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IMPLICATIONS OF SHAREHOLDER DIVERSIFICATION ON CORPORATE LAW AND ORGANIZATION: THE CASE OF THE BUSINESS JUDGMENT RULE

PETER V. LETSOU*

INTRODUCTION

To be sure, there is no single formulation of the nearly two-century-old business judgment rule.[1] But, as is typical in matters of corporate law, the Delaware formulation is probably the best known. Although Delaware's standards have shifted over the years, since 1984 the Delaware Supreme Court has consistently characterized the business judgment rule as:

> [A] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts[, with t]he burden [being] on the party challenging the decision to establish facts rebutting the presumption.[2]

As a practical matter, the presumption established by the business judgment rule is all but impossible to overcome, at least in cases where directors lack any apparent conflict of interest. In that context, shareholder-plaintiffs are required to show either that the substance of the challenged business decision was so egregious that "no reasonable business person would have made the decision,"[3] or that

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1. The business judgment rule has been traced to three nineteenth-century decisions: Smith v. Prattville Mfg. Co., 29 Ala. 503 (1857); Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829); and Hodges v. New England Screw Co., 1 R.I. 312 (1850). *See generally* Marcia M. McMurray, Note, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605 (1987).

2. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted). For a leading discussion of pre-Aronson formulations of the business judgment rule, see S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

3. Brehm v. Eisner, 746 A.2d 244, 264, 266 (Del. 2000) (noting that "[i]rrationality is the outer limit of the business judgment rule" and that "[i]rrationality may be the functional equivalent of the waste test," which requires a showing that "no reasonable business person

the board was grossly negligent in informing itself of all material information reasonably available to it before acting.[4] To my knowledge, the former showing has never been made (at least in a case involving an award of money damages),[5] and the latter only rarely.[6] So in Delaware, the business judgment rule goes much of the way towards putting disinterested business decisions beyond judicial scrutiny.[7]

In other jurisdictions, the protections afforded to corporate officers and directors by the business judgment rule may not be as powerful. For instance, the American Law Institute's *Principles of Corporate Governance* states that a director who makes a business

would have made the decision ... under [the particular] circumstances"); *see also* Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1246 (Del. 1999) ("The presumptive validity of a business judgment is rebutted in those rare cases where the decision under attack is 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'" (quoting *In re* J.P. Stevens & Co., 542 A.2d 770, 780–81 (1988))); *In re* 3COM Corp. S'holders' Litig., No. C.A. 16721, 1999 WL 1009210, at *4 (Del. Ch. Oct. 25, 1999) (stating that to establish a claim of waste the plaintiff must "establish a complete *failure* of consideration" or acts that were "so blatant that *no* ordinary business person would ever consider the transaction to be fair to the corporation"); Zupnick v. Goizueta, 698 A.2d 384 (Del. Ch. 1997). In *Zupnick*, the court stated:

> To state a cognizable claim for waste where there is no contention that the directors were interested or that shareholder ratification was improperly obtained, the well-pleaded allegations of the complaint must support the conclusion that "no person of ordinary, sound business judgment would say that the consideration received for the options was a fair exchange for the options granted." That is "an extreme test, very rarely satisfied by a shareholder plaintiff," because "if under the circumstances any reasonable person might conclude that the deal made sense, then the judicial inquiry ends."

Id. at 387 (citations and footnotes omitted).

4. *Brehm*, 746 A.2d at 259.

5. *See* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049 (Del. Ch. 1996). The *Gagliardi* court noted:

> There is a theoretical exception to this general statement that holds that some decisions may be so "egregious" that liability for losses they cause may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has resulted in no awards of money judgments against corporate officers or directors in this jurisdiction and, to my knowledge only the dubious holding in this Court of *Gimbel v. Signal Companies, Inc.*, seems to grant equitable relief in the absence of a claimed conflict or improper motivation.

Id. at 1051–52 (citation omitted).

6. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

7. S. Samuel Arsht, a leading Delaware attorney who served as chairman of the drafting committee that prepared the 1967 revision of the Delaware General Corporation Law, offered a spirited challenge to this interpretation of Delaware law in a 1979 article in the *Hofstra Law Review*. *See* Arsht, *supra* note 2. In that article, Mr. Arsht suggested that "the primary function of the business judgment rule may be simply to accord to directors the same necessary protection that professionals [(such as doctors and lawyers)] enjoy under Anglo-American tort law if sued for malpractice." *Id.* at 97. This view of the business judgment rule is not one that has found wide support. *Cf.* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (Winter, J.) ("While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading.").

judgment fulfills his duty of care to the corporation only if he "is informed with respect to the subject of the business judgment to the extent [he] reasonably believes to be appropriate under the circumstances," and he "rationally believes that the business judgment is in the best interests of the corporation."[8] Similarly, new section 8.31 of the Revised Model Business Corporation Act provides that a director can be held liable to the corporation or any shareholder for a good faith, disinterested business decision if the "director did not reasonably believe" the decisions "to be in the best interests of the corporation," or "the director was not informed to an extent the director reasonably believed appropriate in the circumstances."[9] These standards suggest somewhat greater judicial scrutiny of disinterested business decisions than would be applied in Delaware. But even so, something more than a showing of ordinary negligence is clearly required before liability can be imposed. And, in any case, even under the more liberal standards that exist outside of Delaware, few cases can be found that actually impose liability on corporate directors for flawed, but disinterested, business decisions.[10]

What explains the traditional reluctance of courts to second-guess business decisions made by disinterested directors? This question is particularly puzzling given the considerably greater willingness of courts to second-guess decisions of other professionals, such as doctors, lawyers and engineers.[11] Over the years, courts and commentators have offered a variety of explanations for the deference afforded directors. These include: (1) the limited ability of judges and juries who are not business experts to evaluate compli-

8. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 4.01(c) (1994).

9. REV. MODEL BUS. CORP. ACT § 8.31 (2001).

10. *See* Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099–1100 (1968) (finding only four cases where directors of industrial, as opposed to financial, corporations had been held potentially liable for negligence in the absence of self-dealing); *see also Joy*, 692 F.2d at 885. In *Joy*, Judge Winter writes:

> Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation.

Id. (citing Symposium, *Officers' and Directors' Responsibilities and Liabilities*, 27 BUS. LAW. 1 (1971); MORTIMER FEUER, PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS 28–42 (2d ed. 1974)).

11. For a comparison of the business judgment rule with liability standards that apply to doctors, see Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587 (1994).

cated business decisions, (2) the need to encourage entrepreneurial risk taking by corporate directors who might otherwise avoid business risks (or even refuse to serve) if they faced potential negligence liability, (3) the availability of other mechanisms, such as employment and securities markets, to provide corporate directors with incentives to avoid mismanagement and (4) the voluntary assumption by shareholders of business risk in exchange for a potential return on their investment which is contractually unlimited.[12] The difficulty with these rationales, as will be explored more fully below, is not so much that they lack truth (though this is sometimes the case), but rather that they frequently "prove too much" because they "apply with equal force to numerous other situations in which the rule of ordinary negligence commonly applies."[13]

Against this backdrop, this Article develops a different explanation for the business judgment rule, one that focuses on the special preferences of *diversified* shareholders. As is explained more fully below, shareholders are unique among legal principals in their ability to diversify away much of the risk (i.e., uncertainty as to future outcomes) associated with acts of their agents, the corporation's officers and directors. Indeed, the analysis in Part III suggests that shareholders can typically diversify away as much as 80 to 90 percent of the risk associated with an individual project.[14] Because shareholders need not take risks that they can eliminate through diversification, shareholders generally prefer their agents to ignore such risks in assessing the adequacy of project returns. By insulating managers from personal liability for corporate losses, the business judgment rule helps achieve this goal.[15]

12. *See generally* 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1037 (perm. ed., rev. vol. 1994).

13. *See* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 304–05 (1994).

14. *See infra* note 75 and accompanying text.

15. It should be noted that the theory offered here cannot explain the apparent adoption of the business judgment rule in the early nineteenth century, when few investors could obtain the benefits of diversification. In this regard, it is interesting to note that many of the earliest business judgment cases appear to have used the language of ordinary negligence. *See generally* McMurray, *supra* note 1. Indeed, in his article noted above, Mr. Arsht relied on many of these early cases to support his argument that the business judgment rule afforded directors no more protection than that provided to other professionals, such as doctors and lawyers, in professional malpractice actions. *See* Arsht, *supra* note 2. So it is at least possible that the modern, more protective form of the business judgment rule is of more recent vintage. It should also be noted that the arguments advanced in this Article do not necessarily extend to closely held corporations, where many shareholders may lack sufficient resources to fully diversify away the firm-specific risk associated with their investment.

Professors Fischel and Bradley hint at a similar explanation for the business judgment rule in their path-breaking article, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*.[16] They note, among other things, that:

> If agents are penalized for poor outcomes, as well as poor performance, they will tend to undertake lower risk projects. This tendency to cause agents to behave in a more risk-averse manner is itself a potentially large cost of liability rules as a governance mechanism in contractual situations where principals want agents to behave in a more risk-neutral manner.[17]

But while Professors Fischel and Bradley suggest differing preferences of diversified shareholders and directors for risk as one basis for the business judgment rule, they devote only two paragraphs of their paper to the point. This brevity has, in my view, caused at least two problems: first, Fischel and Bradley's point is often missed (or misunderstood), possibly because it is seen as embodying little more than the concern that risk-averse directors, who can be sued on ordinary negligence principles, will avoid riskier courses of action that shareholders may prefer, a concern that inheres in *all* principal-agent relationships (i.e., doctor-patient and lawyer-client, as well as shareholder-manager); and second, Fischel and Bradley's brief analysis is incomplete, for, as will be explored later, while diversified shareholders want managers to ignore the variance in potential future returns from some types of project risks (i.e., diversifiable ones), they still want managers to pay close attention to the variance from others (i.e., nondiversifiable or market risks), as well as to the overall level of a project's expected returns. Accordingly, while the business judgment rule offers the benefit of insulating managers from components of risk that diversified shareholders want ignored, the rule comes at the cost of weakening legal incentives to consider other relevant factors. Thus, differing preferences of managers and shareholders for business risk can only support the business judgment rule if the benefits from the rule exceed the costs.

Fischel and Bradley emphasize that the *costs* of the business judgment rule are low, largely due to the availability of other mechanisms to constrain managerial misconduct.[18] But Fischel and

16. Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986).

17. *Id.* at 270; *see also* Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1442 (1985).

18. Fischel & Bradley, *supra* note 16, at 274–76.

Bradley pay less attention to the magnitude of the *benefits* from the business judgment rule, leaving the ultimate balance between costs and benefits uncertain. In addition, Fischel and Bradley's focus on the limited costs of the business judgment rule does little to distinguish corporate managers from other professionals, such as doctors and lawyers, who also face important constraints on their conduct apart from legal liability to patients and clients for professional malpractice. Accordingly, a fuller development of the connection between the preferences of the diversified shareholder and the business judgment rule is both appropriate and necessary.

The analysis below proceeds as follows: Part I discusses the meaning of investor diversification and its impact on shareholder preferences for the conduct of corporate managers; Part II explains and critiques the traditional justifications for the business judgment rule; Part III develops the link between the preferences of diversified shareholders and the business judgment rule.

I. THE MEANING OF DIVERSIFICATION AND ITS IMPACT ON INVESTOR PREFERENCES

The concept of diversification is a familiar one, both to the sophisticated student of corporate finance and to the casual investor. Quite simply, diversification refers to the practice by investors of investing their capital in a larger number of companies rather than a smaller number. Investors can diversify their investment portfolios directly by instructing their brokers to purchase relatively small numbers of shares in a relatively large number of companies, or indirectly by purchasing shares in one or more mutual funds whose holdings include investments in many different firms.

The principal benefit of diversification is that it eliminates a large portion of the risk associated with investing. This means that a diversified investor is better able to predict the future value of his investment portfolio than is an undiversified one. In other words, the range of potential future outcomes faced by the diversified investor is narrowed.

An example can illustrate the capacity of diversification to reduce the risk of investing. Consider an investor who has $400 and two investment options. Option #1 is to invest the full $400 in the stock of a single company, which will dedicate that $400 (and money obtained from other investors) to a single project whose outcome is not certain. The results of the company's investment will be determined at the

end of one year by flipping a coin: if the coin comes up heads, the company will earn a 150% return on the invested funds, so that the investor will receive a total of $1,000 at the end of the year; if, on the other hand, the coin comes up tails, the company's investment in the project will be lost, and the investor will receive nothing. Option #2 is to invest 40 cents in each of 1,000 different companies, each of whom will invest the 40 cents (together with funds received from other investors) in a single project with the same risk and return characteristics as the project considered under Option #1. Accordingly, the success or failure of each project will be determined by a separate coin flip at the end of one year, with heads meaning success and a 150% return on the invested funds (or a $1 return on a 40 cent investment) and tails meaning failure.

The outcome of the second investment option is far more certain for the investor than the first. Assuming that we use a fair coin to determine the outcome of each of the 1,000 projects (i.e., a coin with a 50% probability of coming up heads and a 50% probability of coming up tails), we can be very certain that the investor who chooses Option #2 will end up with $500 (or something very close to it) at the end of one year, since 1,000 coin flips will likely yield approximately 500 heads and 500 tails. The outcome of the second investment option, however, could not be more uncertain: after one year, the investor will have either $1,000 or nothing, depending on the outcome of a single flip of a coin. So by choosing Option #2, the investor can eliminate much of the risk (i.e., uncertainty) associated with investing, even if he has no idea which of the companies in his portfolio will prove to be winners and which will prove to be losers.

To be sure, even the diversified investor under Option #2 still faces some uncertainty. For instance, we cannot be certain that 1,000 coin flips will result in precisely 500 heads and 500 tails; we could have 510 heads and 490 tails, 487 heads and 513 tails, or, less likely, even greater disparities. In addition, it is at least possible that coins of the future may be manufactured so that heads and tails are no longer equally probable. In other words, there may be risks that are endemic to the entire market, such as movements in interest rates, changes in technology, and shifts in consumer spending. (The risks which remain even when investors have diversified to the fullest extent possible are generally referred to in the finance literature as *market*, *systemic* or *undiversifiable* risk,[19] while those that can be

19. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE

eliminated through diversification are referred to as *unique*, *unsystemic*, *residual*, *specific* or *diversifiable* risk.[20]) But even taking full account of the market risks present in my example, we still end up with the result that the diversified investor in Option #2 faces less risk (or uncertainty) than the undiversified investor in Option #1: the undiversified investor will have either nothing or $1,000 after one year, while the diversified investor faces, at worst, a continuum of results from zero, on the one hand, to $1,000, on the other, with the precise distribution depending on the level of market risk.

For the typical investor who dislikes risk, diversification is clearly the rational investment strategy to follow. This is because diversification allows the investor to eliminate risk without sacrificing financial return. A return to the two investment options considered above illustrates this result. For both Option #1 and Option #2, the *expected return* (i.e., the probability weighted average of all potential outcomes) is $500.[21] But while Option #1 and Option #2 have the same expected return, Option #2 provides that return while subjecting the investor to a lesser degree of risk. Accordingly, for the typical investor who requires additional financial returns in order to entice him to take additional risk, Option #2 (diversification) is the sensible choice. And indeed, diversification appears to be the strategy that most investors follow, as illustrated by the present-day popularity of mutual funds.

That diversification makes sense for *most* investors does not mean, however, that diversification makes sense for *all* investors. For instance, investors who enjoy preferential access to information about particular companies may choose to "de-diversify" (i.e., hold more or less of the stock of that company than a diversified investor would) in order to maximize their gains by trading based on that information.[22] Corporate managers may agree to accept a portion of their compensation in company stock or options to improve their incentives to manage more efficiently, provided that the value of the stock and

156 & n.15 (5th ed. 1996). This Article refers to this type of risk as "market risk."

20. *Id.* at 156 & n.14. This Article refers to this type of risk as "diversifiable risk."

21. In the case of Option #1, we have a 50% probability of a $1,000 payoff and a 50% probability of zero payoff, for an *expected* payoff of (.5 × $1,000) + (.5 × $0) or $500; in the case of Option #2, we have 1,000 separate investments, each of which has a 50% probability of a $1.00 payoff and a 50% probability of a zero payoff, for an expected payoff of 1000 × [(.5 × $1.00) + (.5 × $0)] or $500.

22. For a discussion of de-diversification to gain profits from insider trading, see Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088 (1994).

options exceeds the cash compensation foregone by a sufficient amount to compensate for the additional risk. Institutional investors who believe that public companies may be made more valuable if investors actively monitor management may choose to de-diversify in order to capture a greater share of the benefits (i.e., increase in stock price) that result from their monitoring. And still other investors may choose to de-diversify in order to reap the gains associated with taking over publicly held companies whose performance appears to be lagging. In each of these instances, the extra returns from de-diversifying may well offset the costs (i.e., taking on uncompensated, diversifiable risk). Finally, even some ordinary investors may choose to de-diversify for much the same reason that people buy lottery tickets and travel to Atlantic City or Las Vegas: these investors are risk-preferring (rather than risk-averse), albeit with respect to a greater portion of their wealth than is typical. But despite these departures, diversification undoubtedly remains the dominant investment strategy.

We then come to the $64,000 question: How do diversified investors want managers of the firms in which they invest to behave? Financial economics gives an answer that is easy to state, but somewhat more difficult to understand: all diversified investors (regardless of the compositions of their particular portfolios) want corporate managers to invest in projects that have a *positive net present value*, meaning projects that offer a rate of return on invested funds that is superior to the return that the market demands for an investment of comparable *market* (rather than overall) risk. The reason for this focus on market risk is that market risk is the only component of project risk that the diversified investor takes; all other components of project risk are irrelevant because they are offset by the diversified investor's other holdings.

To illustrate the operation of the net present value rule, consider a world in which financial markets demand a rate of return of 5% on investments with no sensitivity to market risk (i.e., investments whose outcomes are independent of movements in the market as a whole). An example of such an investment might be a government bond, which for all intents and purposes is considered to be risk free. Under such circumstances, investors want the firm's managers to accept any project of comparable market risk (i.e., zero in this example) that offers a rate of return greater than 5%. And they want managers to make this choice even if the particular project, when examined in isolation, is extremely risky because of the presence of a high level of

diversifiable risk. In other words, in determining whether the expected returns from a particular project are sufficient to compensate for risk, diversified investors want the firm's managers to ignore all uncertainty associated with the project that can be eliminated through diversification, *even if the firm itself is not diversified.*

The rationale for the net present value rule is simple: if all corporate managers follow the net present value rule, then the market value of the diversified investor's portfolio will increase. Again, an example can best illustrate the proposition. In Option #2 discussed above, the investor made 1,000 different investments of 40 cents each. Does the investor want the managers of the firms in which he has invested to accept the projects discussed earlier—i.e., projects that have a 50% probability of generating a 150% return after one year (meaning a $1.00 return on a 40 cent investment) and a 50% probability of returning nothing? Assuming for purposes of the following analysis that financial markets demand a 5% return on a risk-free investment, the answer is yes.

If we know for sure that a fair coin will be used to determine the outcome of each of the 1,000 projects, each of the 1,000 projects has no market risk. In other words, the success or failure of any particular project is independent of the success or failure of any other. Accordingly, the net present value rule implies that each project should be accepted so long as its expected rate of return exceeds 5%, the rate of return the market demands for risk-free investments. Under the facts provided, the expected rate of return for each project is 25% (i.e., a 50% probability of a 150% return and a 50% probability of a 100% loss or $.5 \times 150\% + .5 \times [-100\%]$ or 25%). Because this exceeds the market rate of return for an investment of comparable market risk, the net present value rule dictates acceptance of the project.

What happens to the value of the diversified investor's portfolio if the managers of each of the 1,000 firms act in accordance with the net present value? Before the managers made the investment decision required by the net present value rule, the investor under Option #2 had a portfolio worth $400 (1,000 separate investments worth 40 cents each). If each manager makes the investment that the net present value rule requires, then we know that the investor's portfolio will almost certainly be worth $500 after one year (i.e., the coin will come up heads in 500 cases and tails in 500 cases, meaning that the total payout to the investor will be $500). In an economy where the market rate of return on an investment with no market risk

is 5%, the present value of the investor's portfolio, assuming each company accepts the 50/50 bet under Option #2, will be approximately $476 (i.e., $500/[1 + .05])—that is, an investor will pay $476 today for a risk-free promise of $500 in one year. So by ignoring the diversifiable risk associated with the project in assessing the adequacy of the project's expected returns, the firm's managers have increased the value of the investor's portfolio from $400 to $476.

If, however, the managers of the various firms ignore the dictates of the net present value rule and consider diversifiable risk, as well as market risk, in evaluating the project under consideration, we get a different result. In this instance, the managers will consider whether the expected rate of return of 25% is sufficient to compensate, not for a sure thing, but for an investment that might be worth a lot in one year or might be worth nothing at all. That range of potential outcomes represents a high degree of risk; accordingly, it is at least possible that managers would deem a 25% expected return insufficient to compensate for project risk. As a consequence, all managers may elect to reject the proposed investment with the result that the investor will be left with a portfolio worth only $400, a far less desirable result than if the dictates of the net present value rule had been followed.

It should be noted that the example considered above involved a project with zero market risk. But the result that the value of the diversified investor's portfolio increases if managers follow the net present value rule holds equally well for projects where some market risk remains even for investors who have diversified their investment portfolios to the fullest extent possible: so long as the project's expected rate of return is greater than the market rate of return for projects of comparable market (rather than overall) risk, the value of the diversified investor's portfolio will increase if corporate managers accept the project.

It should also be noted that the result that diversified investors benefit if managers follow the net present value rule in no way depends on the composition of the particular investor's portfolio. Some investors may like portfolios with higher levels of market risk and correspondingly higher levels of expected returns (i.e., portfolios rich in internet and biotech stocks), while other investors prefer lower levels of market risk and correspondingly lower levels of expected returns (i.e., portfolios that match broader indices like the S&P 500,

perhaps mixed with more conservative investments like government bonds).[23] But both sets of investors (those who prefer higher risk portfolios and those who prefer lower risk portfolios) benefit when managers follow the net present value rule, even when following the net present value rule results in an alteration of the overall risk of the investor's portfolio. To see why this is so, consider the position of an investor who prefers high risk and high returns *after* the managers of one company in his portfolio make a new low risk investment that is required by the net present value rule. This new investment may result in a portfolio with lower risk and lower expected returns than the investor prefers. But the investor is nonetheless made better off by the new investment because he can sell his new higher valued portfolio, use the cash generated from the sale to purchase a portfolio with the risk and return attributes of his original portfolio, and pocket the leftover cash. We know there will be cash left over because the new portfolio created by following the net present value rule necessarily has a higher market value than the old one. The same result holds for an investor who sees the risk of his portfolio increased as the result of an investment decision dictated by the net present value.[24]

Accordingly, if the world included only diversified shareholders, the net present value rule, which requires managers to ignore *diversifiable* risk when evaluating the expected return from firm projects, would clearly be the rule of choice. But as noted earlier,[25] not all investors are diversified, because, in at least some instances, the extra returns available from de-diversifying may more than compensate for the extra risk. Undiversified investors care about both the *market* risk and the *diversifiable* risk of any new investment

23. Under ideal circumstances, all investors would hold the same market portfolio and satisfy their individual preferences for risk and return by either borrowing or lending at the risk-free rate of interest. Those who wanted lower risk and lower return would lend some of their money at the risk-free rate of interest (i.e., replace a portion of their investment in the market portfolio with government bonds), while those who wanted higher risk and higher return would increase their investment in the market portfolio by borrowing at the risk-free rate of interest. That each investor should put his money in two benchmark investments—the market portfolio and risk-free loans or borrowing—is known as the Separation Theorem and was first put forth by J. Tobin in J. Tobin, *Liquidity Preference as Behavior Towards Risk*, 25 REV. ECON. STUD. 64 (Feb. 1958). In fact, all investors do not behave as the Separation Theorem predicts, in large part, because many investors are not able to borrow at the risk-free rate of interest. Accordingly, investors who prefer higher risk and higher returns often satisfy their preferences by purchasing higher risk portfolios. *See generally* BREALEY & MYERS, *supra* note 19, at 179; LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS app. at 6–8 (3d ed. 1996).

24. Nor does the result depend upon the timing preferences of investors. *See* BREALEY & MYERS, *supra* note 19, at 17–24.

25. *See supra* note 22 and accompanying text.

because, by definition, their holdings are not spread thinly enough to fully eliminate the diversifiable risk associated with a new investment. Accordingly, we would expect undiversified investors to want their agents, the firm's managers, to care about diversifiable risk as well. The question then arises: Does the presence of undiversified investors in the marketplace undermine the net present value rule as the guiding principle for corporate managers?

The answer to this question is no. First, diversification appears to be the dominant strategy in the marketplace, so the losses from departing from the net present value rule would likely exceed the gains. Second, at least some undiversified investors will only be undiversified for short periods of time, such as when they are in possession of nonpublic information that they may use to generate trading profits. Third, many other undiversified investors, such as institutional investors who engage in active monitoring, are undiversified for the very purpose of ensuring that stock prices rise (i.e., for ensuring that managers follow the net present value rule). Such investors will only profit from de-diversifying if the firm's stock price rises in the long-term, a goal which may be jeopardized if short-term departures from the net present value rule are regularly tolerated.

Finally, even undiversified investors will generally benefit from managerial decisions that follow the dictates of the net present value rule. First, such decisions will result in increases in the market price of the firm's shares, even if they also result in increases in the diversifiable risk faced by undiversified investors. This result follows because diversified investors, who, by definition, are indifferent to diversifiable risk, determine the market price of a firm's shares.[26] Second, because diversifiable risk is not priced in the marketplace (i.e., securities with high levels of diversifiable risk sell for the same price as securities with low levels of diversifiable risk, assuming their market risks and expected returns are the same), undiversified investors should be able to readjust the diversifiable risk of their portfolios at a relatively modest cost by swapping securities with higher levels of diversifiable risk for ones with lower levels of diversifiable risk. Accordingly, as long as the transaction costs associated with these risk-adjusting trades are less than the increases

26. That diversified investors determine the market price of a firm's shares is implicit in the Capital Assets Pricing Model, which predicts that investors should be concerned primarily with risks that cannot be eliminated through diversification. This aspect of the Capital Assets Pricing Model has broad support. *See* BREALEY & MYERS, *supra* note 19, at 184.

in the market value of the undiversified investor's shares, undiversified investors, as well as diversified ones, should generally benefit from managerial decisions that follow the net present value rule.

That managers should follow the net present value desired by diversified investors has been challenged by some. For instance, Professor Richard Booth has argued that management duties should not be defined with reference to the interests of diversified shareholders because doing so "[(1)] would require management to identify a single clientele of investors whose interests should be served, [(2)] would often lead management to undertake strategies which were redundant of cheaper stockholder strategies and [(3)] would sometimes compel management to divert returns which would ordinarily flow to other constituencies."[27] Instead, Professor Booth argues "it is probably the better view that management duty should be interpreted as if it is owed to the corporation or to a reasonable undiversified stockholder."[28] Professor Booth's arguments are, in my view, flawed.

First, Professor Booth is not correct when he states that focusing on diversified shareholders is impractical because it requires management to consider the wealth effects of its decisions "in many different portfolios with many different goals."[29] As the above discussion of the net present value rule demonstrates,[30] and as corporate finance texts confirm, the beauty of the net present value rule is that it enables managers to make capital investment decisions without "know[ing] anything about the personal tastes of their shareholders. . . . Their task is to maximize net present value. If they succeed, they can rest assured that they have acted in the best interests of their shareholders."[31] Clearly, the net present value rule rests on assumptions, such as well-functioning capital markets, that may not always hold.[32] But the available evidence suggests that capital markets function fairly well, and that the net present value rule generally furthers the interests of shareholders, even if imperfect markets and transactions costs sometimes cause it to fail.[33]

27. Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 447 (1998).

28. *Id.* at 456.

29. *Id.* at 447.

30. *See supra* p. 188–89.

31. BREALEY & MYERS, *supra* note 19, at 24.

32. *Id.*

33. *Id.* at 23–24.

Second, Professor Booth's statement that a focus on diversified shareholders would frequently lead management to undertake strategies which are redundant of cheaper stockholder strategies is not supported by the evidence. The suggestion here appears to be that managers who focused on the interests of diversified shareholders would pursue such strategies as company-level diversification through the formation of conglomerates, even though the best evidence suggests that shareholders dislike company-level diversification (because even shareholders of modest means can diversify more easily and cheaply on their own).[34] The problem with Professor Booth's analysis is that there is no reason to believe that a diversified shareholder would favor company-level diversification. Indeed, there is every reason to believe just the opposite because a shareholder who is fully diversified has absolutely nothing to gain from further diversification by the companies in which he invests.

Third, we come to Professor Booth's statement that focusing on the interests of diversified shareholders would sometimes compel management to divert returns that would ordinarily flow to other constituencies, such as creditors. This may indeed be the case, particularly as a company nears bankruptcy, because shareholders of nearly insolvent firms have little to lose and everything to gain by causing the firm to speculate with assets that, in effect, belong to the firm's creditors. But throwing out the net present value rule because of its perverse effects on companies nearing bankruptcy seems to be overkill. The better solution, I believe, is the one the courts have generally adopted: extending fiduciary duties of managers to the firm's creditors when the firm nears insolvency.[35]

34. Booth, *supra* note 27, at 451–52.

35. *See, e.g.*, LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 292 (D. Del. 2000) (holding that officers and directors of an insolvent corporation have a "fiduciary duty to act in the best interests of the estate as a whole, *including its creditors*, equity interest holders and other parties in interest") (emphasis added); Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 300 (Bankr. D. Mass. 1997) (stating that directors owe fiduciary duties of care and loyalty to creditors when a transaction leaves the corporation "insolvent or with unreasonably small capital," so the trustee in bankruptcy can sue directors even though the challenged transaction did not injure the corporation's stockholders); Odyssey Partners v. Fleming Cos., 735 A.2d 386, 420 (Del. Ch. 1999) (rejecting stockholder complaints that the board should have filed for bankruptcy, rather than allowing foreclosure action, because the board of an insolvent corporation was "obligated to consider and protect interests other than those of the stockholders"; the effect of corporate action on "shareholders, creditors and other corporate constituencies" had to be balanced); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. C.A. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."). *See generally* Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of*

Finally, we face what I believe is the most problematic part of Professor Booth's analysis: his statement that shareholders would be better off if management duties were defined with respect to the "reasonable undiversified shareholder." First, because each undiversified shareholder's portfolio will be marked by a different level of diversifiable risk, there is simply no single reasonable undiversified shareholder to whom managers can refer in assessing the impact of a new corporate project; that is, the same project may result in an increase in diversifiable risk for one investor and a decrease for another. Indeed, the differences among undiversified investors are likely to be far greater than the differences among diversified ones, particularly given the ability of all diversified investors to agree on the rationality of the net present value rule. Second, the evidence that Professor Booth cites to support his view that shareholders favor defining management duties with reference to undiversified investors is equivocal at best. Professor Booth relies primarily on the decision by many companies to "pay a substantial portion of compensation in the form of stock options."[36] Professor Booth argues that this decision causes management to view decisions more as an undiversified investor would.

But there is another way to view option compensation that is consistent with the preferences of diversified shareholders for the net present value rule. Insiders typically make large human capital investments in their firms (i.e., investments in skills that have reduced value outside the particular firm), with the result that they are exposed to a high degree of *downside* firm-specific risk: if the firm fails, these firm-specific investments will be lost.[37] Accordingly, insiders have a difficult time ignoring the firm-specific risk that diversified shareholders wish them to ignore in assessing the adequacy of project returns. Compensating insiders with options provides a partial solution to this problem by allowing insiders to share in the *upside* benefits of firm-specific risk (thereby offsetting, at least to some extent, the downside risk they face because of firm-specific human capital investments). Indeed, the ability of options to permit insiders to share in the upside benefits of corporate risk taking without magnifying their downside exposure may partly explain the popularity of option, as opposed to stock, compensation. Thus,

the Financially Troubled Company, 48 BUS. LAW. 239 (1992).

36. Booth, *supra* note 27, at 453.

37. *See* Fischel & Bradley, *supra* note 16, at 269–70.

compensating insiders with options may make it easier for managers to act in the interests of diversified investors, not more difficult.

In short, Professor Booth's arguments do not provide persuasive reasons for abandoning the net present value rule favored by diversified shareholders as a basic guide for corporate managers.

II. TRADITIONAL JUSTIFICATIONS FOR THE BUSINESS JUDGMENT RULE

As the analysis in Part III below will illustrate, the insights from the financial theory discussed above, particularly the insights from the net present value, provide a powerful explanation for the modern business judgment rule. But before turning to a closer examination of the implications of the net present value rule, this Article will first examine some of the traditional justifications offered for the business judgment rule. As noted earlier, these explanations include: (1) the limited ability of judges and juries who are not business experts to evaluate complicated business decisions, (2) the need to encourage entrepreneurial risk taking by corporate directors who might otherwise avoid business risks (or even refuse to serve) if they faced potential negligence liability, (3) the availability of other mechanisms, such as employment and securities markets, to provide corporate directors with incentives to avoid mismanagement and (4) the voluntary assumption by shareholders of business risk in exchange for a potential return on their investment which is contractually unlimited.[38] The difficulty with these rationales, as indicated earlier, is not so much that they lack truth (though this is sometimes the case), but rather that they frequently "prove too much" because they "apply with equal force to numerous other situations in which the rule of ordinary negligence commonly applies."[39] In particular, many of the rationales commonly offered in support of the business judgment rule would seem equally applicable to doctors, lawyers and others who are subject to the considerably more demanding liability rules of ordinary tort law.

Probably the most common explanation for the deference afforded to corporate directors under the business judgment rule is that "judges simply lack the information and skill necessary to evaluate business judgments."[40] For example, in *Shlensky v. Wrigley*,[41] a

38. *See* 3A FLETCHER ET AL., *supra* note 12, § 1037.
39. Gevurtz, *supra* note 13, at 304–05.
40. *See* 3A FLETCHER ET AL., *supra* note 12, § 1037, at 42.

minority shareholder of the Chicago Cubs baseball team challenged Philip Wrigley's refusal to install lights at Wrigley Field in Chicago, alleging, among other things, that (1) all other major league baseball teams scheduled games at night, (2) attendance at night games substantially exceeded attendance at day games and (3) the funds for the installation of lights could be easily obtained. Relying on the business judgment rule, the court dismissed the complaint for failure to state a claim. In rendering its decision, the court stated, "[it did] not mean to say [it had] decided that the decision of the directors [not to install lights] was a correct one."[42] That determination, the court stated, was simply "beyond [its] jurisdiction and ability."[43]

As others have noted, this justification is problematic at best, because it "would apply equally to a large number of cases outside of the corporate law area where negligence liability is routinely imposed."[44] For example, "judges often have to decide exceedingly technical factual issues in tort and contract cases, yet no one suggests that . . . a manufacturer should be free to negligently design a jet engine on the ground that judges are too dim to decide such issues."[45] Along the same lines, Judge Easterbrook and Professor Fischel ask "why the same judges who decide whether engineers have designed the compressors on jet engines properly, whether the farmer delivered pomegranates conforming to industry specifications, and whether the prison system adversely affects the mental status of prisoners cannot decide whether a manager negligently failed to sack a subordinate who made improvident loans."[46] Finally, as Professor Gevurtz has noted, it is not difficult to imagine a single decision that would, at once, be scrutinized under ordinary negligence principles in an action brought by third parties, but be protected by the business judgment rule in an action by corporate shareholders. As an example, Professor Gevurtz offers a variation on the Exxon Valdez oil spill, where a board of directors decided to construct a tanker with a single hull, rather than a double hull which might have avoided a catastrophic spill. Professor Gevurtz notes that a suit by coastal property owners damaged by an oil spill from the tanker would

41. 237 N.E.2d 776 (Ill. App. Ct. 1968).
42. *Id.* at 780.
43. *Id.*
44. 3A FLETCHER ET AL., *supra* note 12, § 1037, at 42.
45. 3A *id.*
46. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 94 (1991).

undoubtedly be governed by ordinary negligence principles, while a challenge to the same decision by corporate shareholders would be protected from scrutiny by the business judgment rule.[47]

A second rationale for the business judgment rule focuses on the concern that negligence liability would discourage directors from entrepreneurial risk taking, the very kind of action that shareholders wish to encourage. This rationale finds its clearest statement in the American Law Institute's *Principles of Corporate Governance*: "The basic policy underpinning of the business judgment rule is that corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove the judgments right or wrong) in order to stimulate risk taking, innovation and other creative entrepreneurial activities."[48] The idea underlying this rationale for the business judgment rule is that actions that involve considerable risk for the corporation may often be in the shareholders' best interests. In the terms of financial economics, these risky strategies may often constitute the highest net present value opportunities available to the corporation, even when discounted for the risk they entail. So shareholders will want managers to accept these opportunities, even though they realize that there can be no guarantee of success. But if managers face potential *personal* liability if less favorable outcomes result, they may steer

47. Gevurtz, *supra* note 13, at 325–26. Professor Gevurtz notes a variation on the "expertise" justification for the business judgment rule. He writes as follows:

> If judicial expertise cannot justify different treatment, perhaps there is something about the nature of business decisions which renders review more speculative. A number of courts and writers have made the argument that each business decision is unique, heavily intuitive, and judgmental. These qualities, such courts and writers assert, both undermine the accuracy of after-the-fact review and are not true of other fields.

Id. at 308. For a good example of an argument along the lines suggested by Professor Gevurtz, see Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984); *see also* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (Winter, J.) (noting that "[t]he circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information"; so "a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge"). Professor Gevurtz rejects these arguments, contending that many professionals (not just business people) "undertake[] actions in unique situations based upon intuition and experience, without being able to articulate the exact reason for the course of action." Gevurtz, *supra* note 13, at 309. He concludes: "To the extent this sort of intuitive 'knowing in action' does not lend itself to an accurate after-the-fact judicial assessment of reasonableness, then perhaps there is a need to rethink the standards of malpractice generally." *Id.*

48. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS, pt. IV, introductory note (a) (1994); *see also* E. Norman Veasey & William E. Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 931–32 (1980).

clear of these risky opportunities. That is, as between two business opportunities, one which involves a considerable risk of legal liability because its results are uncertain (i.e., the results may be very good or they may be very bad), and one which involves little risk of personal liability because the outcome is clear, corporate managers may choose the latter, even though, on net present value terms, shareholders prefer the former.[49]

This rationale for the business judgment rule suffers from the same flaw identified above: the same concerns with deterring risk taking apply equally in law, medicine and a host of other fields, because in those fields, as well as in business, risky strategies may often be consistent with the principal's best interests.[50] For example, consider the doctor-patient relationship. A patient with a particular debilitating condition might face two potential courses of medical treatment: one course might promise, with a degree of certainty, that the patient will get no worse, but at the same time offer little, if any, hope of improvement; a second course of treatment, however, might entail greater risks, both on the upside and the downside. For instance, the more aggressive treatment might offer a prospect of complete recovery, subject to a risk of making an already debilitating

49. This rationale for the business judgment rule was adopted by former Chancellor Allen in *Gagliardi v. TriFoods International, Inc.*, 683 A.2d 1049 (Del. Ch. 1996), where the former Chancellor wrote:

> Corporate directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any "upside" gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky . . . , their liability would be joint and several for the whole loss. . . . Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on "negligence" . . . could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence . . . to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.

Id. at 1052.

50. *See, e.g.*, Gevurtz, *supra* note 13, at 311–12. Professor Gevurtz writes:

> [T]he concern that liability for ordinary negligence will deter directors from taking worthwhile risks sounds remarkably like the lament of doctors who complain that the threat of malpractice suits has forced them to engage in "defensive medicine" with the result of unnecessarily increased costs and the avoidance of worthwhile but more risky medical treatments. Similar laments can be heard coming from other professionals faced with liability for negligence. The concern about director liability and risk taking may well be valid. It is not, however, unique.

Id. at 312 (footnotes omitted).

condition even worse. It is at least possible that the patient would prefer the latter course of treatment because the greater reward is sufficient to compensate for the greater risk. But a doctor, focusing on the prospect of potential personal liability, might counsel against it. So a business judgment rule based on encouraging (or at least not deterring) risk taking would seem to apply to doctors and other professionals as well as to business people.[51]

A third explanation for the business judgment rule focuses on the availability of other mechanisms to provide corporate managers with incentives to avoid mismanagement. For instance, Professors Fischel and Bradley have argued that "liability rules play a relatively minor role in assuring contractual performance by corporate managers in publicly held corporations."[52] They base this statement, in large part, on the availability of alternative governance mechanisms that deter managerial misconduct. These alternative mechanisms include: (1) voting rights that are generally apportioned by shares, rather than shareholders, so that those with the largest stake in the venture have the greatest impact on the firm's decision making; (2) freely transferable shares that facilitate the formation of control blocs and transfers of control and, therefore, help ensure the removal of deficient managers; (3) institutional arrangements that make possible the continuous monitoring of managerial performance, including the use of independent directors, the sale of securities through investment bankers, and the use of independent third party accountants to certify financial statements; (4) efficient capital markets that provide information about the quality of management that can be used to measure the value of managers in external labor markets and to facilitate the operation of the market for corporate control; and (5) managerial stock ownership and incentive compensation schemes that link changes in managerial wealth to changes in the value of the

51. Some have argued that encouraging risk taking in business is acceptable while encouraging risk taking in fields such as medicine is not. *See, e.g.*, Arkes & Shipani, *supra* note 11. Professors Arkes and Schipani argue that "[f]ailure is acceptable in business but not in medicine" because "the loss from business failure is usually only economic loss and is seldom catastrophic for any single individual." *Id.* at 623. But that the stakes are often larger in the medical context does not mean that rules discouraging risk taking will be in the interests of patients. For while the downside risks of certain medical procedures may be great, the upside rewards may be even greater. For instance, a patient facing a 50 percent risk of death during the next year may well be willing to take a 10 percent risk of immediate death on the operating table to gain even a small chance at extending his life by another ten years. So in my view, the statement that failure is not acceptable in medicine is simply not supported by the evidence. Indeed, if anything, risk taking may be more important in medicine than in other fields.

52. Fischel & Bradley, *supra* note 16, at 263.

firm.[53] Although Fischel and Bradley acknowledge that these alternative governance arrangements do not reduce agency costs (i.e., the costs of managerial misconduct) to zero,[54] they suggest that these arrangements show that liability rules play only a "minor role" in ensuring that managers act in accordance with shareholder interests.[55]

The problem with this rationale for the business judgment rule is, once again, that it fails to provide an adequate basis for distinguishing corporate managers from other professionals, such as doctors and lawyers. Like corporate managers, other professionals are clearly subject to constraints apart from legal liability that deter professional misconduct. For instance, professional reputation undoubtedly plays a key role in both law and medicine.[56] Moreover, doctors, lawyers and other professionals often face potentially career-ending discipline by licensing bodies, as well as sanctions (including expulsion) from the organizations where they work, should they be found to have engaged in professional malpractice. True, those who impose sanctions on doctors and lawyers (e.g., customers who choose to take their business elsewhere, licensing boards, and employers) do not have the benefit of an efficient securities market to help assess whether a doctor or lawyer has performed appropriately. But the lack of an efficient market to measure the performance of doctors, lawyers and other professionals is a double-edged sword: on the one hand, the absence of such a market may make alternative discipline systems less effective because misconduct becomes more difficult and costly to detect; on the other hand, the lack of such a market may increase the costs associated with liability rules by heightening the risk that professionals will be adjudged liable for conduct which may have been wholly justifiable from an ex ante perspective. So, on net, there is no clear basis for subjecting doctors, lawyers and other professionals to more expansive liability rules than those applied to corporate managers.

A final explanation for the business judgment rule focuses on the shareholders' voluntary assumption of the risk that corporate managers will make bad business judgments,[57] as well as the ability of shareholders to eliminate or reduce business risk through diversifi-

53. *See id.* at 274–76.
54. *See id.* at 276.
55. *Id.*
56. *See* Gevurtz, *supra* note 13, at 320.
57. *See* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (Winter, J.).

cation.[58] On this view, investors have opted to purchase stock, rather than less risky investments (like bonds), because of the potentially higher returns available from riskier investments. Accordingly, as a rule, they should not be heard to complain when the risks they have voluntarily assumed result in losses rather than gains, particularly since many of the assumed risks can be reduced or eliminated through diversification. Under this view, legal liability should generally be precluded because investors have voluntarily assumed some risks (i.e., the *market* risks associated with their investments) and do not take others (i.e., *diversifiable* ones).[59] Building on this theory, Professor Booth has argued that recovery should never be allowed for merely negligent bad management because the risk of negligence can be eliminated through diversification.[60] Instead, Professor Booth suggests that liability should be reserved for intentional wrongdoing, a risk for which Professor Booth says diversification offers no protection.[61]

In my view, this last rationale for the business judgment rule is flawed in several ways. First, it mischaracterizes the bargain that shareholders make when they invest in stock. Shareholders clearly agree to bear business risk when they elect to invest in common stock, but only on the condition that managers insist on an expected return from the company's capital investment activities that is sufficient to compensate for the market risk associated with those activities. In other words, shareholders agree to take the risk of *bad outcomes* that may follow from *good capital investment decisions* (i.e., those that have an expected return sufficient to compensate for market risk); but they do not agree to take the risk of *bad decisions* (i.e., those that could not be justified, on an ex ante basis, by the net present value rule).

Second, it is not correct to say that liability should not attach merely because investors can diversify away the risk that resulted in the loss. For instance, investors may be able to eliminate the risk of negligent business decisions through diversification. But eliminating

58. *Id.* at 886.

59. *Cf.* Booth, *supra* note 27, at 460–61. Professor Booth writes:

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

Id.

60. *Id.* at 462.

61. *Id.*

the risk of negligent business decisions means only that investors can predict the total losses to their portfolio from negligent business decisions with certainty; it does not mean that losses from negligence will not result.[62] Thus, even if diversified investors face no risk (i.e., uncertainty) from negligent business decisions, they (or, more appropriately, the companies in which they invest) may still benefit from liability rules if such rules reduce the overall level of losses from negligent business decisions in the economy.[63] In other words, particular types of risk may have perfectly predictable impacts on the value of diversified investors' portfolios, but investors (and the companies in which they invest) may still benefit from liability rules related to those risks, if the potential for legal liability leads managers to take cost-effective steps to reduce expected losses.[64]

Finally the argument that there should be no recovery for diversifiable risks proves too much because, among other things, it would bar recovery for intentional misconduct, contrary to standard corporate law principles.[65] To avoid this result, Professor Booth argues that risk of intentional misconduct is not diversifiable because intentional misconduct always "result[s] in loss no mater how

62. This can be seen by comparing the relatively more familiar situation of a property insurer who sells fire insurance. If such an insurer covers a sufficient number of insureds, it may be able to eliminate (or at least greatly reduce) the risk from fires, meaning that the insurer will be able to predict its total losses from fires with relative certainty. That the insurer eliminates or reduces the uncertainty associated with fire, however, in no way implies that the insurer has eliminated the losses from fire. In other words, even if everyone purchased insurance from a single insurer (thereby pooling the risk from fire to the fullest extent possible), fires and related losses would still occur.

63. Similarly, fire insurers and their customers may benefit if legal liability for arson or negligence results in an overall reduction in the incidence of (and damages from) fire, even though fire insurers have reduced the uncertainty associated with fires to the fullest extent possible.

64. Professor Booth seems concerned that recovery for diversifiable risks will unfairly compensate investors for losses they do not suffer. *See* Booth, *supra* note 27, at 460. But that concern is misplaced. As noted above, that the risk (or uncertainty) associated with managerial misconduct has been eliminated through diversification does not mean that no losses will result from managerial misconduct; it only means that the overall level of losses in the economy from managerial misconduct can be predicted with relative certainty. Thus, it is not necessarily correct to say that an investor who is permitted to recover for managerial misconduct is recovering for a loss that is never suffered. Indeed, the latter statement would only be true *if* the legal rules in effect at the time the investor purchased the shares in his portfolio made clear that no recovery would be permitted for negligent misconduct. In that case, the price the investor paid for the shares in his portfolio would have been discounted by the amount of the losses that could be expected to flow from managerial misconduct. But if the rules in place at the time of purchase made clear recovery would be permitted, then there would be no discount at the time of purchase and thus no reason to bar legal liability. In short, whether or not a risk is diversifiable does not determine whether the investor has suffered a loss worthy of compensation.

65. *Cf.* 3A FLETCHER ET AL., *supra* note 12, § 1040.

diversified one is."[66] In contrast, Professor Booth points out, negligent business decisions sometimes turn out well and sometimes turn out badly.[67] But that a risk always results in losses (as opposed to gains in some cases and losses in others) does not mean that the risk is nondiversifiable. For if it did, property insurers, who cover risks from fire, flood and earthquakes (which, like intentional misconduct, *always* result in losses), would find themselves in a business that made no economic sense. All that is required for a risk to be diversifiable is for the losses from that risk to be predictable with greater certainty if individual risks are pooled. So we may have no idea whether our own house will burn down, but property insurers have a reasonably good idea as to the overall level of losses from fire if they insure a sufficient number of households. The same holds with business losses from intentional misconduct: we may not know whether the managers of any particular firm will engage in intentional misconduct, but we may well be able to predict the overall level of losses from misconduct if we invest in a sufficient number of companies. Accordingly, the risk of intentional misconduct may be just as diversifiable as the risk of negligent misconduct.[68]

III. THE LINK BETWEEN THE PREFERENCES OF DIVERSIFIED SHAREHOLDERS AND THE BUSINESS JUDGMENT RULE

If the traditional explanations for the business judgment rule fail to prove convincing, we must either abandon the rule or search for a new explanation. In his article criticizing the traditional justifications for the business judgment rule (often on similar grounds to those advanced above), Professor Gevurtz suggests the former route,

66. Booth, *supra* note 27, at 462.

67. *Id.*

68. Some have also argued that the business judgment rule is based on the problems associated with entrusting corporate litigation to shareholders and attorneys who often have small, or nonexistent, economic stakes in the corporation. *See, e.g.*, Fischel & Bradley, *supra* note 16, at 271–74. Fischel and Bradley write as follows:

> Shareholders with tiny investments can bring derivative actions on behalf of a corporation. Because of his small stake in the venture, the complaining shareholder (or his attorney) has very little incentive to consider the effect of the action on other shareholders, the supposed beneficiaries, who ultimately bear the costs. If the action appears to be a positive net value project because of the possible recovery of attorneys' fees, an attorney will pursue it regardless of its effect on the value of the firm.

Id. at 271–72 (footnote omitted). Professor Gevurtz correctly notes that these may well be problems with the derivative suit, but that these problems cannot justify the business judgment rule because the latter rule applies even when the corporation's elected management maintains the suit. Gevurtz, *supra* note 13, at 316.

arguing that the business judgment rule "should be abolished and directors . . . required to live with the same rules of negligence as everyone else."[69] This Article takes a different course, arguing instead that the business judgment rule follows naturally from the preferences of diversified shareholders.

As the analysis in Part I explains, diversified shareholders want corporate managers to follow the net present value rule in making capital investment decisions on the shareholders' behalf. Accordingly, diversified shareholders want corporate managers to invest in projects that have a positive net present value—that is, projects that offer a rate of return on invested funds superior to the return that the market demands for investments of comparable *market* (as opposed to overall) risk. If corporate managers follow this strategy, diversified shareholders will see the present value of their investment portfolios increase with each investment decision. This is not to say that each investment decision made by corporate managers following the net present value rule will necessarily be vindicated by a successful outcome, but only that the risk associated with the investment is worth taking because the expected return is sufficiently high. Moreover, the analysis in Part I suggests that undiversified investors will also generally benefit if corporate managers follow the net present value rule.

To ensure that managers follow the net present value rule in making capital investment decisions, the corporation must be structured to ensure that managers, like diversified shareholders, are indifferent to the levels of diversifiable risk associated with different projects. In other words, corporate managers must view projects with identical levels of market risk and identical levels of expected returns as equivalent, even if the projects have very different levels of diversifiable risk. For example, corporate managers should consider the investment option summarized earlier in Option #2 (an investment with a 50% chance of a 150% return and a 50% chance of a -100% return with the outcome determined by an independent flip of a fair coin)[70] as equivalent to a government bond with a guaranteed return of 25% because both have no sensitivity to market risk and both have the same expected return (25%), even if Option #2 involves considerably more uncertainty for the particular firm making the investment.

69. Gevurtz, *supra* note 13, at 289.
70. *See supra* Part I.

The business judgment rule can be understood as a device that helps ensure this managerial indifference to diversifiable risk. To see why, consider the case of a corporate manager who might be sued if a particular investment decision was not vindicated by a successful outcome. Such a manager could hardly be indifferent as between investment options that were identical in all respects, other than diversifiable risk, because the project with the higher level of diversifiable risk (i.e., the project whose outcome was subject to the greatest uncertainty) would necessarily entail a greater risk of personal liability. More generally, the corporate manager who faced a risk of personal liability would tend to prefer projects with lower overall risks to those with higher overall risks, even when the project with the higher overall risk also had the higher net present value. The business judgment rule helps overcome this concern by weakening a significant source of managerial concern with diversifiable risk: legal liability.[71]

As noted above,[72] others have sometimes referred to the differing sensitivities of shareholders and managers to business risk as a potential explanation for the protection provided by the business judgment rule. But these analyses have been brief and, more importantly, incomplete: while diversified shareholders want managers to be indifferent to the variance in project returns attributable to diversifiable risk, they still want managers to pay close attention to the variance attributable to market risk, as well as to the project's overall level of expected returns. In other words, while the business judgment rule offers the benefit of insulating managers from factors diversified shareholders want ignored (i.e., diversifiable risk), the business judgment rule also imposes costs by weakening incentives to consider factors that shareholders deem important. Thus, differing preferences of shareholders and managers for business risk can only support the business judgment rule if the benefits of the rule more than offset the costs. Commentators, like Fischel and Bradley, have emphasized the limited costs of the business judgment

71. This is not to say that the business judgment rule, by itself, will enable managers to completely ignore diversifiable risk. Potential legal liability for bad business decisions is only one source of the managers' sensitivity to diversifiable risk. Another source of sensitivity, discussed earlier, is management's concern about the potential loss of its firm-specific investments if the firm fails or managers lose their jobs. As mentioned above, this concern can be reduced, if not entirely eliminated, by compensating managers with stock options. *See supra* p. 194–95. So the business judgment rule should be understood as only one of many devices designed to insulate managers from diversifiable risk.

72. *See supra* notes 16–17 and accompanying text.

rule because of the availability of other mechanisms to constrain managerial misconduct.[73] But these commentators have failed to focus on the magnitude of the benefits of the business judgment rule, leaving the ultimate balance between costs and benefits uncertain.

Although limited, the available evidence suggests that the benefits from insulating managers from diversifiable risk are substantial. Most significantly, the empirical evidence bearing on overall project risk shows that diversifiable risk represents by far the lion's share of the risk associated with any particular project. This empirical evidence consists of "beta books," which set forth data for individual securities, including, among other things, (1) the security's "beta," which measures the correlation between the security's returns and movements in the market as a whole (i.e., the security's sensitivity to market risk),[74] (2) the portion of the variance in the security's returns that can be explained by movements in the market as a whole (i.e., the variance attributable to market risk) and (3) the portion of the variance in the security's returns that are explained by other factors (i.e., the variance attributable to diversifiable risk). These beta books show that as much as 80 to 90 percent, or more, of the variance in the return to a particular security can be explained by diversifiable risk.[75] One can infer from this that if one examined an individual project, rather than a firm which is a collection of projects (and therefore diversified at least to a limited extent), the results would be even more striking: that is, that even a greater proportion of project risk would be attributable to diversifiable, as opposed to market, risk. Accordingly, in the absence of the business judgment rule, shareholders could frequently expect differences in diversifiable risk to play a dominant role in corporate decision making: where different projects carry different levels of overall risk, and diversifiable risk is the principal determinant of overall risk (as the evidence suggests), managers who fear personal liability for bad outcomes (not just bad decisions) would frequently be tempted to accept projects with lower

73. Fischel & Bradley, *supra* note 16, at 274–76.

74. The beta of a stock is its covariance with the market portfolio. Accordingly, a stock with a beta of 1 varies as much as the market portfolio (i.e., if the value of the market portfolio increases by 1%, the value of a stock with a beta of 1 will, on average, increase by 1%). Similarly, a stock with a beta of 2 fluctuates twice as much as the market portfolio, while a stock with a beta of ½ fluctuates half as much. Risk-free securities like US Treasury Bonds have a beta of 0, meaning that their value is independent of fluctuations in the value of the market portfolio. *See generally* RIBSTEIN & LETSOU, *supra* note 23, app. at 7.

75. *See* BREALEY & MYERS, *supra* note 19, at 210 (reprinting a page from the Merrill Lynch beta book).

levels of diversifiable risk, even though other projects offer greater net benefits to shareholders. Thus, by greatly reducing the potential for legal liability, the business judgment rule dilutes a powerful incentive for managers to focus on factors that diversified shareholders want ignored. Coupled with Fischel and Bradley's finding that the business judgment rule has only modest costs (due to the availability of alternative constraints on managerial misconduct),[76] this suggests that the business judgment rule does, in fact, offer substantial net benefits to shareholders.

But, as the analysis in Part II makes clear, the real test for a theory that explains judicial deference to corporate managers is whether that theory can be reconciled with the more demanding scrutiny applied to actions by doctors, lawyers and other professionals. And this is where a theory that focuses on the special benefits of the business judgment rule for diversified shareholders provides the greatest advantages over its competitors (particularly theories like Fischel and Bradley's that emphasize the rule's limited costs): of the principal-agent relationships considered in this Article (i.e., shareholder-manager, doctor-patient and lawyer-client), the shareholder-manager relationship is the only one where the principal prefers the agent to ignore a substantial (and, in fact, overwhelming) portion of the risk that is associated with the agent's decision. Accordingly, if the business judgment rule is designed to address this special concern of diversified shareholders, there is no reason to apply the rule (or a similar one) to other relationships (i.e., doctor-patient or lawyer-client) where this special concern is absent.

An example can best illustrate this point. Consider a patient who consults a doctor about a serious injury to her arm. One course of treatment will surely prevent her from losing her arm, but will not restore any of the motion that has been lost. Another course of treatment promises the hope of restoring full motion to the injured arm, but if the treatment fails, amputation will be necessary. The patient is not in a position to diversify away any significant portion of the risk associated with the second procedure; the patient will undergo the procedure only once and will face the full risk that that her arm may be amputated. Because the patient faces the full risk

76. As noted above, corporate managers are subject to a variety of alternative governance mechanisms that provide incentives to avoid mismanagement. These include shareholder voting rights, freely transferable shares, institutional monitoring, external labor markets, the market for corporate control and incentive compensation schemes. *See* Fischel & Bradley, *supra* note 16, at 274–76.

associated with the particular procedure without any significant potential for eliminating risk through diversification (regardless of how many "second" opinions she obtains), she wants her agent, the doctor, to consider the full risk as well. Accordingly, under the theory considered in this Article, there is no reason to provide the doctor with legal protections analogous to the business judgment rule. Indeed, such a step would appear to be contrary to the patient's interests, because it could lead the doctor to take insufficient account of the risk to the patient.[77]

The analysis is only slightly more complicated in the lawyer-client context. For the typical person who consults a lawyer only rarely, there is little opportunity to significantly diversify away the risk associated with using legal services. So there are few, if any, risks that the client wants his attorney to ignore, and, therefore, little reason to apply a rule analogous to the business judgment rule. For the more sophisticated client, who makes more frequent use of lawyers, there may be some potential for diversification. But even here, it is doubtful that the amount of risk that can be eliminated through diversification comes close to the 80 to 90 percent level that exists in the investment context. Accordingly, the case for business-judgment-rule-style deference, even limited to sophisticated clients, is by no means clear.

Beyond providing a rationale for the business judgment rule that can be reconciled with the different rules applied to doctors and lawyers, the theory explored in this Article is also consistent with some of the principal limitations on the business judgment rule. Among other things, all agree that the business judgment rule does not shield intentional misconduct, nor does it apply in cases where corporate managers face material conflicts of interest.[78] This result is entirely consistent with the theory advanced here because this theory

77. The situation might be different, of course, if the patient was a millipede and had suffered the same injury to each of its one thousand legs. In that case, the millipede might want each doctor who would operate on one of its legs to treat the procedure as risk-free, because the millipede could have a high degree of confidence regarding the outcome of all one thousand procedures. In other words, because of its capacity to diversify away the risk, the millipede might know that the procedure will likely succeed in five hundred cases and fail in five hundred others, even if he does not know exactly which legs would be restored and which would be amputated. So the millipede might benefit from protection analogous to the business judgment rule for its doctors. But people are not millipedes, and multiple injuries similar to the millipede's that permit the patient to diversify away a substantial portion of the risk associated with medical treatment are difficult to imagine. The point here is not that patients have no ability to diversify away the risk associated with medical treatment, but only that their capacity to diversify away risk does not approach that of shareholders with respect to business risks.

78. 3A FLETCHER ET AL., *supra* note 12, § 1040.

expressly recognizes that legal liability has a role to play in ensuring that managers act in accordance with shareholder interests. Admittedly, the analysis above suggests that the costs of legal liability will ordinarily exceed the gains because the potential for legal liability causes diversifiable risk to dominate managerial decision making. But there may be some limited instances where this is not true. For instance, Professors Fischel and Bradley note that "[t]he larger the potential gains from [managerial misconduct], the more important, all else equal, are liability rules"[79] when compared to the alternative governance mechanisms. Accordingly, Fischel and Bradley suggest that liability rules might have an important role to play in deterring "one-shot frauds."[80] The same line of argument could suggest a role for liability rules more generally in cases involving intentional misconduct or conflicts of interests because the latter cases may well involve larger potential gains for corporate managers than cases involving ordinary negligence.

Further, as Professor Gevurtz points out,[81] the business judgment rule has absolutely no application in suits by third parties who have arguably suffered damage as a result of corporate negligence. For example, as noted above,[82] the business judgment rule would have no application in a case where coastal property owners claimed injury from an oil spill by an allegedly defective oil tanker. Like cases based on intentional misconduct or conflicts of interest, suits against the corporation by third parties are consistent with the rationale for the business judgment rule offered here. Under that rationale, the purpose of the business judgment rule is to permit corporate managers to treat similar projects, with different levels of diversifiable risk, as equivalents, not to protect corporate shareholders from the costs of corporate conduct. Permitting suits by third parties against the corporation, as opposed to the managers personally, in no way interferes with this goal. At the same time, permitting suits by third parties advances the social goal of ensuring that all actors, including corporations, consider the costs of their actions on third parties.

79. Fischel & Bradley, *supra* note 16, at 270.
80. *Id.*
81. *See* Gevurtz, supra note 13, at 325.
82. *See supra* notes 46–47 and accompanying text.

CONCLUSION

The business judgment rule has been a centerpiece of corporate law for almost two centuries. But over the last several decades, courts and commentators have struggled to find a rationale for the business judgment rule that, at once, reconciles the judicial deference granted to corporate managers with the more demanding standards applied to other professionals, such as doctors and lawyers. This Article attempts to end this struggle by offering a fuller account of the relationship between the preferences of diversified shareholders, on the one hand, and liability rules, on the other. Based on this account, this Article contends that the protections of the business judgment rule are necessary to address a concern unique to the corporate setting: the need to prevent diversifiable risk from dominating agent (i.e., managerial) decision making.