question, or something of that order.[66] Similarly, legitimacy seems to require some form of consent: If you have agreed (or should have agreed) to this law, you should not be heard to complain that it is coercive.[67] In contrast, majoritarian systems allow a unified majority to prevail, over and over again, without regard for fairness or minority consent.[68]

Consent, especially consent under fair conditions, is notoriously difficult to obtain. Those who premise justice on obtaining actual agreement tend to conclude that all existing societies are unjust and the possibility of creating a future just society is slim indeed, as do

65. *See* John Hart Ely, Democracy and Distrust (1980); United States v. Carolene Prods. Co., 304 U.S. 144, 153 n.4 (1938).

66. *See* The Politics of Aristotle bk. III, ch. XII, § 1 (J.E.C. Welldon, D.D. trans., 1923); Michael Walzer, Spheres of Justice (1983); Isaiah Berlin, *Equality*, *in* 56 Proceedings of the Aristotelian Society 301 (1956); Daniel J.H. Greenwood, On Equality (unpublished manuscript, on file with author).

67. *See, e.g.*, Robert Nozick, Anarchy, State and Utopia (1974) (concluding that the only legitimate form of government would be one that resulted from a series of fair agreements); Rawls, *supra* note 8, at 11-17 (characterizing justice as the results of a properly defined fair agreement); John Jacoues Rousseau, *The Social Contract; Considerations on the Government of Poland*, *in* Political Writings (Frederick Watkins trans. & ed., 1986) (in free society, citizens will have internalized the law to the point where its orders and their wills never conflict); Robert P. Wolff, In Defense of Anarchism (1970) (concluding that all government is coercive and illegitimate unless based on actual unanimity); T.M. Scanlon, *Levels of Moral Thinking*, *in* Hare and Critics 129, 137-38 (Douglas Seanor & N. Fotion eds., 1988) (seeking a principle that could not reasonably be rejected "by parties who, in addition to their own personal aims, were moved by a desire to find principles that others similarly motivated could also accept"). I leave aside the interesting issue of whether consent adds anything to justice: If one consents under unfair conditions (for example, with a gun to one's head) or fails to consent when a fair person would (for example, to put the gun away for the duration of the negotiation), most thinkers seem inclined to disregard actual consents or contracts for hypothetical ones that reflect the principles of justice.

68. For this reason, many defenses of majoritarian systems assume, explicitly or implicitly, that there are no permanent majorities. By conceiving of society as unattached individuals or as a shifting group of forming and reforming coalitions, theorists can make the majoritarian difficulty seem to disappear into a proportionality principle (everyone wins some of the time). For classic examples, see Shaw v. Reno, 113 S. Ct. 2816, 2827 (1993); Robert A. Dahl, A Preface to Democratic Theory (1956); Robert A. Dahl, Who Governs? Democracy and Power in an American City (1961).

Robert P. Wolff, Robert Nozick and John Jacques Rousseau. Furthermore, their work can easily become a justification for creating agreements by force—by killing or expelling those who disagree, as in the nationalist and revolutionary reinterpretations of Rousseau.

In contrast, if we could imagine an agreement that all rational people would agree to under fair conditions, some philosophers have argued that there would then be no need to reach an actual agreement. Real people might well refuse to agree—but their refusal may be disregarded, since it must (by hypothesis) stem either from irrationality or from an unfair bargaining situation.[69]

Hobbes thus argued that all people, whatever else they want and whatever their goals in life, wish to stay alive; accordingly, under fair bargaining conditions they would all agree to create a government that will keep them alive. From this foundation, he constructed the *Leviathan*—a massive defense of a rather unfree politics based on a hypothetical unanimous agreement. The power of his argument is that if we were persuaded that all rational people would, after reflection, agree to the society he describes, then such a political arrangement would be legitimate regardless of its history or origin: No investigation of real history, no questioning of real people, no actual debates or politics in this world are necessary to show the legitimacy or illegitimacy of the existing government. Hypothetical politics replaces the real form.

The preeminence of hypothetical politics—the unanimous agreement into which all citizens would enter if, counterfactually, they were all fully rational, fully informed and in a fair starting position—over actual messy, unfair, irrational ordinary politics is most striking in Hobbes since his hypothetical rational beings agree to a state that, to save their lives, bans anything resembling ordinary politics. But the model, in a less extreme form, underlies the work of philosophers ranging from Locke to Rawls to the scripted "dialogues" of the early Bruce Ackerman.[70] Indeed, I believe it is implicit in virtually every

69. RAWLS, *supra* note 8, at 3-53.

70. BRUCE A. ACKERMAN, SOCIAL JUSTICE IN THE LIBERAL STATE 358-59 (1980) (arguing that requirements of justice can be determined by examining "dialogues"—both sides of which are written by the philosopher). Ackerman's more recent work appears to be an attempt to avoid the hypothetical politics solution and its accompanying problems. By postulating higher and lower (more and less legitimate) moments of politics, he is able to claim a majoritarian basis for the Constitution without invoking rights theories or hypothetical politics. But higher politics doesn't solve the majoritarian difficulty unless we have some assurance that the people, in their more excited moments, recognize the requirements of justice and just treatment of minorities.

nontheological rights-based defense of constitutional law: The Constitution is meant to embody the hypothetical agreement that actual politics has no right to abrogate.

The exciting thing is that once the philosopher has identified a common goal—life, or maximization of primary goods, or whatever—the philosopher can then derive the agreement that such individuals would reach if they were in a fair starting point. No actual discussions with actual people are necessary: We can figure out what they would want by applied logic.

The hypothetical agreement reached has two broad elements, as a rule: certain basic rights that the parties would agree should be guaranteed in all circumstances, and a majority rule for the remainder of issues. This reduces or eliminates the majoritarian problem by shrinking the sphere of politics and eliminating most issues of uncompromisable principle: The difficult to resolve and truly controversial issues are removed from the majoritarian process. Freedom of conscience, freedom of movement, in Rawls' version a minimum standard of living—each of the things about which one might be inclined to fight rather than switch are depoliticized, given over to the hypothetical agreement of the theory rather than the actual politics of a majoritarian democracy.[71]

Ackerman's demand that higher politics be characterized by a consensus seems to be designed to replicate in the real world the hypothetical unanimous agreement of the theorists, paralleling Rousseau's requirement that the just law also be consensual.

In contrast, other thinkers simply capitalize the People and treat the Constitution as if it were Torah from Sinai, given by all-knowing Founders and ratified by a holy People who, like the Giver of Torah, are by definition just. This, of course, is the solution to the problem of operationalizing the hypothetical contract that Rousseau proposed in *The Government of Poland.* Treating our own Constitution as holy writ, however, requires a certain amount of intellectual gymnastics, given that we have long since abandoned most of its original premises, including slavery, extremely limited suffrage, indirect and nonpartisan elections to the Senate and presidency, no professional army and a virtually nonexistent federal bureaucracy. I assume that the transmutation of the "Founding Fathers" into the "Founders" in some recent work is partly to ease the cognitive dissonance of basing an allegedly democratic theory on the binding force on us of the political compromises of a tiny subsection of very different and not obviously God-like people 200 years ago.

71. *See, e.g.*, U.S. CONST. art. I, § 9; U.S. CONST. art. IV, § 2; U.S. CONST. amends. XIII-XV (deeming slavery, equality and citizenship too important to be left to democratic process); Charles A. Reich, *The New Property*, 73 YALE L.J. 733 (1964) (deeming welfare policy too important to be left to democratic process); Lochner v. New York, 198 U.S. 45 (1905) (deeming free market too important to be left to democratic process); Virgiuia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. 748 (1976) (deeming a corporation's right to advertise too important to be left to democratic process); United States v. Carolene Prods. Co., 304 U.S. 144, 153 n.4 (1938) (deeming democratic process too important to be left to democratic process).

Most remaining politics is not issues of principle but rather matters of administration, namely increasing the size of the pie (best left to experts and the market) and dividing it (best dealt with by general principles of fairness or the very rough equality of the spoils system in a pluralist democracy).

Thus, in the American application of this theory, the Constitution was meant to remove from majoritarianism each of the most divisive issues of the age: Religion and speech, each core areas of politics as understood by the ancients, were simply excluded from the sphere of governmental competence. Slavery, the most important issue of the day, was removed from majoritarianism: A mere majority vote would not have been enough to convince the losers to give up their position. What is left for majoritarianism is public works—pork, in the modern deprecatory terminology. And for that, the constitutional solution is Publius' version of pluralism: splitting the governmental process into a multitude of different routes, with the goal of preventing anyone from creating a winner-take-all majority. Instead, to get anything done, ever-changing broad coalitions must be formed—hopefully assuring that everyone gets a chance at the trough in something resembling a fair share. Indeed, the sharp decline in public respect for government in recent years may be due to the elective branches' increasing willingness to tackle ideological issues or issues with clear losers rather than sticking to issues where everyone (or at least all those represented in the bargaining process) can get some, like the interstate highway system. In times when the government commanded more respect, the elective branches tended to avoid principled issues, instead dumping them on our operationalized version of the hypothetical agreement, the courts, or hiding them in the invisibility of administrative agencies or local governmental bodies.[72]

b. *The hypothetical agreements of corporate law: a unified goal reduces politics to administration:* In our corporate law, this liberal model of a hypothetical politics is taken to its fullest, Hobbesian, extreme. Fictional shareholders all want to maximize the value of their shares. They exist without context or history. Since the value of their shares is nothing more than the discounted value of the future income

72. Classic examples of these American devices to avoid making principled decisions by majority rule include, respectively, Roe v. Wade, 410 U.S. 113 (1973), the FCC's mandate to regulate in the public interest, 47 U.S.C. § 151 (1988), and the hidden politics of local school boards. A recent recognition of the weakness of majoritarianism may be the "depoliticization" of armed service base closings.

stream represented by the dividends, they are time indifferent. Since dividend streams are fully fungible, they are as uncommitted as persons in the state of nature. Since fictional shareholders function in a free market, they are individualist and self-interested. And like the persons in the state of nature or behind the veil of ignorance, they are fully equal and able to enter into a fair bargain.

Fictional shareholders, then, meet all the requirements of hypothetical politics. Here, as in the Hobbesian model, something very exciting happens: Once we agree that all the shareholders share this common goal, actual politics becomes an unnecessary distraction. We can calculate what rational and equal shareholders want by mere reason. Discussion is unnecessary; expertise can replace persuasion and voting.

Under the model of hypothetical politics, then, the wills of the people who own shares are no longer particularly important. Since management and the board, a reviewing court or any other expert can determine what the hypothetical shareholder interests in fact are, it is not necessary to ask shareholders what they think. Indeed, in light of the well-known problems of bounded rationality, it probably would be foolish to do so.[73]

So the fictional shareholder model explains why corporate law reverses the usual agency law and contract law presumptions. If shareholders all share the same basic goal, namely maximization of the present discounted value of future dividends, then we can construct the agreement they would have reached under more ideal conditions. It follows that freedom and autonomy for the principal and contracting party are completely unnecessary. Paradoxically, the principal can be empowered by being barred from deciding the key issues. Indeed, even if an overwhelming number of shareholders support a given action, the board, a reviewing court or other expert may be better positioned to determine that shareholder interests are different from their expressed views.[74]

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73. That is, rational and self-interested shareholders will decide not to learn enough to manage the firm intelligently, but will depend on market diversification instead.

74. For examples of this modified version of false consciousness theory, see, for example, T.W. Servs. v. SWT Acquisition Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,334 (Del. Ch. Mar. 2, 1989) (88% of shares tendered); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989). Detailed theoretical explanations of when and why shareholder votes will be a poor indicator of shareholder interests abound in the literature. *See, e.g.*, Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985).

Following the liberal model, actual contracts and actual agency agreements can be replaced by imaginary ones. All the important issues are removed from the political sphere, determined instead by the hypothetical agreement of the fictional shareholders in a state of nature. Thus, shareholders may not, by majority vote, transform a corporation into an eleemosynary institution.[75] Indeed, they may not even decide that some shares of common stock will receive more dividends than other shares in the same class. Stepping away from the fictional shareholder's fixation on mammon, shareholders may no more determine whether the firm is to be pagan or Christian in its outlook than the voters in a liberal democracy may make the state Catholic or Baptist. Indeed, shareholders may not even determine that the purpose of the corporation is to produce some particular product: If, for example, the Coca-Cola Corporation decided to stop producing Coca-Cola (or to change its formula), shareholders would have no vote on this decision.[76]

This lack of power, strange on the agency view, is natural on the hypothetical politics view. For fictional shareholders, whatever else the people behind them may want, all want to maximize the value of their shares. And as follows from the basic teachings of Adam Smith regarding the division of labor, rational share-value-maximizers would agree to delegate management of the company to professionals. Maximizing the value of the shares is a job for technical experts; there is no reason to think that the average (or indeed any) shareholder is particularly good at it.

It follows, then, that the separation of ownership and control is not a vaguely illegitimate deprivation of the rightful prerogatives of ownership, but rather a supremely sensible application of the division of labor. Companies need professional managers; the shareholding system allows competent managers to be chosen without regard for whether they also have the wealth to be shareholders.

But see the Hobbesian transition: If the corporation were run by and for real people, it would be a hotbed of political controversy. Real people argue about goals—so they must be represented by politicians, not technicians. The fictional shareholders, however, all agree on the goal; they have no need or use for politics. If the real people

75. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

76. A corporation's articles of incorporation could—though they never do—grant the shareholders a vote on such matters. But both the initial change to the articles and later votes would have to be initiated by directors, not shareholders.

disagree with the fictional representation, the real people may simply be disregarded as not real shareholders.[77]

Corporate democracy, in short, is not a Greek forum in which men seek to see and be seen or struggle to define a way of life. The goal is set before "politics" begins; the function of shareholder votes is not to set the goal but simply to police the experts. Indeed, given that shareholders have only one goal, expert managers acting in good faith are more likely to be able to do what shareholders want than shareholders themselves are. In this model, the only purpose to giving the shareholders any actual control at all is to ensure that their experts, the managers, are in fact acting in good faith. And in this model, it is entirely natural that we would only rarely see actual political action by shareholders: They have no disputes and they can generally rely on the market to take care of the occasional corruption problem.

We have come then to a solution to the shareholder puzzle. The fictional shareholder reduces politics to administration. Fictional shareholders do not have the conflicting goals that drive real politics and that are the reason why real principals must have ultimate control over their agents. Rather, like the Hobbesian monads in the state of nature, they know that whatever their goals in the real world, as shareholders they want more stock value rather than less. Given this common interest, they can be imagined to have agreed to let the philosophers (or in this case, the MBAs) decide how best to reach the common goal. Having entered into this original agreement, they can, like Hobbesian subjects, drop out of politics entirely.[78]

Note the importance of the particular goal: Maximizing value of shares, unlike, say, the merits of Time Culture or Classic Coke or American Cans, is something on which all shareholders can be deemed to agree. Thus, no vote is necessary on the ultimate goal; anyone who proposes an alternative goal can be assumed to be acting

77. *See, e.g.*, State *ex rel.* Pillsbury v. Honeywell, Inc., 191 N.W.2d 406, 411 (Minn. 1971), where the court described a petititioner who sought to influence Honeywell's policy of manufacturing war munitions as having only "tenuous" standing as a shareholder due to his failure to make a "showing of investment intent."

78. The process of dropping out is greatly facilitated by the Fischer Separation Theorem. That fundamental principle of corporate finance teaches that profit-maximizing shareholders interested in different time frames or with different risk preferences can nonetheless agree on a single investment strategy for the firm. For a clear explanation, see generally RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT (1993).

in bad faith.[79] But no vote is needed on particular methods of reaching the goal, either—the decision whether to produce cans or insurance, sweet or less sweet cola, or turgid or less turgid magazine prose, appears as merely an issue of implementation, best left to the experts and the full-timers.

So, if a corporation is run in the interests of *fictional* shareholders, it need not have actual owners of shares controlling it, contrary to the implications of the agency model if one assumed that the principals were real human beings. Nor need it have the actual political struggles that the diversity of the Americans who own shares would suggest is inevitable. Instead, experts considering how best to serve the single interest of the fictional shareholder can run the company all by themselves. Indeed, most likely, professional managers will run it far better than the real owners of shares would, for unlike the managers, the people behind the shares are neither trained experts nor full-time professionals.

c. *Politics as policing corruption rather than setting goals:* Only one function for politics remains within this paradigm; the same one that ultimately led Hobbes' successors to replace his authoritarian king with the thin majoritarianism I have discussed above. That is the problem of corruption. The logic of the division of labor counsels in favor of giving the maximum power and discretion possible to the expert managers who will run the company in the theoretically derived interests of shareholders. But, as we know, power corrupts. Thus, the key remaining function of shareholder democracy is to eliminate corrupt or self-serving managers—in the modern jargon, to reduce agency costs.

Finally, the fictional shareholder model explains the strikingly primitive understanding of agency problems in the corporate law agency cost literature. Corporate law agency theory concerns itself almost exclusively with corruption costs—the problem of agents who deliberately refuse to do the job they are hired to do, or who ignore their duties, intentionally putting their own interests ahead of their principals'.

Compare this thin view of the difficulties of the role of the professional agent to, for example, the elaborate discussions of how best to

79. *See, e.g.*, Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733 (1994).

represent another that arise entirely within good faith models of professionalism in other fields: lawyers and doctors struggling to understand how to pursue their clients' interests and goals in a world where those interests and goals may be nonexistent, underdeveloped or incoherent.[80] These issues drop out of corporate law because the fictional shareholder—unlike the human clients of doctors and other professionals—is seen as having only a single, consistent and clear goal.

Corporate law's limited understanding of agency issues flows directly from the hypothetical politics view: The simplicity of the fictional shareholder eliminates any need to talk about more sophisticated failures of agency and representation. Rather, the directors and managers are seen as mere administrators in an uncomplicated professional role of implementing a policy decision made prior to politics. If they would only keep their promises, corporate law would be dead.[81]

d. *The solution to the agency puzzle:* In this Part, then, we have seen that the claims of agency theory would be absurd if the principal were the American citizenry, in its full committedness and diversity. On the other hand, if shareholders are viewed as simple beings interested in nothing but share value maximization, the existing intellectual legal structure makes a great deal of sense. Given the clarity of the fictional shareholder's single goal, it is highly appropriate to delegate to professionals enormous discretion in managing the daily affairs of the firm. Under the fictional view, it is reasonable to restrict shareholder votes: Predictably, most shareholder interventions will be irrational, uninformed or in bad faith and doomed to be overwhelmingly rejected by a rational majority—surely fictional shareholders would agree that such exercises are a waste of time and money. Similarly, most shareholder litigation will be, as is commonly claimed, no more than a form of blackmail, in which a share owner (or an entrepreneurial lawyer purporting to act on behalf of such a person)

80. On the difficult issues lawyers face in representing the interests of their clients, see DOUGLAS E. ROSENTHAL, LAWYER AND CLIENT: WHO'S IN CHARGE? 168-70 (1974) (arguing for a "client-centered" approach in which a lawyer must attempt to allow a client to actively participate. On the difficulties professionals, particularly doctors, often encounter in determining how to represent the interests of their clients, see DAN W. BROCK & ALLEN E. BUCHANAN, DECIDING FOR OTHERS: THE ETHICS OF SURROGATE DECISIONMAKING 134-42 (1989). On the difficulties of determining when it is in the interest of a person to die, see DWORKIN, *supra* note 18. On the difficulties of determining the interests of various types of groups, see generally AFTER IDENTITY (Dan Danielson & Karen Engle eds., 1995). On thin views generally, see MICHAEL WALZER, THICK AND THIN (1994).

81. *See* Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990) [hereinafter Black, *Analysis*].

presents a meritless claim and then seeks to negotiate a settlement based on the expense to the firm of winning in court.

The fictional shareholder/hypothetical politics analysis also clarifies the business judgment rule, which often bars courts from examining whether directors have in fact fulfilled their duties to their supposed principals. Courts need concern themselves only with possible corruption, not problems of representation, shareholder self-governance or the primacy of the principal.

The key question remains, however: Do real owners of shares take the same one-sided view of corporate goals as does the fiction? If not, our replacement of real debate with the thin politics of corporate law must be as troubling as Hobbes' *Leviathan*.

III. THE IMAGES OF THE FICTIONAL SHAREHOLDER

In this Part, I will discuss some of the ways the fictional shareholder appears in the law and the cases and then describe some of its basic characteristics. The picture of the fictional shareholder, however, is confused by two complicating factors.

First, corporate law and corporate culture today reflect two different notions of the shareholder. In both, the shareholder has no interests other than the shares it owns. Under the traditional view, the shareholder owns nothing but the shares of the company in question. This I will call the "corporate law" fictional shareholder.

Recently, the corporate law view of the shareholder as a permanent investor in a single company has come under sharp challenge from an image of the shareholder as holder of a diversified portfolio; that is, as an investor holding shares of many companies. This second view I will call the "portfolio investor" shareholder.[82]

The corporate law and portfolio investor images of the shareholder share certain important characteristics. Each is a version of

82. A third view dominates in securities regulation, but is not important for the purposes of this Article: the shareholder as a passive consumer of securities. This shareholder has lost all characteristics of ownership; it simply purchases a product of the company (stocks or bonds). Unlike most consumers, however, the securities shareholder is deemed by the law to be largely helpless and in need of a degree of consumer protection not offered to consumers in any other part of our legal regime. The perceived helplessness of the securities law shareholder stems, in part, from the corporate law shareholder image of the undiversified widow entirely dependent for her life's income on the performance of this particular investment; recent reforms devoted to reducing securities law protection have been heavily influenced by the portfolio investor's greater ability to self-protect. Further elaboration, however, is beyond the scope of this Article.

economic man, driven only by profit maximization, with no connections to time, place or community—in effect a type of immortal, unencumbered monad. But because they differ in the shares they hold, they differ in how they profit-maximize, with dramatic differences in how a corporation run in their interest should be run.[83]

Second, the two images of the shareholder differ in the way they influence the corporation. The first one, the corporate law shareholder, is largely a metaphor—a powerful organizing theme that influences how human actors in the corporate world, particularly directors, managers and judges, go about doing their jobs. Like the Pope, the corporate law shareholder has no army divisions, but enormous power.[84] This shareholder is an abstraction from the full human beings who ultimately own shares; in the process of abstraction, it becomes radically different from any human.

Directors acting in the interests of the corporate law shareholder are under its control in a powerful, but limited, sense. The corporate law shareholder is an image of the law and corporate culture, not a human being. Directors who avoid its strictures may be censured by their consciences, and in extreme cases by the courts. But as a rule, there is no one who forces them (in the "how many divisions does he have" sense of force) to act as the corporate law and its shareholder wish.[85] Indeed, there is no one who wishes as the corporate law shareholder wishes. It is a construct, driving our behavior much as Locke's men in the state of nature influence the behavior of humans and the history of states without ever having been flesh and blood, living or breathing. Corporate managers and directors manage the corporation

83. The two leading views of the shareholder—what I call the corporate law view, and the portfolio investor or finance view—are widely accepted, almost background parts of the intellectual culture of corporate law. But there are few explicit discussions of the differences between them—perhaps because they are so often viewed as unproblematically the same. One important exception is Hu, *New Financial Products*, *supra* note 7, at 1277 (stating that the law requires that a corporation be run for the benefit of its shareholders, but has "three conflicting understandings of this principle: the classic entity-oriented model, the 'pure' shareholder wealth maximization model, and the 'blissful' shareholder wealth maximization model"). Hu's entity-oriented model uses an image of the corporate law shareholder; his other two models are different ways of responding to the needs of a portfolio shareholder.

84. William L. Lawrence, *Truman Charges Smears and Gossip Hinders Scientists*, N.Y. Times, Sept. 14, 1948, at 1, 24 (Truman quoting Stalin's uncomprehending remark).

85. The rights of the corporate law shareholder may be enforced by entrepreneurial lawyers via class action and derivative lawsuits. However, the effectiveness of this enforcement mechanism is limited, first by the wide range of protected discretion for managerial decision-making created by the business judgment rule, and second by perverse incentives regarding lawyer-managed litigation that encourage monetary settlements with little institutional change.

in the interests of the corporate law shareholder because they believe it is right to do so, not because they have a gun pointed to their heads.

The second image, in contrast, has Stalin's divisions—perhaps more divisions than ideological legitimacy. The portfolio shareholder is an accurate description of the way our large institutional shareholders act. But those shareholders are themselves corporate entities, driven to act not by the decisions of thoughtful human beings acting in their own interests and according to their own beliefs, but rather by the legal and moral compulsion to serve their own fictional corporate law shareholders.

Thus, the two fictional shareholders control the corporation in two quite different ways. Unfortunately, this makes the story rather complicated—I hope my readers will bear with me as I try to separate the interconnected strands.

A. The Corporate Law Shareholder

The corporate law fictional shareholder is a person with no interests other than its shareholdings in the particular corporation at issue, and no will other than the desire to maximize the value of that shareholding.[86] It is, then, no more than a personification of a share of the particular corporation.

This, I take it, is why shareholders are often described as widows and orphans. Widows and orphans, presumably, are stereotyped as purely passive investors who accept the deceased father's choice of stock and hold on to it indefinitely.[87] Widows and orphans in Iowa presumably have no connection to the company's factories in Flint, or its headquarters in New York, or its union members nationally, or its consumers abroad, or its charitable contributions in Pittsburgh. Like the fictional shareholders, these stereotyped widows and orphans are

86. The corporate law shareholder is generally referred to by the male pronoun as if it were a gendered human being, despite the well-known fact that a majority of shares are held (and the overwhelming majority of trades are made) by institutions. Following Carol Gilligan's descriptions of characteristically male and female moral reasoning, the shareholder is paradigmatically male: Only abstract logic, not relationships, governs its action. It is not embedded in any ongoing relationships, but rather is a pure market participant. *See* Carol Gilligan, In a Different Voice 24-29 (1982). On the other hand, in judicial opinions the fictional shareholder is often referred to as "widows and orphans"—presumably, again, to emphasize its one-sidedness and disconnectedness on the stereotypical view of widows and orphans as passive recipients of male (managerial) favors.

87. *See, e.g.*, Jay W. Lorsch with Elizabeth MacIver, Pawns or Potentates: The Reality of America's Corporate Boards 48 (1989).

entirely dependent on the performance of the stock and have no other relationships with the firm.

Perhaps because the corporate law shareholder is so similar in its interests and will to a reified share, lawyers and academics writing in corporate law tend to blur the distinction between shareholders and shares. For example, advocates of so-called *shareholder* democracy generally support what would better be called *share* democracy, with a voting rule of one share (not one shareholder)/one vote. This corporate governance rule suggests that shares, not shareholders, are the bearers of corporate rights or, as it were, the citizens of the corporate polity. In this Article, I use the traditional terminology, referring to shareholders rather than shares, because of the ideological importance of the terminology: It makes share rights seem like human rights, and share interests seem like human interests.[88]

The corporate law shareholder as share is deeply embedded in corporate law. An example from a well-known case in a sophisticated court should make clear how powerful the image is.

88. A share, of course, is simply a bundle of legal rights; it is hard to imagine it as having interests, beliefs and the like of its own. However, it is not unheard of to treat non-humans as if they were right-bearing moral beings with interests of their own. Thus, Peter Singer and many other utilitarians would extend morality to include animals. PETER SINGER, ANIMAL LIBERATION 8 (1975); JEREMY BENTHAM, PRINCIPALS OF MORALS AND LEGISLATION 30-31, 310 n.1 (1823); Christopher D. Stone, *Should Trees Have Standing?—Towards Legal Rights for Natural Objects*, 45 S. CAL. L. REV. 450 (1972) (extending rights to inanimate objects); Sierra Club v. Morton, 405 U.S. 727 (1972) (Douglas J., dissenting) (wilderness areas have rights too). The Supreme Court long ago held that certain organizations are entitled to the same consideration as people. Santa Clara County v. Southern Pac. R.R., 118 U.S. 394 (1886) (corporations are "persons" entitled to due process of law); First Nat'l Bank v. Bellotti, 435 U.S. 765 (1977) (corporation, as distinct from either its managers, stockholders or employees, has First Amendment speech rights). In addition, international law as well as many philosophers grants rights to peoples or nations that are different from and not summations of the rights of the individuals who compose them; thus, genocide is commonly considered worse than mass murder, even when the numbers go the other way. *See* U.N. CHARTER art. I, ¶ 2 (self-determination is a right of peoples, not people); WILL KYMLICKA, MULTICULTURAL CITIZENSHIP: A LIBERAL THEORY OF MINORITY RIGHTS (1995). A nonsentient but complex and long-lived organism, such as a redwood, or a system, such as an ecosystem, clearly has some claim to be treated as an end in itself. Indeed, the relative popularity of the Environmental Protection Act as opposed to the exclusionary or habeas corpus rules in criminal procedure suggests that many Americans would grant *more* rights to trees than to certain humans. I have offered a slightly fuller discussion of the problem of granting rights to non-humans in Greenwood, *supra* note 18, at 588-591, 596 n.178, 610-611; a full discussion of the application of such theories to shares must wait.

In *Revlon v. MacAndrews & Forbes Holdings, Inc.*,[89] the Delaware Supreme Court took the most extreme pro-shareholder position it has taken in recent years: It held that once a board has decided to put a company up for sale, its sole fiduciary obligation is to the shareholders and its sole duty is to maximize the price they will receive for their shares. The case is striking, in part, because it abandons the usual Delaware rule that directors have a duty to the corporation and its shareholders—this case, more than almost any other, accepts the position of the agency cost theorists that an obligation to the corporation can only mean an obligation to the shareholders.

But even more extraordinary is that the facts of the case make clear that the Revlon board in fact was acting in the interests of at least some owners of Revlon shares when it took the "anti-shareholder" action the Delaware court condemned. Revlon had been the target of a hostile takeover attempt. Its board ran through a number of devices in combating it. One of its maneuvers was a coercive exchange offer of up to ten million shares of its stock for newly issued notes. The exchange offer was structured so as to guarantee a large tender: thirty-three million shares (about eighty-seven percent of the total) were tendered and about one third of those were accepted pro rata. Thus, it appears that virtually all Revlon shareholders became noteholders as well.[90] Subsequent defensive measures led to a sharp drop in the value of the notes. Apparently fearing a lawsuit from disappointed noteholders, Revlon's board then structured a sale of the company that was designed to shore up the value of the notes, at some reduction in the consideration given to shares.[91] This the Delaware court said was forbidden: Once the company was to be sold, the "directors' role changed . . . to auctioneers charged with getting the best price for the stockholders at a sale of the company . . . . [C]oncern for the non-stockholder interests is inappropriate when an auction . . . is in progress."[92]

The key fact to note is that the history of the transactions makes clear that, by and large, the noteholders and the shareholders were the same people. The Delaware court does not require any investigation into the degree or consequences of this overlap: whether the stock or

89. 506 A.2d 173 (Del. 1985). *Cf.* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1286-87 (Del. 1989) (reaffirming that the goal in a sale of the company must be obtaining the best possible price for shareholders).

90. *Revlon*, 506 A.2d at 177.

91. *Id.* at 178.

92. *Id.* at 182.

notes had traded, or whether investors who held both notes and shares were injured—on average or at any extreme—on balance by the benefit given to the notes at the expense of the shares. It does no investigation into whether even in the aggregate the notes gained more or less than the shares lost.

In short, despite its language, which talks of the interest of the stock*holders*, the court is utterly uninterested in the implications for the financial well-being of the owners of the shares. It does not take note of the fact, recited in its own opinion, that the owners of the shares and the noteholders are, to a large and undetermined extent, the same people and that consequently a benefit to noteholders *is* a benefit to the holders of shares (if not necessarily a net benefit). Similarly, it does not consider the possibility that the shareholders also might be employees with a far greater interest in assuring that Revlon chose a course with institutional continuity (even if in the name of a new legal entity), less likelihood of downsizing or a greater ability to resist demands to dedicate a large part of revenues to financial interests rather than employees. Rather, its focus is purely on the price of the shares themselves: "Stockholders," as the court uses the term, refers not to the people who own the shares, but to an imaginary creature with no interest but the shares themselves, no plans or desires but maximizing the value of those shares.

The *Revlon* case is unusual in the explicitness with which it rejects any consideration of the interests of the real, as opposed to the fictional, shareholders, but it is not unusual in its narrow focus. In a world that has long since adopted the principle of diversification, it will often be the case that bondholders and shareholders are the same people.[93] Similarly, it will commonly be the case that shareholders are also neighbors, employees or customers—yet no case that I am aware of ever suggests that shareholder interests might include those other interests simply because the people are the same.

93. *See, e.g.*, Aladdin Hotel v. Bloom, 200 F.2d 627 (8th Cir. 1953). Like *Revlon*, this case involves facts that make clear that shareholders were also bondholders. Also as in *Revlon*, the fiction of the unified shareholder blinds the court to the real economic relations at issue. In *Aladdin*, the Jones family were both the controlling shareholders and the holders of most of an outstanding bond issue. The company issued a large dividend, allegedly benefiting the shareholders at the expense of the bondholders. Suit was brought by minority bondholders (who were not shareholders). Missing the obvious possibility that the Jones family stood to gain more from increases in the value of their shares than they would lose from decreases in the value of their bonds, the court treated shareholders and bondholders as separate beings with no connection between them: "[I]t is inconceivable that the Joneses should deliberately act to the prejudice of the bondholders when they held and owned some 72% of the entire bond issue." *Id.* at 630.

The cases and articles assume that it is unproblematically beneficial for "shareholders" if corporate profits or the share price goes up, even though it is easy enough to imagine situations where that is not true. If the real owners of the shares, rather than the fiction, were at issue, corporate directors—and courts adjudicating breach of duty cases—could not assess competitive activities without first examining 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. This is never done; rather, inquiry is invariably restricted to the fictional shareholder.

Think, for example, of a diversified investor that owns shares of several of the large airline companies. Aggressive competition by one company ("Aggressive Air Inc.") might well increase that company's market share and its profit while leading to great injury to other companies in the industry. Clearly, this is beneficial for the fictional unified shareholder of Aggressive Air: Providing that the market concludes that Aggressive Air's long-term profit potential is improved by its behavior, Aggressive's stock price should increase and its shareholders—thought of in the corporate law fictional way—will be better off. But for an investor holding shares of both Aggressive Air and its corporate victims, the issue should be one of aggregate welfare: Did the competition help or hurt industry-wide (or at least portfolio-wide) profit potential? If Aggressive is doing well entirely at the expense of its competitors, this more diversified investor would not benefit from its activities.

Similarly, the famous case of *Dodge v. Ford*[94] established that it is a potential breach of duty to shareholders, for example, to pay employees more than the minimum the market demands, or to employ more of them than it might, or to charge consumers less than what the market might bear, or even to reinvest proceeds in expanding the existing operation rather than pay out a high dividend. In each of these instances there is an arguable injury to the fictional shareholders.[95]

94. 170 N.W. 668 (Mich. 1919) (ordering Henry Ford to cause Ford Motor Co. to pay out a large dividend rather than reinvest in the business).

95. I leave aside the inevitable debates about whether shareholders might actually be benefited in the long run by loyal workers, adequate staffing, happy customers or a well-financed research operation. *See, e.g.*, Samuel Bowles & Herbert Gintis, *The Revenge of Homo Economicus: Contested Exchange and the Revival of Political Economy*, J. ECON. PERSPECTIVES, Winter 1993, at 83 (arguing that firms acquire power over, and loyalty of, employees and customers by overpaying and undercharging them, respectively); A.P. Smith Mfg. v. Barlow, 98 A.2d 581 (N.J. 1953) (upholding firm's charitable contributions on the implausible ground that the

But while many cases and authors have sought to loosen the *Dodge v. Ford* rule or to allow corporations to show some degree of social responsibility,[96] I know of no instance where a court has considered the possibility that it might be a breach of duty to shareholders to underpay employees, overcharge customers or pay out profits as dividends instead of reinvesting them. Nor is there any law suggesting that a company decision to abandon a traditional site of a manufacturing plant or headquarters might be against the interests of shareholders: Proponents of restrictions on such changes always invoke other interests.

In each of these cases, the interest of the fictional shareholder is clear and explains the law. But the interests of actual people behind the shares are far from clear. Most indirect holders of AT&T stock, for example, no doubt have a bigger financial stake in the company in their role as customer than in their role as shareholder. Similarly, many owners of the stock of the old Reynolds Tobacco were far more invested in the town and the surrounding tobacco-based economy than in the shares they owned.[97] Quite commonly, employees of a firm own stock in it as well, yet find their identity as employees far more important than their identity as shareholders.

These real people who own shares might be very interested in the corporation taking actions that would injure the value of their shares,

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gifts in question would benefit the firm and its shareholders in the long run). For current purposes, it is enough to assume that in at least some instances there will be no long-term benefit to this firm's fictional shareholders, even if there is a great benefit to society as a whole.

96. *See, e.g.*, E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); REV. MODEL BUSINESS CORP. ACT § 3.02(13) (1984) (authorizing charitable contributions). Proponents of corporate social responsibility usually have not, however, based their argument on a claim that shareholders are the society as a whole or on an interpretation of shareholder interests to include larger social interests. Rather, they have called for corporations to look beyond shareholder interests to other social purposes. Indeed, in the great Dodd/Berle debate, it was not Dodd but Berle—arguing against permitting corporations to look beyond the fictional shareholder—who pointed out that almost half of Americans directly or indirectly owned shares. To Berle, this was an argument for requiring corporations to consider only the fictional interest, in order to safeguard all those individuals' savings.

97. *See* John Helyar, *In Winston-Salem Workers' Good Will Goes Up in Smoke*, WALL ST. J., Nov. 30, 1988, at A3 (almost 10% of Reynolds shares were held by residents of Winston-Salem); John Helyar, *RJR Nabisco's Possible Move to Atlanta Prompts Worry in North Carolina City*, WALL ST. J., Jan. 14, 1987, at A12 (describing the impact on Winston-Salem of a planned move of Reynolds' headquarters); Eben Shapiro, *Big Spender Finds a New Place to Spend*, WALL ST. J., Oct. 6, 1994, at B1 ("The real irony is that Ross [Johnson, the Reynolds CEO who presided over the sale of Reynolds] did a great financial service to these people [Winston-Salem residents whose Reynolds stock appreciated greatly when Reynolds went private] and to this day people continue to think of him as a demon."). Those who viewed Johnson as a "demon" clearly had interests that outweighed their interests as shareholders.

if there were a compensating benefit in another relationship to the company. *Dodge v. Ford* would look quite different if the court had considered the case from the perspective of a shareholder who held three shares of Ford stock but was looking for employment in one of its expanding divisions and planning to buy a Model T each year for the foreseeable future.

The fictionality of the shareholder also explains other puzzling aspects of corporate law, including the odd concept of long-term shareholder value in takeovers—where by the time any important takeover is consummated, the real owners of the shares are virtually all either professional short-term investors (arbitragers), insiders or hopeful insiders with other more salient identities than "shareholder," or simply dead. The only player that looks even remotely like the imaginary long-term shareholder is, paradoxically, entrenched management. Undiversified and well fortified with share options and golden parachutes, top managers increasingly have an economic interest closely paralleling that of the fictional shareholder.[98] (It follows that the view of corporate law as centrally about the conflict between shareholders and management may be near obsolescence—management has become something approaching a fictional shareholder, and the next story will be about something else.)

The fictional shareholder also explains a key difference between securities class actions and, for example, a normal class action over a tort. In other areas of the law, after a class has been certified and class-wide claims have been adjudicated, each member of the class must establish that he or she was in fact injured. Thus, a member of a class of asbestos exposure victims who died in an automobile accident long before the appearance of any asbestosis symptoms would be denied recovery. In sharp contrast, in securities actions, the individual claimant need only establish that he, she or it owned, purchased or sold the security at the relevant time. No court, to my knowledge, has ever suggested that a class member's damages relating to one security might be diminished by a showing that another security held by the

98. Traditionally, academics concerned with the law of takeovers have seen managers as the key opponents to the fictional shareholder. Particularly in the "end game" of a takeover, managers may be tempted to abandon their duty and seek, instead, to preserve their jobs. *See, e.g.*, Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981). But to a large extent this emphasis is an illusion created by the case method: Only those instances where management aggressively resists takeover result in reported cases. The cases do not pick up the increasingly common circumstances where management decides to maximize its wealth as an undiversified stockholder instead.

same class member (or some other relationship with the firm) increased in value. Yet in many competitive situations it should be the case that an injury to one company (and its securities) will be a benefit to its competitors (and their securities), so that a diversified investor would have little or no net injury from the original violation.[99]

We have seen, then, that if the focus of interest were the actual people who own the shares, rather than the fictional unified shareholder with no other interests, 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.[100]

B. The Portfolio Investor

The first fictional shareholder is a very odd beast. It is a profit maximizer, in the manner of economic man, with no obligations or responsibilities to constrain its attempts to maximize the value of its stockholdings. On the other hand, it defies the first rule of rational investing as understood by modern financial theory: It is undiversified and a permanent investor in the company.[101]

99. Commentators using a model of an undiversified shareholder do commonly discuss potential conflicts between shareholder interests and the goal of maximization of corporate value. *See* Kraakman et al., *supra* note 79, at 1743 (arguing that individual shareholders may have incentives to bring lawsuits that are not value-maximizing for the corporation's shareholders as a group under a variety of litigation regimes; apparently assuming that corporate shareholders are undiversified).

100. Some directors apparently are quite aware of the fictional nature of the shareholder they seek to defend. *See, e.g.*, Lorsch & MacIver, *supra* note 87, at 47, at 1743 (quoting a director as saying " 'more and more people are coming to the realization that the shareholders are really a bunch of 26-year-olds sitting behind their trading desks, and that the people who have the best interest of the company and its employees at heart are really those in management.' "). This director is taking a sociological entity view of the corporation—as a creation with value of its own—and noting the conflict with a corporate finance view of the shareholder.

101. For example, consider the director, quoted in *id.* at 44, who in explaining why a board should look towards the long term, says short-term profit maximization can lead to " 'your competition [gobbling] you up, and you won't have a company.' " Clearly, the director is assuming that the shareholders are not diversified; otherwise, there is no clear injury when one competitor gains at the expense of another.

Also, see *id.* at 46: " 'If the stock is underpriced . . . I'd like that value to go to the shareholder and not to the guy who buys it at some point between the current price and the full price.' " For this director, as Lorsch and MacIver point out, some who own shares—the "guy"—are not real shareholders. Other directors quoted explicitly differentiate between arbitragers and shareholders. *See, e.g.*, *id.* at 48 (" 'the only winners are the arbitragers—not the stockholders' ").

Since the financial market is dominated by investors that *are* diversified, this oddity has resulted in the second major image of the fictional shareholder: not a share but a portfolio.

Roughly half the shares of publicly traded American corporations are held by institutions. Far more than half the stock market activity is institutional trading. Institutional shareholders, therefore, have become an enormously important part of the financial markets and the corporate structure. An entire academic enterprise has grown up to describe (and prescribe) the behavior of the institutional investors, and both law and ordinary discourse have sometimes adjusted to reflect the dramatic differences between the institutional investors and the traditional corporate law fictional shareholder.

Institutional investors come in several varieties. Some, such as bank trust funds or some insurance companies, are straightforward business corporations, or corporation-like entities such as mutual funds, mutual insurance companies or mutual savings banks. Others are ERISA-regulated pension funds, often attached either to business corporations or unions, and sometimes managed by one of the other listed entities. Still others are endowment funds for not-for-profit organizations. These differences make generalization risky, but I believe that certain broad characteristics are shared by virtually all the institutional investors and are key to understanding the image of the portfolio investor in the law.

1. *The Fictional Shareholders of the Institutional Investors*

The key point about institutional investors is that they invest on behalf of the interests of their own fictional corporate law shareholders; that is, they act as if they were agents for an undiversified investor with no interests beyond the portfolio held by the institution, without offering any mechanism by which their own investors could indicate any contrary interests or desires.

Institutions that hold shares vote those shares as an institution; they do not pass the vote through to their own shareholders.[102] In managing their shareholdings, the institutional investors act as if they were controlled by corporate law fictional shareholders. That is, they attempt to maximize the return to an imaginary being who is solely

102. Bird v. Wilmington Soc'y for the Arts, 43 A.2d 476 (Del. 1945) (stating that the corporation, not its shareholders, owns the stock that the corporation holds); DEL. CODE ANN. tit. 8, §§ 123, 141 (1991).

invested in the institution in question. Why they do so varies from organizational type to organizational type.

a. *Mutual funds and insurance companies:* Mutual funds, for example, are even less controlled by shareholder voice than are standard Berle and Means corporations: Shareholder votes are meaningless as a control mechanism. On the other hand, market pressures force mutual funds to act as if they were completely controlled by the fictional shareholder. Mutual funds are subject to constant rating and comparison. Any fund that increases the value of its shares—that is, acts in the interests of its fictional shareholders—is effectively rewarded by a rapid and vast flow of money, as its shares are purchased by investors seeking high returns. Conversely, funds that do not perform well shrink, though less rapidly. For these entities, far more than for large publicly held corporations, the corporate law shareholder is a real and powerful presence.

Note, however, that the shareholder remains fictional. Investors have and continue to have many values and conflicting goals, even as they move their money around in search of the highest possible return. Those other goals and values, however, drop out of the message as it is transmitted to the mutual fund. From the perspective of the mutual fund, its shareholders are not full, conflicted and situated human beings but rather merely capital flows, attracted to the latest quarterly results as bugs are phototropically attacted to a light. Whatever complexity the owners of the fund's shares may have as human beings, as shareholders they are simple, one-sided and monolithic.

Other portfolio investors in competitive industries face more or less the same market pressures. Insurance companies must maximize their investment returns to offer competitive insurance rates. Those that do survive; the others fail. Even mutually owned insurance companies, without clear shareholders and with virtually complete management autonomy (in the Berle and Means sense) will be compelled, if the market is competitive enough, to act as if they were maximizing returns for a fictional shareholder.

b. *Pension funds:* Pension funds generally are local monopolists and need not, at least in the short run, concern themselves with the pressures of competitive markets. Usually, the beneficiaries are more or less captive, since they can change pension funds only by changing jobs, and it is rare that pension decisions drive job decisions. Thus, the fund and its managers need not worry about flight of customers in the way that insurance companies and mutual funds do. However, ERISA compels pension funds, as a matter of law, to act for the sole benefit of a person much like the fictional shareholder: A plan fiduciary must act "solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to [them] and defraying [administrative expenses]."[103] Thus, ERISA plans are required by law to reduce the plan participants to a fictional creature who is interested only in benefits from the plan, regardless of any other considerations. Since fiduciaries are required to act in the interest of this variant on the fictional shareholder, there is little left for them to do but assess how to maximize those benefits.

Specifically, ERISA plans have been barred from voting their shares in ways that arguably might benefit the individuals who are the plan's ultimate beneficiaries, but would be bad for fictional undiversified investors in the plan. For example, investing plan assets to rescue an employer is generally barred. This rule makes sense from a fictional perspective: Such an investment almost certainly would not be in the interest of an imaginary person whose sole connection to the company is a desire to maximize returns from the pension, since it reduces diversification in a particularly unsound way, tying pensioners' fortunes even closer to the employer's.[104] In contrast, from the perspective of the employees who make up the bulk of the fund holders, this result is by no means clear. Thus, employees might find it in their interest to increase the odds of preserving or improving their current salaries by, for example, using shareholder voting rights to

103. 29 U.S.C. § 1104(a)(1)(A) (1994).

104. Standard investment theory teaches that investors should not put all their eggs into one basket, and ERISA enacts this principle into law. 29 U.S.C. § 1104(a)(1)(C) (1994). A fiduciary considering how to invest a pension fund, therefore, should reject any investment that requires a substantial part of the entire fund. Separately, standard investment policies often counsel against investments that are large in relation to the size of the firm in which they are invested: Such large investments are illiquid and can be difficult to reclaim when the fund needs cash or if the investment climate changes. This standard advice may be less applicable if the fund's future cash needs are quite predictable, as is often the case, or if the fund has special expertise or knowledge regarding the potential of the particular investment. Investing in the firm that is the fund's sponsor and the employer of the fund's beneficiaries is especially dangerous to fictional shareholders, for several reasons. Not only does it violate the two basic principles of diversification, but in addition it exposes the fund to the unnecessary risk of an investment that is likely to be doing poorly (due to business setbacks) just as the fund needs unexpected liquidity (to pay benefits resulting from layoffs or closings that, in turn, result from the business setback). For an argument that institutional investors ought to be permitted greater flexibility in taking large, illiquid positions, see ROE, *supra* note 13.

cause the employer's business to be run more in the interests of employees and less in the interests of fictional shareholders. Even if this benefit came at substantial expense to their future pensions, they might well conclude that obtaining it is worth giving up a good deal of value in a pension many years down the road.[105]

In contrast to the problem of how best to maximize the welfare of a fictionalized fund beneficiary with only one interest, the tradeoff for full people who are both employees and pension beneficiaries (and perhaps also long-term residents of a local economy with few alternative employment opportunities) cannot be resolved a priori. Instead, the proper resolution depends on the risk and consumption preferences, alternative job opportunities, age and family circumstances, fears and hopes, political and religious attitudes of each individual employee/pension fund holder/citizen. Pensioners who have already retired and moved to Florida or Arizona and have no remaining connection with the employer's activities, for example, will have dramatically different views regarding proper fund investment from a young highly mobile employee or from a long-time resident of the company-dominated town with extensive diversified savings. In contrast to the Hobbesian expert calculation by a disinterested fiduciary contemplated in the fictional model, this type of conflict between different and important goals can only be resolved by genuine political debate and struggle.

ERISA, by mandating that the pension fiduciaries consider only the interests of the fictional beneficiaries, cuts off this potential political debate.[106] In effect, it requires the trustees to assume that all the

105. Indeed, it appears that the highly publicized pension fund failures that precipitated ERISA may have resulted from such a rational calculation. Employee unions seeking to create jobs for returning soldiers after World War II concluded that they had to provide pensions to allow older workers to retire. When it became clear that they did not have the power to force employers to fund such plans, the unions reached a compromise with employers allowing for actuarially unsound pension plans funded on a pay-as-you-go basis. The new pension funds created immediate benefits for current retirees, who had not paid into them, thus opening up job slots for returning soldiers. The new employees, in turn, made contributions into pension funds effectively to fund current retirees, rather than building up their own retirements. From the perspective of the representatives of the younger employees, the decision seems to have been that a job and income now were worth the possibility of pension fund failure later. *See* James Wooten, "The Infamous Studebaker Case": The Studebaker-Packard Corporation, the United Auto Workers, and the Origins of ERISA (1996) (unpublished manuscript, on file with author). ERISA's model of the fictional fund beneficiary now prohibits any similar compromise, since the interest of younger fund participants in obtaining or retaining jobs would not be entitled to any weight.

106. ERISA does not contemplate the possibility of multiple roles or conflicting goals and the courts have taken ERISA's abolition of multifacetedness quite seriously. *See, e.g.*, Donovan

present and future pension beneficiaries have no connections or commitments to the investments made by the fund.

c. *Not-for-profit endowments:* Private endowment funds are the most difficult of the institutional investors to understand as driven by a fictional investor. Most of the time, no doubt, a university endowment fund will act as if the university were a fictional shareholder with only one interest, namely maximizing the risk-adjusted present value

v. Bierwirth, 538 F. Supp. 463 (E.D.N.Y. 1981), *aff'd as modified*, 680 F.2d 263 (2d Cir. 1982). This case stemmed from an attempt by Grumman Corporation directors to use pension funds to purchase the maximum legally permitted amount of Grumman stock as a defensive maneuver to fend off a hostile takeover attempt by LTV in the form of an unsolicited tender offer to Grumman shareholders. Notwithstanding the fact that 17,000 of the 22,000 employees covered by the plan signed a petition stating that they supported the trustees' actions, 680 F.2d at 265, the court concluded that the trustees' actions were improper, because the trustees were required to act in the sole interest of the participants and the beneficiaries. *Id.* at 265. As the ERISA statute appears to require, the court sees that interest as entirely separate from the expressed views of the actual human beings behind the beneficiaries. The interest that the trustee may consider is only the fictional one of the fictional beneficiary who has no interests other than maximizing pension benefits; it has no necessary connection either with the "true" interests of the people who will receive those benefits or with their views as to those interests. The simple imaginary interest of Hobbesian fictions has prevailed over the more complex actual politics of the real human beings.

See also Withers v. Teachers' Retirement Sys., 447 F. Supp. 1248, 1256-67 (S.D.N.Y. 1978) (A trustee of a teachers' retirement fund, over 3/4 of the beneficiaries of which were actively employed as teachers, testified that he believed that "the possibility of teacher layoffs [resulting from fund investment decisions] was simply not a relevant consideration for them in their capacity as trustees."); Department of Labor Opinion 81-12A, Jan. 15, 1981, at *4, *available in* LEXIS, Employment Library, ERISA File (plan making mortgage loans to participants may not consider the "incidental advantages which might accrue to borrowers [who are the same people as the participants] from the availability of plan financing"). In Blankenship v. Boyle, 329 F. Supp. 1089 (D.D.C. 1971), a pre-ERISA decision holding it impermissible for a union-run welfare trust fund to support union activities, the court held that the fund must be run entirely for the benefit of the beneficiaries without collateral advantages to the union. "The beneficiaries were in *no* way assisted by these cash accumulations while the Union and the Bank profited." *Blankenship*, 329 F. Supp. at 1096 (emphasis added). In *Blankenship*, since virtually all the beneficiaries were members of the union, the bank was owned by the union and often "use[d] . . . for union objectives," *id.* at 1102, and the 26-page opinion makes no mention of any evidence suggesting that the union was not working on behalf of its members, this statement and the accompanying ruling barring the fund from depositing any funds in the bank must be based on a conception of a fictional beneficiary separate from the underlying union members.

These cases do not conclude that preserving pensions is more important than alternative values (as may well be the case). Rather, they simply reject the need to think about any possible conflict. *See also* Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1290-91 n.113 (1992) [hereinafter Mitchell, *Critical Look*]. Similarly, 29 U.S.C. § 1103(c)(1) (1994) commands that "the assets of a plan shall never inure to the benefit of any employer." Now, surely, even the most die-hard unionist would acknowledge that *sometimes* there is overlap between the interests of employer and employee such that a "benefit to the employer" might also be a benefit to the human beings behind the fund's fictional beneficiaries. The fictional structure, however, eliminates any need to consider this possibility.

of the future returns on its endowment. But great universities do not hesitate to assert other interests as well: Yale, for example, used endowment funds for urban renewal projects in its immediate vicinity that probably could not have been justified on grounds of purely economic returns to a fictional shareholder/beneficiary of the endowment. Perhaps its more controversial use of endowment principal to cover current operating expenses for a period of time in the last decade can also be understood as the university acting as a real owner rather than a fictional shareholder of the endowment fund. Nonetheless, it seems safe to assume that these interventions remain exceptional. Most of the time, endowment funds are managed by professional managers in precisely the same way that other institutional portfolios are managed: that is, in the interest of a fictional shareholder with no interests or goals other than the performance of this investment.[107]

2. *Serving the Fictional Shareholder, Portfolio Style*

Paradoxically, the institutional investors serve their own fictional shareholders by acting in a way significantly different from the way that the corporate law shareholder is presumed to act. While the corporate law shareholder is assumed to be a permanent investor who is completely dependent on the fate of this particular investment, the institutional investors diversify. In order to reduce the risk of any particular investment failing to perform as hoped, they spread their investments among many varying companies and many varying types of investment: not merely stocks, but also bonds, other forms of debt instruments, real estate and various derivative instruments.

The institutional investor, thus, is a portfolio investor. It is concerned not with maximizing the value of a particular security, as the fictional shareholder is, but rather with maximizing the value of an entire portfolio. In other respects, it is much like the fictional shareholder. Because of its obligation—whether legal, market or moral—to act in the interests of its own fictional shareholders, the portfolio investor is as one-sided as the other fiction. It, too, will neither balance economics against other values nor consider economic values

107. *See, e.g.*, Chester Hartman et al., *Letter to the Editor*, HARV. MAG., July-Aug. 1995, at 108 (letter describing the failure of the Harvard Corporation to authorize disinvestment from South Africa at any time during the apartheid regime's existence). Harvard set aside any position on apartheid it might have taken as a university, instead treating its investments as if it had no interests other than those of a fictional shareholder.

that do not appear in its portfolio. And, again like the corporate law shareholder, one portfolio shareholder is much like another.

In some ways, the portfolio investor is even more inhuman than the corporate law fiction. Portfolio investors have a very different attitude towards risk, time, change and place than do most human beings. If the fictional shareholder was a stripped-down human, deprived of many of the characteristics that make us who we are, the portfolio investor is a souped-up version, more like a god than a human. In significant ways, its interests are premised on its very much not-human character as an infinite and immortal being, living at the average, indifferent to local variation or individuality. Each of these claims requires some argument, and I will address them sequentially in the following sections.

3. *Unsystematic Risk Indifference*

Corporate finance has centered on the portfolio investor's approach to reduction of risk. As the now familiar argument goes, imagine that a corporation has a possible investment with a small chance of an extremely high return and a large chance of no significant return at all—for example, drilling an oil well, developing a new drug or investing in a biotechnology startup. In each case, the attempt will probably fail, but if it succeeds, the payoff will be huge.

To make the example more determinate, assume the investment has a 20% chance of yielding a return of $1,000, and an 80% chance of yielding a return of $2. To simplify further, assume the payoff is immediate (so as to eliminate any problem of the time value of money). A risk-neutral investor would value this investment by simply taking the probability-weighted average of the possible results: 20% x 1,000 + 80% x 2 = $201.60. That is, if the investment costs less than $201.60, it is worthwhile.

However, for most investors, the average is not a very accurate measure of the value of the investment taken in isolation. The result will be either $2 or $1,000, not $201.60, and the difference can be critical if, for example, one has an obligation to pay $100 in the near future. When I discuss the difficulties of relying on averages with my corporate finance classes, I often ask the students to consider packing for a trip to Utah's national parks. Spring temperatures in the desert could reach 100 degrees at midday, and then drop to freezing at night. The weighted average temperature might be a balmy 72 degrees—but dressing for that average would be a mistake. Human beings normally need to take into account the dispersion as well as the average.

More technically, few investors are risk-neutral; most investors would refuse to make this investment unless the weighted average payoff were substantially higher than the cost of the investment. Many gamblers, on the other hand, would be willing to pay far more than the expected value, particularly when the probability of payoff is extremely low and the size of the payoff extremely high: That is the psychological fact that makes lotteries, casinos and retail trade in the commodities future markets possible.[108] Thus, the value of this investment to any given investor will depend on the investor's particular attitude toward risk, need for predictable cash flows and the like.

When the investor is diversified, however, a miraculous change takes place: The value of the investment becomes fixed, altogether independent of risk attitudes, and the same for every investor. Imagine an investor who is able simultaneously to invest in 10,000 instances of the above investment, perhaps as a 1/10,000th investor in each. For each oil well, or drug development, the odds remain the same: a high probability of a low payoff ($2), a low probability of a high payoff ($1,000) and no probability whatsoever of the average payoff ($201.60). But if the different instances are independent of each other, that is, if the success or failure of one has no influence on the others,[109] the investor faces very different odds. It is overwhelmingly likely that this diversified investor will, in fact, receive the weighted average return or something quite similar to it. The diversified investor *can* go to Bryce Canyon dressed ouly for 72 degrees.

Diversification, then, under the right circumstances, allows the investor to live at the average without regard to dispersion. In the corporate context, the consequence is that (taxes, information, agency and other transaction costs held equal) the diversified investor will be

108. An extensive literature exists on the odd ways in which human beings evaluate risks. Most investigators conclude that people systematically overestimate the probability of extremely unlikely events, especially when the event is dramatic and easily brought to mind. On the other hand, we seem to consistently underestimate the probability of relatively common negative outcomes—such as auto accidents. For a survey of the psychological literature regarding subjective risk, see, for example, Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974); *cf.* ADAM SMITH, THE WEALTH OF NATIONS 96 (Everyman ed. 1910) (1776) (lotteries exist because people overestimate the likelihood of success and underestimate the likelihood of failure). Modern research suggests a somewhat more refined vision than Smith's, explored delightfully in the Kahneman and Tversky article.

109. That is, the statistics will not work if the oil wells are all drilled into the same oil field: In that case, either all the wells will flow or none will.

indifferent between (a) an investment in a single large oil company that drills many oil wells in many different places, or (b) multiple small investments in many separate small corporations, each of which drills a single oil well. While the large company is likely to be a fairly safe, stable, 72-degree investment, and the small companies are likely to be highly risky freeze or boil investments, the aggregate is the same: In each case the diversified investor lives at the average, receiving the 72-degree weighted average payoff rather than the extremes.

This means that corporate expenditures to achieve diversification or protection from unsystematic risks at the corporate level add no value for the diversified shareholder. Corporate level diversification may well be good for the corporation, considered as an entity—the large diversified oil well drilling company is likely to survive for many years, while most of the small undiversified wildcatters will be out of business when their first drilling attempt fails. Some of the corporation's employees may also prefer it: Risk-averse employees may prefer to work for a stable employer who will move them (administratively) from one well to another, rather than to rely on a market to move them from one corporation to another.

But unless the diversified corporation has a cost advantage over the aggregate of the small ones—that is, unless administrative allocation of resources is cheaper than market allocation—diversified portfolio shareholders will be indifferent to corporate-level risk reduction. And if it costs money for the corporation to reduce its risk—if, for example, a market is able to move resources from one project to the next more cheaply than administrative action—the portfolio shareholder's interest is better served by leaving (corporate-level) risk high.

Current political ideology often assumes that the market will have a cost advantage over administration. However, this is a difficult empirical issue which must be determined in each instance by examination of the facts, not a priori reasoning. For example, if oil well drilling (or whatever) is most efficiently done by a team of workers who have extensive experience working with each other, the diversified corporation may have a dramatic cost advantage over the market of undiversified ones. On the other hand, if administration adds extensive overhead, the market may have the cost advantage.

In many areas of production, neither the market nor administration appears to have a decisive social cost advantage. History, or contingent factors of organization, or ability to externalize costs of doing business onto other sectors of society, makes the difference. For example, in many sectors of the economy, when a corporation goes bankrupt, its employees are likely to lose their pensions or medical insurance (which, for those with pre-existing conditions, may be irreplaceable). Thus, in these sectors, diversified employers can offer a substantially more attractive package to employees, which may lead to a more motivated workforce and a significant cost advantage over less diversified employers. Alternatively, firms that learn how to use unmotivated workforces (or to motivate with sticks instead of carrots) and firms in industries with a highly mobile and very young workforce, such as the early days of Silicon Valley computer programming, will have a substantial cost advantage due to their externalization of significant costs of doing business: Unlike the diversified firm, they do not have to absorb much of the cost of pensions or adequate medical insurance.[110] In yet another variation, industries, such as trucking, with transferable benefits packages, often offered through centralized unions, may leave small firms able to offer big firm employment packages without adding administrative costs.

Similarly, small undiversified companies may be more profitable for portfolio shareholders in industries where this allows externalization of tort or pollution control costs,[111] while large diversified ones may be more profitable where externalization is by lobbying rather than threats of bankruptcy or avoidance of regulation.

In some industries, both market and administrative diversification coexist for extended periods of time. Thus, Lloyds of London, an insurance market with diversification at the investor level, competes successfully with conventional insurance companies that diversify at the corporate level, without either organizational form dominating the other.[112]

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110. Note that these costs do not go away; they are simply paid by someone not included in the portfolio shareholder's portfolio.

111. *See, e.g.*, Walkovsky v. Carlton, 287 N.Y.S.2d 546 (App. Div. 1968) (taxi company avoided costs of insurance and accidents by organizing as a small, judgment-proof, business). The same smallness that makes such companies able to avoid paying the true costs of their business also makes it difficult for them to attract investment capital. Some of the spectacular profitability of venture capital firms may be due to their ability to invest in a portfolio of highly risky "wildcat" operations without becoming a single diversified company that might be forced to internalize costs of reallocation, torts, pollution and the like.

112. The classic work on these issues is WILLIAMSON, *supra* note 6. Henry Hansmann, in a series of extremely useful and interesting articles, has applied similar analyses to various sectors of the economy and organizational forms. *See* Henry B. Hansmann, *Condominium and Cooperative Housing: Transactional Efficiency, Tax Subsidies, and Tenure Choice*, 20 J. LEGAL STUD. 25 (1991); Henry B. Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORGANIZATION 267 (1988);

For our purposes, however, the key point is that portfolio shareholders care about internalized cost, not social costs or unsystematic risk. Because they can live at the average, they—regardless of their personal or institutional risk preferences—will be benefited by corporate attempts to reduce fluctuating income only to the extent that the corporation can diversify more cheaply than its shareholders can. Even the proverbial risk-averse widow and orphan are better off investing in multiple risky single oil drillers rather than a safe diversified oil driller, if the former have an internalized cost advantage and externalized costs (and noneconomic values) are ignored.

For an undiversified fictional shareholder, of course, the reverse would often be true: The greater predictability of the large company would be worth a great deal, and might well more than offset any cost advantage associated with riskier organizational forms. For the undiversified shareholder, the $2 and $1,000 figures are the salient ones, not the $201.60.[113]

Critically, the portfolio shareholder's interest is different not only from the corporate law shareholder's fictional interest but also from the social interest and the interests of the human beings who stand behind the portfolio shareholder's fictional shareholders. Often the cost advantage of one form of organization may be a simple result of externalization of costs to outsiders—including the people behind the portfolio investor.

This might be the case, for instance, if a market imposes much of the cost of moving resources from an unsuccessful oil well to the next attempt on workers (by leaving them unemployed between jobs and

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Hansmann, *supra* note 21; Henry B. Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749 (1990); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

113. Professor Coffee has used this difference between diversified and undiversified investors to propose that managers, considered as undiversified investors in their jobs, will be systematically more risk-averse than the shareholders of their employer. *See* Coffee, *Shareholders*, *supra* note 6. at 16-24.

Modern CEO compensation practices, by reducing the proportion of a CEO's wealth represented by his future salary through enormous current salaries, generous stock option plans and golden parachutes, may serve to reduce the conflict seen by Professor Coffee by making CEOs more likely to perceive their interests as more similar to those of diversified investors than those of undiversified salarymen. Simultaneously with this important carrot, the increased liquidity of the market for corporate control seen in the 1980s and now apparently again reappearing may serve as a stick holding CEOs to the interests of the corporate finance diversified shareholder. *See* Randall Smith & Gary Steinmetz, *Merger Stars of the 80s Are Hot Again*, WALL ST. J., Aug. 4, 1994, at C1.

making them pay the costs of searching for a new team) or on taxpayers (who finance the bankruptcy courts used for reallocation of resources, and pay for the unemployment or welfare benefits used to cover the costs of reallocating workers but do not pick up the salaries of headquarters officials who perform these functions in the diversified firm). The portfolio shareholder will not include these social costs in calculating the relative return of market and administrative organization: Those costs will not be reflected in the returns of the portfolio of wildcatters. This gives an unfortunate boost to the wildcatters relative to the diversified company, which must internalize much of the costs the wildcatters avoid. Unless the administrative mechanism has such a large cost advantage that it exceeds even the invisible costs of the market mechanism, the portfolio shareholder seeking to further the interests of its fictional shareholders will be forced to choose the wildcatters.

The people behind the fictional shareholders, however, are roughly representative of the general public. They, thus, bear the externalized costs ignored by the market calculation and the portfolio shareholder. In addition, some of those citizens are likely to have views about the morality or political expediency of the more stable administrative structure or the more dynamic market one, and those views may or may not correlate with their economic interests.[114] Both these economic calculations and the political ones drop out of the considerations of portfolio investors and the firms they invest in: The structure of the fictional shareholder's relationship to the portfolio investor guarantees that the portfolio will consistently support the market's externalization of costs onto workers or the general public unless the internalized costs in employee morale are stupendous.

In short, then, the portfolio shareholder has radically different notions of risk from both ordinary people and corporate law shareholders. Like the corporate law shareholder, the portfolio shareholder's fictional unity suppresses many of the difficult political and economic decisions that affect the real people behind them.

4. *Wealth Transfer Indifference*

The second main area where portfolio shareholders have fundamentally different interests from the corporate entity or undiversified

114. Thus, the old stable IBM and the infant Silicon Valley firms seem to attract different people with different preferences. The fictional shareholder mediated through portfolio shareholders, however, will almost always choose Silicon Valley.

shareholder is that they are indifferent regarding transfers of wealth from one security to another. For example, a corporate action that expropriates bondholders in favor of shareholders—or that takes market share from a competitor without increasing the total profits derived by the two companies—is of no value to the portfolio investor. The portfolio investor stands on both sides of such transactions and thus should view them as, at best, a waste of energy that could be put into something useful, such as increasing the total pie.[115]

In most instances, however, portfolio investors will view such transactions, including ones that are at the core of a competitive market system, as downright harmful. First of all, any transaction that takes from one investment and gives to another costs money—money that goes to unsecuritized investment bankers[116] and lawyers rather than investors, or money that is simply lost when management attention shifts to financial gamesmanship rather than more productive enterprise.[117] Thus, unless there is some synergy or increase in efficiency involved, the portfolio investor loses out, because the benefit to the gaining security will be less than the loss to the losing one.

Second, the possibility that corporations will opportunistically raid one security for the benefit of another should lead to a "market

115. *See, e.g.*, Robert Parrino, Spinoffs and Wealth Transfers: The Marriott Case, J. FIN. ECON. (forthcoming 1996). This event study suggests that Marriott's 1992 spinoff plan in its initial version led to a three-day industry-adjusted $358 million loss of value to bondholders and a smaller $232 million increase to shareholders; later modifications may have eliminated most shareholder gains and almost half the bondholder losses. Diversified investors, holding both stocks and bonds, presumably were made worse off by the Marriott transaction. Of course, the controlling Marriott family, which apparently owned roughly 25% of the shares, none of the bonds and was not well diversified, may have been in a different position. *Id.* § 4. For an accessible general discussion of the mechanisms of wealth transfers from bondholders to shareholders, see GILSON & BLACK, *supra* note 78, at 245-48. For more technical accounts of option pricing theory and its application here, see Dan Galai & Ronald W. Masulis, *The Option Pricing Model and the Risk Factor of Stock*, 3 J. FIN. ECON. 53 (1976) and sources cited in GILSON & BLACK, *supra* note 78. *See also* Leslie Cauley, *Bell Atlantic and Nynex Sue to Block AT&T's Planned Acquisition of McCaw*, WALL ST. J., Aug. 9, 1994, at B7 (Bell Atlantic suing AT&T to prevent latter's incursion into the former's market). This lawsuit should be a net loss—by the amount of legal fees and lost management attention—to diversified shareholders owning both companies.

116. I say bankers, rather than banks, because the portfolio investor will share in the returns of publicly traded banks.

117. *See, e.g.*, Parrino, *supra* note 115, § 5.2 (discussing transaction costs associated with the Marriott spinoff).

for lemons" problem,[118] to the ultimate detrimeut of all market participants. If bond investors are concerned about the possibility that bond issuers will increase their risk by such transactions, they will attempt to increase the bond return to reflect that risk. But since the risk is entirely in control of the issuer, rational bond buyers should assume the worst—thus forcing all issuers to pay higher interest rates regardless of whether they actually do plan to engage in such transactions. In such a market, corporations that do not engage in raids are at a competitive disadvantage (since they are paying for a right to raid but not using it); presumably, then, both raiding and the premium charged for the risk of a raid will increase over time in a downward spiral.[119] If such raids could be eliminated, everyone would benefit—issuers from lower interest rates and investors (and the economy as a whole) from refocusing of managerial energy and other resources towards more productive activity.

Similarly, competition for market share often hurts portfolio investors who hold both competitors: When competition drives down profits, as in the airline or the personal computer industries, the gains to the winning stock may be less than the losses to the losing one.[120]

More generally, often when the corporation spends money (or executive attention) in order to reduce its risk from volatile markets, or to shift risks or resources from one security to another—whether in this corporation or outside it—or, in many instances, to take market share from (securitized) competitors, it will not be acting in the interests of the fictional shareholder of the portfolio investor, since that

118. *See* George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970), *reprinted in* GEORGE AKERLOF, AN ECONOMIC THEORIST'S BOOK OF TALES (1984). A market for lemons occurs when buyers are unable to distinguish good products from bad ones (lemons). Rational buyers, then, are willing only to pay for lemons; sellers, then, are unable to charge for quality and are forced to manufacture lemons. In a downward spiral reminiscent of Say's Law, bad products force out the good and mutually beneficial transactions involving higher prices for higher quality cannot occur.

119. Parrino, *supra* note 115, § 5.1, suggests that following the Marriott spinoff market participants increased their estimation of future opportunistic behavior by Marriott. This fact, if true, suggests that the full market-for-lemons effect has not been felt, but rather that a downward spiral is in progress as market participants learn more about the possibilities for opportunistic behavior.

120. Portfolio shareholders, of course, may benefit as well, if the competition-induced lower prices result in a larger market, with higher (absolute) industry-wide profits even though profit margins are lower. That may have happened in the personal computer industry, although perhaps not in the airlines. And, of course, the people behind the shares may benefit even if the portfolio does not: Losing $1 per share on your airline stock is a good deal if you save more than that on tickets.

shareholder may well be a cheaper risk reducer than the corporation or may be on both sides of the transaction.

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The portfolio shareholder, then, is largely indifferent or hostile to changes in the division of the economic pie between different security holders. Gains that come at the expense of corporate competitors, suppliers or customers or other types of publicly traded securities in the company are of no value to a portfolio holder who holds both the loser and the winner. To this extent, the portfolio investor is analogous to the utilitarian who, in Rawls' description, does not take the distinction between persons seriously.[121] All that matters is the aggregate change in wealth of securities holders, not the distribution among them.

Critically, however, portfolio shareholders are far from indifferent to divisions of the pie between securities holders, on the one hand, and entities in which they do not hold an interest, on the other, such as employees, retirees, noncorporate consumers or the public health. For portfolio shareholders—who are thought of as pure securities holders with no other interests—gains at the expense of employees, retirees or (unsecuritized) customers are valuable even if they result in substantial leakage or shrinkage of the total social pie. It is the wealth of securities holders alone that interests the portfolio investor.

Additionally, even competition in its purest form may be contrary to the interests of the portfolio shareholder. As one director put it:

> For example, if a firm takes on a new research project, then the pension fund managers will sell your shares, and your share price will decline even though the project may be an essential move to put you in a stronger competitive position for the future, and may also be in the shareholders' best interests.[122]

The director's puzzlement at shareholders punishing the company for taking actions that are in the shareholders' interest stems from a confusion of the two different images of the shareholder. The research project necessary to preserve the corporation's competitive position very well may not be in the portfolio investor's interest. First, as noted above, competitive advantages are often zero sum games for diversified shareholders, when one company's gain is another's loss. Again, the classic example is airline price wars.

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121. RAWLS, *supra* note 8, at 27.

122. LORSCH & MACIVER, *supra* note 87, at 48 (internal quotation marks omitted).

Second, even research that allows the company to provide a better product (without increasing the size of the market) may be contrary to portfolio investor interests. After the expenditure and the innovation (and its match by competitors), total profits in the industry may be no higher despite a higher capital investment. In these cases, the diversified portfolio shareholder is rational, from a self-interested point of view, to oppose the "research project." Note that the portfolio shareholder rationally may oppose the research even if the director is right that the investment is necessary to preserve the company's competitive position: An investor who also owns shares of the competitor may not care if this company withers and dies.

In short, while the company may benefit, fictional corporate law undiversified shareholders may benefit and consumers will certainly benefit from this type of competition, the fictional shareholder of the portfolio shareholder will not. What it gains on the one hand it loses on the other. So, the director's problem is in part the result of a shift in the shareholder about which he is thinking: The pension fund managers—representing here the diversified portfolio shareholder—have a fundamentally different interest from the "widow in Iowa" undiversified corporate law shareholder in whose best interest the project is.

The other source of the director's puzzle has to do with the will/interest distinction. Many research projects may be in the long-term interests of even diversified portfolio shareholders: If an innovation increases the size of the market or allows a company to exploit a market imperfection to charge higher prices, diversified portfolio shareholders—the pension funds—benefit from the price rise in this stock without an offsetting drop in some other security. However, agency and information cost problems may result in the expressed will of diversified shareholders diverging from their long-term interests. They may drive down the stock price even when the research project is in their long-term interest when, for example, institutions rely on quarterly results of their investment managers as a cheap proxy for more accurate assessment measures and investment managers are unable to distinguish, at a reasonable cost, research projects that will benefit diversified shareholders from ones that will not.[123]

123. *See* Akerlof, *supra* note 118.

5. *Immortality*

Portfolio investors are time indifferent. They are simultaneously the shortest of short-term investors and the longest of long-term investors, with oddly paradoxical results from the perspective of the corporations in which they invest.[124] A diversified investor is time indifferent because the market allows the sale of any liquid investment at any time for the present discounted value of its future income stream. Thus, any long-term investment can instantly be converted into a short-term one, and vice versa. Stocks, which from the perspective of the issuing corporation are permanent investments (the corporation is under no obligation ever to return the shareholder's investment) are, by this strange alchemy, the quintessential short-term investment from the portfolio investor's perspective.

A portfolio investor is in a deep sense always a short-term investor. This shareholder has no interest in any stock or any company except to the extent that the security represents an interest in a future income stream. At all times, the portfolio investor seeks to hold the portfolio with the best risk/reward ratio—it has no commitment to any product or institution behind that ratio. Thus, if the ratio changes, as it does with each additional bit of information about the corporation's prospects or each fluctuation in security price, the investor is always prepared to switch to another security offering a better ratio. Acting rationally, this shareholder has no preference for existing holdings, no commitment and no friction: Like the sinner in the Weavers' song, it is always prepared to slide down into the Promised Land.[125]

In another sense, however, the portfolio investor is long-term. Just as stocks are permanent investments in the corporation regardless of the constant changes in the identity of the shareholders, so too many portfolio investors are permanently invested, regardless of shifts in the identity of the stocks held. Retirement funds, mutual funds,

124. For discussion and further citations regarding the short-term and long-term aspects of institutional investing, see Mitchell, *Critical Look*, *supra* note 106, at 1291-92 nn.115-20 (noting high turnover rates in institutional investors, high need for current cash on the part of defined benefit pension plans, and long-term orientation of permanent investors).

125. Other commentators have emphasized institutional pressures that lead to short-termism. Mutual funds and managers of all funds are judged by their quarterly returns; even a brief lag in returns may lead to substantial capital outflows. This pressure for short-term results may lead to short-term investments (although most portfolio theorists seem to believe that performance is enhanced by a longer-term approach), because "laggard managers, knowing they will be replaced, have an incentive to gamble and cut costs recklessly." *See* Coffee, *Liquidity*, *supra* note 20, at 1324-26.

insurance companies and the like, unlike widows and orphans, do not grow up, go to college, buy houses, move to retirement homes or die: They exist in a world of statistical probability in which each year is the same as the last. They are time indifferent in the strong sense that they have no life cycle with its accompanying seasons to spend and seasons to save.[126]

6. *The Inhumanity of the Portfolio*

Portfolio investors, then, are deeply inhuman. Humans are never diversified and never time indifferent: A job here is quite different from an (otherwise similar) job in five years or 2000 miles away. Humans live in particular communities, enmeshed in particular relationships, connected to particular landscapes, people and products. They need money now, or later, but are rarely indifferent between the two.

For humans, fungibility is the rare exception, not the norm. For humans it always matters whether the local company (or your employer, or your customer) wins or loses the fight for competitive advantage; the aggregate changes most important to the portfolio investor are likely to be far less salient and perhaps even imperceptible.

Perhaps most significantly, portfolio investors 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.

This disparity of interests has concrete results in important conflicts: For example, if corporations were able to reduce their employees' share of the corporate pie in favor of security holders, the portfolio investor would support this action *even* if the reduction to employees were far larger than the benefit to securities holders and *even* if most of the people behind the fictional shareholders found their identities as employee far more salient than that as shareholder.

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126. *Cf. Kohelet* (*Ecclesiastes*) 3:1-3:8.

Consider, for example, a hypothetical situation in which corporations suddenly began to abrogate implicit contracts of lifetime employment.[127] Conceivably, downsizing and reduced real wages might lead to demoralized employees spending more energy planning their future careers outside the company than inside it. In the aggregate, losses might substantially outweigh gains if, for example, under the new regime employees found it disadvantageous to acquire firm-specific skills (since they might be back in the job market at any time) and therefore the economy as a whole lost a substantial part of the benefits of specialization and the division of labor.[128]

In this hypothetical circumstance, since the economy as a whole is worse off, citizens, as a whole, must be worse off. The losers must outweigh the winners. But portfolio investors will support the change provided that the absolute amount of corporate wealth going to securities holders increases—even if corporate wealth as a whole (including the portion going to nonsecuritized employees) is substantially diminished.

In the real world, economists will dispute whether the detrimental effects of demoralization are larger or smaller than the beneficial effects of greater labor market flexibility. Similarly, concerned citizens no doubt will have varying views on whether implicit contracts ought to be given any weight and on whether the greater security of a system of presumptively stable employment is worth the cost in flexibility. Fictional shareholders, however, will cut off that debate; they can hear only one side.

Similarly, the increase in power of the fictional shareholder may be directly related to the decline of the unions. In the early part of the post-World War II expansion, a vast portion of the increased pie went to workers. In the last generation, however, profit-maximizing firms have found that they need not pass profits on to their employees. While workers have actual commitments to actual places that make it impossible for them to be completely flexible in choice of workplace, fictional shareholders (and the real capital they represent) have no such commitments. Unions can be rather easily broken in a world in which capital is infinitely more mobile than labor and unions are restricted by law to plant-by-plant organization: Plants can simply leave

127. *See* Coffee, *Shareholders*, *supra* note 6, at 73-81.
128. *See* SMITH, *supra* note 108, at 19, 301-04.

the unions. Once one firm's management learns to act like the fictional shareholder, with no commitment to particular plants or particular employees, others will be forced to join in order to be able to compete with the nonunion firm. The market does not look kindly upon high cost producers, even if the high costs are socially responsible. Thus, firms seeking to act in the interests of their fictional shareholders will do their best to union-bust.

The social perspective, however, may differ from the fictional shareholder's. Unions may well have been collectively beneficial, since they led directly to a wealthier middle class and thus to the broad base of consumers necessary to fuel rapid economic growth. Additionally, a union-based economy provided useful occupations paying family wages for the broad range of undereducated men who so often are the source of social disorder; with the decline of the unions, we have marginalized many formerly productive men, with predictable results in areas ranging from crime, divorce and drug use, to educational failure in the next generation, the isolated antiestablishmentism of the militias and the condition of New Haven.

But any given firm can get a competitive leg up by busting its union. Tolerating unions was a type of cartel behavior, and like all cartels, it is difficult to maintain even when it is in the best interest of all the players (collectively). In the post-World War II period the government enforced the cartel;[129] later it began to attack it. Without an outside enforcer, firms acting in the interests of their fictional shareholders generally were not going to tolerate unions voluntarily, and given the mobility of modern capital, the unions certainly were not able to force them to do so. Ironically, even the pension funds created by the unions (or created by firms to avoid unionization) must, by the logic of the fictional shareholder (and the ERISA statute), participate in the dismantling of the unionized family wage.

If any of this picture of the benefits of unionization is true, then the fictional shareholder was instrumental in transforming unionization into a form of the prisoner's dilemma and ensuring that firms—each seeking to win by betraying the others—will make us all lose. Again, even if it is not clear that unionization created social benefits, it should be entirely clear that firms driven by their fictional shareholders can see only half of an important social controversy.

129. *See* National Labor Relations Act, ch. 372, 49 Stat. 449 (1935) (codified as amended at 29 U.S.C. §§ 141-87 (1994)).

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Critically, each of these instances of one-sided behavior by portfolio investors and firms acting on their behalf is not the result of evil, ill will or the political views of the participants in the firms—whether managers, shareholders or employees. Since managers are acting as trustees or agents for someone else, they will—if they are acting in good faith—put aside their own views. But since the persons on whose behalf they are acting are simplified legal fictions, no other humans' views enter the system to replace the managers.

Nor can the one-sidedness of corporate behavior be changed by greater professionalism or education regarding the "true" needs of the economy: More professional managers will simply act more often in good faith, thus amplifying the automatic nature of the system. Indeed, the one-sidedness is overdetermined; both the law and the market require it. The law requires it, because most institutional investors are required by their fiduciary duties to imagine that their beneficiaries have no interest other than the interest of a fictional shareholder in their portfolio. And the market requires it, because those who do not act as portfolio investors will soon be out of business.

C. Now You See It, Now You Don't: The Disappearing Shareholder

The image of the shareholder is unstable in another way. For portfolio shareholders, companies appear as nothing more than risk-reward ratios. Conversely, from the perspective of the company, portfolio shareholders quickly collapse into an anonymous market, in which those portfolios that own the company's stock are no different from those that do not. If the portfolio shareholder is " 'with you on a Tuesday and on a Wednesday he's gone and then he's back again on a Friday,' "[130] whether he is actually with you or not on Thursday does not really matter.

In the world of corporate finance, the corporation's actual shareholders disappear and become completely unimportant; the corporation is thought of as if it were owned by the market as a whole. Indeed, with the constant churning of portfolios by professional managers each attempting to improve their risk-return ratios or to outguess the other market players, this image is quite realistic: The corporation's shareholders change continuously and continually, with only

130. *See* Lorsch & MacIver, *supra* note 87, at 48.

the index investors remaining constants. The notion of an identifiable shareholder begins to collapse, and with it, the distinction between the actual and the potential shareholder.[131]

If the corporate law model is epitomized by *Revlon*'s treatment of the bondholders and shareholders as separate and opposed interests, despite the fact that they appear to have been largely the same people,[132] the disappearance of the shareholder is central to the holdings in *Paramount Communications, Inc. v. Time Inc.* and *Basic Inc. v. Levinson.*[133]

In *Basic*, the Supreme Court relied on a "fraud on the market" theory to determine that a plaintiff need not have been aware of the allegedly misleading disclosure or omission, if the market was aware of the misinformation and it was incorporated into the share price.[134] That holding makes perfect sense within the portfolio theory model of shareholders. If unhappy portfolio investors sell the stock or decline to buy it, the price will decline until management corrects the problem or an arbitrager purchases the low-priced stock and replaces management. The fraudulent misinformation, then, can damage a plaintiff who was unaware of it by distorting the basic pricing and governance mechanisms.

But the *Basic* logic also eliminates the distinction between shareholders and nonshareholders. Prices are determined not only by transactions that occur but by the ones that do not occur—that is, by the investors who might have bought or sold but for the misinformation. It is the market, not just (this Tuesday's) shareholders, that determines the share price. Consequently, it is the market, not just (Wednesday's) shareholders, that controls the company's future—nonshareholders as much as shareholders.[135]

131. *See also* Hu, *Risk*, *supra* note 7, at 288, 295 (managers must consider not only existing but also potential shareholders in decisionmaking; in making investment decisions, a corporation should consider risk and time preferences of the market, not its own shareholders). Note that the status of potential shareholders appears to be radically different from, for example, the status of potential humans in moral discourse. Compare my discussion of potential humans in Greenwood, *supra* note 18, at 612-24.

132. Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985); *see supra* part III.A.

133. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) (discussing control in the market); Basic Inc. v. Levinson, 485 U.S. 224 (1988) (discussing fraud on the market theory).

134. *Basic Inc.*, 485 U.S. at 247.

135. This also suggests that *Basic*'s limitation of a cause of action to investors with some connection to the stock is illogical (if not necessarily unfounded in statutory language). It is the

Time is similarly based on a collapse of the identifiable shareholder. *Time* holds that control of Time Inc. did not change despite two virtually complete turnovers in share ownership (first, to professional arbitragers—a change not even mentioned by the court—followed by a transaction involving transfer of sixty-two percent of Time Inc.'s shares to Warner Brothers' shareholders). Both before and after the events, according to the court, control remained "in a fluid aggregation of unaffiliated shareholders representing a voting majority—in other words, in the market."[136]

On a corporate law fictional model, the *Time* ruling is incomprehensible; on a portfolio model, it is surely correct. If shareholder control is by share price rather than by voting, it makes no difference who the shareholders are, and a change in share ownership has no connection to a change in control.

Time and *Basic* illustrate the near collapse of the determinate shareholder. Control is in "the market"—the shareholder and the nonshareholder alike. But the *Time* court was wrong to emphasize the voting majority; the key to control is, rather, the *Basic* Court's "correct" pricing. Standard theories of the financial markets suggest that shareholders control the firm through pricing, not through ordinary voting; if the firm does not act to further the interests of a hypothetical, fictional shareholder, then the real institutional investors, acting on behalf of their own fictions, will bid down its share price until it sees the error of its ways, or an arbitrager forces it to do so. If pricing is the issue, it is, as the *Time* court said, "the market" that controls the firm—those who refuse to buy the stock at any given price control the corporation as much as those who do. In short, the distinction between actual and potential shareholders is meaningless.

We have come, then, full circle. Fictional shareholders are all the same; that is why corporations can be managed without any mechanism for determining the actual views of the actual shareholders. For the corporate law fictional shareholder, all businesses, places, employees, products are the same—all that matters is the risk-reward ratio. In the portfolio model, all that is true, and even more: All stocks are fungible; all corporations as well can replace one another. Now, we see that from the perspective of the corporation, the shareholders are so similar that it does not even matter if they even own the firm or

entire market that is injured by the misinformation—those who did not buy the stock but would have but for the misinformation or the mispricing just as much as the *Basic* plaintiffs.

136. *Time Inc.*, 571 A.2d at 1150.

receive its disclosure. Control is "in the market," not the particular owners of the shares.

The portfolio shareholder, then, becomes the entire market, regardless of whether particular institutions are here this Tuesday or gone, soon to come back. The implications of this view are staggering. Simply, it suggests that corporations are no one's property, or perhaps everyone's.

On the one hand, the publicly traded corporation belongs to everyone: Portfolio theory collapses the distinction between shareholders and nonshareholders. It seems, then, to collapse the distinction between public and private property, suggesting that publicly traded companies are in fact, as well as in name, "public." If control is in the "market" and it is the "market" that must be informed about them, then they belong to the market—and the market, after all, is all those who could own some stock directly or indirectly; that is, almost all of us. But if public corporations are not private property, they should not be entitled to the deference due private property in a democratic capitalist system. Rather, they should be seen as fundamentally political, governmental institutions, using social resources ("our" joint property) for public purposes, and thus ultimately subject to public, political control whenever the uses to which they put our property are not useful, or whenever the fictional shareholder drives them in ways we dislike.

On the other hand, the publicly traded corporation belongs to no one, and is controlled by no one, except the fictional shareholders. The corporation will act as the market drives it to act, for good or for bad, regardless of the interests or desires of any of its human participants. I explore this view further in the next Part.

IV. THE CONFLICT BETWEEN THE FICTIONAL SHAREHOLDER AND LIVING HUMANS

Because the corporation's principal is fictional and one-sided, corporations are likely to take extreme positions. They may continue to pursue their simple goal long after most humans—Richard Epstein possibly excepted—would have deferred principle to Aristotelian practical wisdom.[137] And they may take positions of which few, or even none, of their human affiliates would approve.

137. For a discussion of practical wisdom—appropriate deliberation about politics—see ANTHONY T. KRONMAN, THE LOST LAWYER 54 (1993). Corporations (or corporate managers)

A. THE PARABLE OF THE AGENT WITH NO PRINCIPAL (PRINCIPLES)

Imagine a company operating lunch counters in the South in 1963—a publicly traded version of Hooper's Lunch Counter as described in *Bell v. Maryland*.[138] In my variant on *Bell*, the company's shares are mostly held by defined benefit pension funds (anachronistically subject to ERISA) and mutual funds. As it happens, by a strange fluke of fate, the beneficiaries of those pension funds and the shareholders of those mutual funds do not reflect the national division on the future of apartheid in 1963; rather, all the beneficiaries and mutual fund shareholders already believe—as virtually every American will profess to believe a few years later—that apartheid is immoral and should be illegal. I choose mutual funds and defined benefit funds intentionally: Both have easily identifiable human beings who are the ultimate beneficial owners of the shares the institution holds, and neither, in the usual manner of organizations, has any way for those people to indicate their views on segregation or similar matters.

The CEO of the lunch counter firm (call him Mr. Popper), who built the company before taking it public, is also a bit ahead of his time. Like Mr. Hooper in the real case, Mr. Popper is proud of his African-American employees (he calls them "Negroes") and of the jobs he provides for them. He agrees with Mr. Hooper: "I've nothing against these people [the lunch counter demonstrators of the civil rights movement] . . . . Talk to my boys—they're all with me."[139] Indeed, he goes beyond the reported facts—he is prepared to state (if it

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acting on behalf of fictional shareholders utterly lack practical wisdom because they wear blinders that render them incapable of considering matters fairmindedly or discerning where the public good might be.

138. 378 U.S. 226 (1964). In *Bell*, a corporate-owned Southern lunch counter refused to seat and then had evicted for trespass several African-American would-be customers. The case dates to the period of the Civil Rights struggle shortly before passage of the 1964 Civil Rights Act. The Supreme Court decided the action on procedural grounds that are not relevant here. Justice Black, however, wrote an opinion treating the issue as one of freedom of association, likening the lunch counter to an individual's living room and treating the corporation as if it were a human being. Indeed, Justice Black goes so far as to refer to the business throughout the opinion by the name of an individual, Mr. Hooper, who, one gathers (although it is not explicitly stated) owned or controlled the corporate shares. Justice Douglas' dissent, in contrast, is one of the few examples in Supreme Court jurisprudence of serious grappling with the differences between corporate and individual behavior. This Article is in large part an attempt to spell out the different understanding of corporate rights toward which Justice Douglas hints.

139. For Mr. Hooper's explanation of his actions, see *Bell*, 378 U.S. at 245-46.

is not quoted in the local media) that he would support a civil rights act himself.

The company's lunch counters have always been segregated—it was the custom when Mr. Popper began the business and he never thought much about it after that. In 1963 demonstrators have begun to challenge the segregation policy, sometimes going so far as actually to have black students sit down at white-only counters and demand to be served. However, I shall assume, at least in the towns where this company operates, the white population (which includes virtually all of the population affluent enough to patronize the lunch counters) is still committed to segregation.

Mr. Popper, like Mr. Hooper, is no hero. But he thinks of himself as a decent human being who does his duty and what is right. He recognizes that segregation is wrong, but he also believes that if he integrates, he will be out of business, with attendant consequences for his wife and five children and his 500 employees, half of whom are "Negroes" and all of whom have others dependent on them.[140]

What will Mr. Popper do? When I ask my Business Organizations students to put themselves in his place (generally without specifying any particular shareholders), the class often breaks down into two large groups. One group refuses to accept the facts as given: They counsel Mr. Popper to believe in the good fairy, or the invisible hand, and to decide that integration is good business despite the statement in the facts to the contrary.[141] Pressed to accept the facts as given, they often conclude Mr. Popper should resign, notwithstanding the impact on his family and other dependents.

The second group bites the bullet: They counsel Mr. Popper to set aside his political convictions and to do his duty—that is, to manage

140. *Compare Bell*, 378 U.S. at 245. Mr. Hooper implicitly concedes that segregation is wrong by defending his actions based on their economic consequences, not on a defense of the apartheid system.

141. For a classic case taking the same approach, consider A.P. Smith Mfg. v. Barlow, 98 A.2d 581 (N.J. 1953) (claiming that charity is good for business and ignoring the rationality of free-riding).

While fighting the facts is out of order in a law school classroom, it may be a reasonable stance in the real world, where Mr. Popper's marketing study may well be flawed by racism (perhaps unconscious), or projection of his own qualms onto his neighbors. Thus, in the real *Bell*, Mr. Hooper claimed to be similarly convinced that integration would put him out of business, despite record evidence that suggested that white customers were less racist than he thought. Or perhaps that evidence is just an example of Justice Douglas' version of the good fairy.

the company in the interests of its fictional shareholders.[142] In short, they conclude that Mr. Popper should take an action they believe is wrong, and that they believe Mr. Popper believes is wrong, in order to promote the interests of third parties—who, as it happens, also believe the action is wrong.

This, I believe, is the scandal of the fictional shareholder writ in black letter—the fictional shareholder allows people to take actions they know are wrong while believing they are doing the right thing.[143] Simultaneously, it strongly hinders attempts to take actions that may be not only right, but in the best interest of all the real people concerned: Even most of the students who do not take refuge in the role morality of serving the fictional shareholder are unable to articulate a principled basis for ignoring it. Some of them, to be sure, imagine themselves as heroes—but even then, the most they can do in good conscience is to resign, leaving the administration of the firm to those who have less problem following the institutional norms. While the hero who resigns and his family pay a price for his clean conscience, they have little effect on the course of the institution; with the corporation guided by a more complacent leader, the fictional shareholder's vision will prevail anyway.[144]

If the power of the fictional shareholder is enough to force one to segregate—almost as unquestionably a wrong action as one can imagine in an American law school in the 1990s—how much stronger it must be in hotly contested issues of today.

The Mr. Poppers of corporate America surely will often act much as my students did: They will set aside their political beliefs when they can. When they cannot, they will distort the facts (or, in an option I didn't allow my students, adapt their political beliefs to fit the ones they feel compelled to advocate). But they will not ask the people behind the fictional shareholders what they really think. And they will not act against the interests of the fictional shareholders even

142. *Compare* ROBERT M. COVER, JUSTICE ACCUSED: ANTISLAVERY AND THE JUDICIAL PROCESS (1975); Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32, *quoted in* CARY & EISENBERG, *supra* note 54, at 122.

143. *See* HANNAH ARENDT, EICHMANN IN JERUSALEM (1964) (discussing Eichmann's emphasis on his impartiality in carrying out the final solution).

144. *Compare* John M. Crewdson, *Bork Asserts He'd Press White House for Evidence*, N.Y. TIMES, Oct. 25, 1973, at A1, A42 (Mr. Bork explained that he decided to follow President Nixon's order to fire Special Prosecutor Cox, rather than resign as Mr. Richardson and Mr. Ruckelshaus had, because "[Cox's] departure had become 'inevitable—it was going to be done.' ").

when those interests conflict with the desires or interests of the people behind them. Or, if they do, they will shortly be cashiered, if not by their superiors, then by the arbitragers and the portfolios, leaving the job to be done by those who will follow the fictional shareholder's direction.

B. Corporate Speech: Lobbying for the Fictional Shareholder

As Professor Victor Brudney has pointed out,[145] following Justice White's dissent in *First National Bank v. Bellotti*,[146] management willing to act in *bad faith* may have free rein to use corporate resources to lobby or otherwise attempt to influence the political process as it wishes if shareholder returns do not obviously drop by a significant amount. Given the limited dollar amounts necessary to influence our political processes, de minimis amounts (from the perspective of shareholders) may be quite significant (for the purpose of influencing politics). So as to firms that do not reduce shareholder returns enough to attract the attention of the arbitragers, Brudney argues that the key issue regarding corporate "speech" is whether we wish to allow corporate managements to amplify their own voices with money that is entrusted to them, but is not their own. Stating the issue determines the answer. A democratic society may have good reasons for allowing the rich to amplify their voices at their own expense. But it is hard to imagine any reason why it should allow the well-positioned to amplify their own voices at someone else's expense.

The fictional shareholder approach, however, adds a different twist to the Brudney/White analysis. Management acting in *good faith* to promote the interests of their fictional shareholder should systematically advocate political and legal changes that are in the fictional shareholder's interest. If the model proposed in this Article is correct, both the law and the market (including the portfolio investors) will endorse and encourage such lobbying and political activity whenever it is a cost-effective means to increase fictional shareholder returns.

However, to the extent that the theoretical interest of fictional shareholders is different from the beliefs, will or interests of the people who stand behind the fiction, the institution is likely to take positions quite different from the ones its participants might endorse. As

145. *See* Victor Brudney, *Business Corporations and Stockholders' Rights Under the First Amendment*, 91 Yale L.J. 235 (1981).
146. 435 U.S. 765 (1978).

we have seen in the story of Mr. Popper, one group of people—the managers—take positions they do not necessarily agree with because they feel obligated to set aside their own views and pursue the interest of the fictional shareholder. They then use corporate resources to lobby for this position, not out of bad faith, as Professor Brudney and Justice White fear, but in good faith, and perhaps even with some feeling of virtue as they put aside their own views to do the job they have been hired to do. At the same time, the people who stand behind the fictional shareholder may have views and interests quite different from the ones imputed to them by the fictional model.

The final result is an institution that pursues a particular position—the imputed interests of the fictional shareholder—regardless of either the views or the interests of any of its participants. Social resources with no clear owner are used to fund lobbying on behalf of only one side of a series of highly controversial issues. Furthermore, since the position is taken on behalf of a one-sided, voiceless fiction, there is no one in a position to say "stop!" or "enough!" or "it is not worth sacrificing [insert any value you like] to the cause of shareholder wealth maximization."

A contemporary example of this one-sided corporate action gone out of control may be corporate lobbying for less restrictive environmental protection. Public opinion polls suggest that an overwhelming majority of Americans support strict environmental regulation. Owners of shares and corporate managers alike no doubt reflect this general view. Indeed, even on a purely economic analysis, owners of shares will often stand to lose more from the effects of pollution than they could possibly gain from any particular company's successful attempt to externalize its costs of production. After all, the actual owners of the shares are, more or less, the society at large, and thus they must bear the costs of the externalization.

In contrast, however, the fictional shareholder sees such externalization as a pure benefit. Someone else (a human) pays the costs, while all the benefits go to the shares. Thus, corporations, even corporations led by managers who accept the general American view in favor of pollution control, may feel obligated to use corporate resources to promote a position rejected not only by most of the corporation's managers, employees and customers, but even by the ultimate owners of its shares.

Classical agency theory explains corporate lobbying quite differently. It predicts that there will be opinionated corporations that announce positions in advance and pursue them regardless of the theoretical interests of fictional shareholders; shareholders who disagree will then sell their shares to those who agree. We see few such firms, however, for reasons easy to understand within the market model. In essence, the opinionated firm can be seen as producing two products: politics and widgets. Consumers who purchase the widgets cross-subsidize the politics. But that is the case any time a firm produces two products one of which is overpriced and the other underpriced. The market is full of such inefficiencies, and Wall Street is full of professionals who attempt to evaluate when they are sufficiently large to warrant arbitrage: specifically, splitting the firm in two to eliminate the cross-subsidy and allow the capital market to price the two firms separately.

The same process should apply to corporations producing political activism: Unless the politics and the widget fit together in some useful way, the market will price the combined firm at less than the sum of its parts, due to the difficulty of correcting for cross-subsidy. Thus, a clever entrepreneur could make a quick buck by separating the two firms into a political foundation and a company.

Provided there is a sufficiently active market for corporate control, market pressures should tend to eliminate the ideological corporation that presents any position other than that of the fictional shareholder.[147] Protecting its right to speak is of little use, since the market will usually silence it anyway. If we see such firms, it is a sign that the market for corporate control is not working well, and an invitation to regulate to eliminate what the market should have eliminated anyway.[148]

147. Corporate managers acting in bad faith may have a fairly broad range of discretion before market forces (arbitragers enforcing the will of the fictional shareholder) rein them in. Rational shareholders ordinarily will ignore the political and charitable acts of the corporation unless they exceed some fairly high standard. Investments are to make money; individuals owning insignificant portions of the corporation's stock will be compelled by collective action problems to undertake their speech elsewhere, while institutional shareholders ordinarily will be compelled to profit-maximize.

148. Where the market cannot eliminate such ideological corporations is in instances of a closely held corporation with a good product. In these cases—since the owner in any event has a fully protected right of free speech—the main impact of barring corporate speech is to eliminate some public tax subsidy of the owner's speech: It is easier to characterize expenditures for political speech as deductible business expenses at the corporate level than as deductible business or charitable expenses at the personal level. *Compare* I.R.C. § 162(e) (1994) (permitting business

In sum, when corporations are allowed to use corporate resources to influence the political process, they can be expected to do so in the interests of their fictional shareholders and, to a large extent, without regard for the actual opinions or desires of the citizens who stand behind those fictions, or, indeed, any other participant in the corporation.

C. The Radicalism of the Fictional Shareholder

Fictional shareholders are indifferent between earnings resulting from an automobile plant in Detroit or one in rural Tennessee, or from a can factory or an insurance business: Earnings are entirely fungible.[149] For many of the human beings involved in the firm (including many of the people behind the shares), however, these things make a great deal of difference. Jobs lost in one industry or one city are not replaceable by jobs in a different industry or a new exurb. People, unlike shares, depend on communities and are never fully mobile or liquid.

Because fictional shareholders are eternal, mobile, liquid, diversified and risk-indifferent, they are fundamentally different from people, who are none of those things. This is perhaps the most detrimental aspect of the political enfranchisement of shares by the fictional shareholder device: We have given tremendous power to a fiction that does not take the distinction between persons seriously.

Schematically, the conflict can be seen as underlying many of the great political disputes from the Luddites onwards. Though a full discussion is well beyond the scope of this Article, arguably the conflict between mobile capital and conservative humans is one of the great sources of political strife in all post-feudal economies. I have in mind something like this: The glory of our economic system is that capitalism is revolutionary. It constantly makes and remakes itself and everything around it. Competition ensures that those who stand still, fall backwards, and that, as the Red Queen says, "it takes all the running you can do, to keep in the same place."[150] As new and more efficient methods are developed, firms (and countries) rise and fall.

corporations to deduct all business-related lobbying expenses) *with* I.R.C. § 501(h) (1994) (restricting lobbying by recipients of deductible charitable contributions).

149. Portfolio and corporate law shareholders differ, however, in that the former are also indifferent between earnings within or outside the corporation, while the latter are indifferent only so long as the investments and return remain within the current legal entity.

150. Carroll, *supra* note 3, ch. I.

Jobs, techniques and workplaces change. Rewards for different skills change. Physical landscapes are built and destroyed. Populations move back and forth across the globe.

People, on the other hand, are inherently conservative. We have only one life to live, and we cannot remake it an indefinite number of times. Building relationships with our spouses, families, friends and communities takes time and stability. Learning a language, becoming a literate (or even an illiterate) member of a particular culture, even mastering the simpler skills of a career, take time, and people are more able to do those things when they are young than later in life. Raising children is most easily done with an extended community: two parents and several grandparents, at least. We cannot simply pick up and move cities, or change professions, or even jobs, without massive pain and dislocation. On the other hand, the stasis of poverty does not seem to be terribly attractive either.

Much of the history of the twentieth century can be understood, superficially perhaps, as a series of attempts to obtain the affluence of capitalism without the destabilizing change. Marxism, despite Marx's revolutionary rhetoric, seems to have played out as fiercely reactionary resistance to the forces of change in a capitalist economy in both its social democratic/labor union versions (the British Sclerosis) and its Bolshevist versions (Brezhnev). The other mass political movements of the twentieth century as well—Fascism and Nazism, the various nationalisms, the new and revived religions, even the popular incarnations of the American Democratic Party of the New Deal and the Republican Party of "law and order" and "traditional" values—often seem to draw much of their power from the fear and resentment created by the change and instability inherent in capitalist economies. Perhaps even much of the current perception of social collapse, rampant crime and dislocated families can be related to the economic forces that in one generation have moved Americans out of the cities into suburbs and beyond, westward and southward, out of factories and lifetime jobs into new "McJobs" or highly mobile professions, out of two-parent, one-career families into one-parent, two-career ones, from bearing children at twenty to adopting them at forty (or having them at fifteen), and so on.[151]

151. I do not mean to suggest that all these changes are necessarily good or bad—merely that change itself is likely to be discomforting, whether the change is positive or negative.

In this great struggle between economic progress and social stability, 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,[152] corporations will be on only 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[153]—towards mobility, flexibility, change, novelty and other accommodations to the 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.[154] One side of the debate is promoted without any human in a position to consider when the time has come to stop advocating.[155]

D. Why Should We Care?

We have seen that the shareholder of corporate law is a fictional stripped-down being interested in only one thing. Corporations acting in good faith consider only the needs and interests of the stripped-

152. That is, leaving aside Professor Brudney's problem of bad faith. *See supra* note 145 and accompanying text.

153. Current practice, and Supreme Court doctrine, fully protect corporate attempts to influence the political process in ways protective of the interests of the fictional shareholder, regardless of social cost. The Supreme Court held in First Nat'l Bank v. Bellotti, 435 U.S. 765, 794-95 (1978), that corporate expenditures related to political issues are core First Amendment speech immune from all governmental regulation. Furthermore, even the leading dissent in that case—as well as the leading academic article criticizing the decision—worries only about conventional agency cost problems: that is, that corporate management might use its right to spend corporate assets to pursue interests *other* than those of the fictional shareholder. *See* Justice White's dissent, *id.* at 802-22; Brudney, *supra* note 145. My concern, of course, is precisely the opposite: It is that management might do what it is supposed to do. *See supra* notes 127-29 and accompanying text.

154. *See* Michael Walzer, Spheres of Justice (1983) (discussing the importance of maintaining such boundaries).

155. *See supra* note 137 and accompanying text.

down fiction, not the desires or wishes of the underlying complex humans. At the same time, institutional investors seeking to advance the interests of their own fictional shareholders push the corporations whose shares they own to act in ways they deem beneficial to their portfolio (and therefore to their fictional shareholders).

Many of the difficult issues in modern corporate law can be understood in terms of the conflict between these two visions of the shareholder. Unlike the corporate law shareholder, the portfolio shareholder does not take seriously the distinction among companies: The institutional integrity of a particular corporation is of no interest to it. For the portfolio shareholder, dismantling a company is of no special significance; all that matters is the total value of the portfolio and the particular security's contribution to that value. Similarly, prevailing against a publicly traded competitor may not even seem a desirable goal to the portfolio shareholder.

Some rational portfolio shareholders, then, should oppose a series of investment and competitive decisions—including all those aimed at shifting wealth from one set of securitized interests to another—that less diversified fictional investors would support. Because of their different perspective, portfolio investors drive companies to take actions that are likely to seem inappropriate to managers deeply invested (literally and figuratively) in the particular institution.[156]

These conflicts between the portfolio shareholder view and managerial perspectives may drive managers to seek to free themselves from shareholder control—through poison pills, anti-takeover laws and other takeover defenses that effectively reduce the portfolio shareholder's ability to use the right to sell the company to force it to adopt portfolio perspectives, or through constituency statutes that essentially remove any threat of judicial enforcement of a fiduciary duty that might remain even after the business judgment rule. Alternatively, the conflict between portfolio and corporate law shareholder perspectives may create a space in which corporate leaders may feel conflicting duties without a clear guide explaining which to follow (or

156. *See, e.g.*, Paramount Communications, Inc. v. Time Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989) (describing commitment of employees and directors to a particular business organization and its distinctive identity). In contrast, fictional shareholders, at least when mediated through a portfolio, *will* view "the continued existence of its distinctive identity as a matter of indifference." *Id.*

may be able to appeal to conflicting norms to justify actions adopted for other reasons).

At least equally important as the ongoing conflict of the fictions, however, is a set of conflicts largely ignored by modern corporate law and the associated scholarship. Both the diversified and the undiversified fictional shareholder agree on far more than they disagree. If only the portfolio investor fails to take the distinction among companies seriously, both fail to take the distinctions within companies seriously. That is, fictional shareholders of all varieties are supremely inhuman in their indifference to particularity within the corporation.

The fictional shareholder takes the position that a dollar is a dollar. It does not matter if it is earned in the company's traditional field of business or a new acquisition (unless, of course, experience allows the company to be more profitable). It does not matter if it is earned in the Rust Belt or the Sun Belt or the Third World. So long as the dollar results are the same, it does not matter if it is earned with highly paid, highly motivated labor or with low-paid child labor abroad. It does not matter if it is earned in a high-risk operation with a high potential for putting many people out of work or a more stable operation. All that matters is the risk-adjusted present discounted value of the future income flows.

Fictional shareholders will never stand up to preserve Penn Station or to resist the spread of trash journalism, fast food or violent television (unless cultural preservation becomes more profitable than redevelopment and debasement). They will never stand up to abolish child labor (unless consumer boycotts make it unprofitable). They will, entirely without personal prejudice, support the continuance of Jim Crow segregation and discrimination of every variety wherever it is profitable. Unless the benefits to the bottom line of a happy and stable workforce are clear, they will always support union busting, the abrogation of implicit contracts and the increasing liquidity of the labor market (or, what is the same thing, the decreasing mutual loyalty of employer and employee).

Fictional shareholders will advocate and lobby for statutory regulatory schemes that permit the formation of cartels and monopolies, or the imposition of the costs of doing business on employees, taxpayers or the general public, through weak environmental and safety regulation, weak tort laws, strong limited liability laws or the like. And they will advocate lowering of barriers to economic change, mobility of capital or fluidity of the labor markets.

To be sure, fictional corporate law shareholders may have a somewhat different view on particular issues from portfolio shareholders. Corporate law shareholders look to the bottom line of the particular company (and thus, for example, support AT&T in its attempt to keep the Baby Bells from competing with it, and vice versa). Portfolio shareholders take a broader view: They are interested in the welfare of the entire publicly traded industry, not just a particular company, and so will be hostile to litigation between publicly traded entities over market share or cartelization that appears to victimize other publicly traded entities (high trucking rates, for example).

But all the fictional shareholders can agree that redistribution of wealth from the unsecuritized sector (that is, ordinary individuals, whether in their roles 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.

Fictional shareholders, acting through the institutionalized portfolio investors, have vastly increased their market power in recent decades.[157] The result, as the "death of corporate law" scholars contend,

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157. In the 1960s, John Kenneth Galbraith could write seriously that shareholders simply were not a factor in corporate decisionmaking, echoing the original Berle and Means thesis. JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (1967) (describing an alliance of top management of large companies and large unions to serve the interests of managerial and unionized employees at the expense of consumers, and the near total neglect of shareholders). For a contemporary critique by the General Electric general counsel, accepting Galbraith's basic position regarding shareholder impotence and unimportance, see Fritz F. Heimann, *Review: Galbraith, The New Industrial State*, 35 U. CHI. L. REV. 207 (1967). Today a suggestion that one could ignore shareholder interests would be ludicrous.

Presumably reflecting this shift in power from employees to shares, real wages have stagnated for 20 years, *see* KRUGMAN, *supra* note 23, at 136 (from 1979-89 a typical worker's real wage decreased while median family income rose at a 0.4% annual rate, despite an increased number of two-income families), while the stock market has increased at a compound annual rate of 10.6% per year since 1967 and 17.6% in Krugman's 1979-89 period. *See* IBBOTSON ASSOCIATES, SBBI YEARBOOK 264 (1995) (total return on S&P 500 compounded annually is 10.6% for the period Jan. 1967 to Dec. 1994 and 17.6% for the 1979-89 period); Fidelity Website: Magellan Fund (http://www.fid-inv.com/mutual/fund-data/EQ/21.html) (S&P 500 total return compounded annually for Sept. 30, 1985 to Sept. 30, 1995 is 16.04%). It is somewhat puzzling why a fully fungible and not terribly important factor of production (only an infinitesimal part of the capital of any major corporation comes from shareholders) should have as much control as is that companies reflect the fictional shareholder's characteristics far more. Public companies are more fluid: less committed to particular projects, people (employees or customers), products or places.[158] They are more aggressive in resisting obstacles to fictional shareholder interests, including unions, environmental and other regulations, basic research in the Bell Labs style, growth of middle-management career ladders, long-term employment commitments or "corporate responsibility" generally.

The issue is not whether this is a good change or a bad one; no doubt it is both. The increased mobility of the real factors of production is, most economists are certain, a prime factor in maintaining economic growth and avoiding the economic sclerosis of the "British Disease" or the former Soviet Union. Deep commitments to large, polluting, unsafe and unreliable cars, white shirts and mainframe computers, or even Time Culture are not necessarily the kind of deep commitments that should be set up as ultimate values. The old independent corporations were solid and stable even when a good deal more change could only have been an improvement; the old steady jobs were, in too many instances, like the pin factory that Adam Smith explained makes the ordinary people stupid.[159]

On the other hand, the same mobility that has rescued us from seatbeltless, gas-guzzling cars and stifling layers of bureaucracy is the mobility that accelerated the changes underlying much of our "crisis of family values." Rapid economic change first made and then as quickly eliminated the jobs that used to allow men without a high school education to support a family. It has shifted us over and over again since World War II—up from the South, into the cities, out

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modern theory—and market reality—grant shareholders. The increased liquidity of the market for corporate control, perhaps accompanied by the increased concentration of (direct) stockholdings with the growth of the institutional shareholdings, seems to be the main cause for greater stockholder power. The literature arguing that the market assures that fictional shareholders will prevail is enormous. *See, e.g.*, Winter, *supra* note 6; Black, *Analysis*, *supra* note 81.

158. Although I mean this to be law professor's casual empiricism in the classic mode, unsupported by quantifiable data and hopefully reflecting the reader's sense of the world, or at least of recent Wall Street Journal career advice columns, one particularly ironic example is the aftermath of the *Paramount* case. After successfully defending its actions based on the need to assure continued dominance of Time's corporate culture, as embodied in its CEO and his heir apparent, the new Time-Warner board oversaw a series of rapid changes in the course of the company, including firing the upper managers whose jobs were so central in the litigation. Contrary to my thesis that shareholder-dominated companies have no commitments to anything (and perhaps contrary to my implicit condemnation of that rootlessness), however, Time Magazine remains just as it always was.

159. SMITH, *supra* note 108, at 301-04 (division of labor makes workers stupid).

again to the suburbs, and into the factories and out again, from the Rust Belt to the Sun Belt, to California and away—in population shifts that sometimes dwarf wartime refugee flows.[160] Even if these movements have been caused as much by the attraction of a booming economy as by the push of declining ones, the problems are not trivial: raising children without grandparents, communities of transients without history or local culture, those left behind in abandoned Flint, the Bronx or the militia-filled rural West. Increased job mobility is the same phenomenon as disrupted families seeking work, children pulled from school to school, employees focusing on resume padding rather than job-specific skills, shattered expectations and waves of hideous "executive homes" covering the exurbs with ersatz mockeries of Tara.

We are Americans. Far too many of us still remember how many of our ancestors fled too-traditional, too-stable societies to embrace the dynamism of a country that remakes itself every half-generation for neo-medievalism or neo-Ludditism to be likely to win longstanding support, the current cries for "traditional family values" notwithstanding. But surely equally few of us are as resolutely uncommitted as the fictional shareholder; few of us are as wholeheartedly supportive as is that creature of a capitalism in which

> constant revolutionizing of production, uninterrupted disturbance of all social conditions, everlasting uncertainty and agitation distinguish the [capitalist era] from all earlier ones. All fixed, fast frozen relations with their train of ancient and venerable prejudices and opinions are swept away, all new formed ones become antiquated before they can ossify. All that is solid melts into air, all that is holy is profaned.[161]

The problem of the fictional shareholders, then, is that corporations acting in their interest will fail to consider both sides of these issues. Like the trustee in *Withers v. Teachers' Retirement System* they will deem the effects on the human beings behind the shareholders to be "simply not a relevant consideration for them in their capacity as

160. In 1992, 815,172 U.S. taxpayers took an itemized deduction for moving expenses for moves of more than 50 miles for job-related reasons. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1992, INDIVIDUAL INCOME TAX RETURNS 35 (1995). By comparison, the famous Palestinian refugee problem of 1948 involved roughly the same number of people, most of whom moved less than 50 miles. This is not to suggest that the difficulty of moving to find a better (or any) job is often comparable to the difficulties encountered by wartime refugees. *But see* JOHN STEINBECK, THE GRAPES OF WRATH (1939).

161. Karl Marx, *Communist Manifesto* (1848) *in* KARL MARX & FRIEDRICH ENGELS, SELECTED WORKS IN ONE VOLUME 38 (1968).

trustees."[162] Our corporations, then, will—indeed must—deem enormously important issues to be out of the scope of their decisionmaking process, focusing on a narrow and inhuman bottom line instead of the true social consequences of their actions. The result is that our corporations are a tremendous force for growth and instability—for one side of perhaps the central conflicts and most difficult tradeoffs of our political and economic lives.

The fictional shareholder focuses our corporate managers' minds admirably. But sometimes we need a little less focus and a little more breadth. The old task of corporate law has been to tie the managers to the shareholders; the new task must be to align the fictional shareholder more closely with us.[163]

162. Withers v. Teachers' Retirement Sys., 447 F. Supp. 1248 (S.D.N.Y. 1978).

163. Traditional corporate law has vacillated between shareholder control and managerial "professionalism." The fictional shareholder approach suggests that these are two aspects of a one-sided coin. Dodd's paean to managerial professionalism, reiterated in some of the modern writings on corporate responsibility and the constituency statutes, is clearly inadequate: It is a key aspect of professionalism to put aside precisely the considerations we need to make more central. Adam Smith wrote that "no one but a beggar chuses to depend chiefly on the benevolence of his fellow citizens." SMITH, *supra* note 108, at 13. We should not have to beg our leading institutions to act in a responsible manner—and we would be foolish to expect them to do so when the dominant role model tells them that it would probably be immoral, if not illegal, to do so.

Similarly, greater "shareholder democracy" cannot help ease the problems discussed in this Article so long as most shares are held by corporate entities that necessarily cannot reflect the views of those behind their own fictional shareholders, or in diversified portfolios where the individual (human) holder's interest in any given corporation is too minuscule for realistic participation. "Pension fund socialism," *see generally* PETER F. DRUCKER, THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA (1976); William H. Simon, *The Prospects of Pension Fund Socialism*, *in* CORPORATE CONTROL AND ACCOUNTABILITY (Joseph McCahery, Sol Picciotto & Colin Scot eds., 1993), is no more likely to benefit the people in whose name it rules than did the vanguard of the proletariat.