For Whom is the Corporation Managed in 2020?

The Debate over Corporate Purpose

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LARRY FINK'S 2018 LETTER TO CEOS

A Sense of Purpose

Dear CEO,

As BlackRock approaches its 30th anniversary this year, I have had the opportunity to reflect on the most pressing issues facing investors today and how BlackRock must adapt to serve our clients more effectively. It is a great privilege and responsibility to manage the assets clients have entrusted to us, most of which are invested for long-term goals such as retirement. As a fiduciary, BlackRock **engages with companies** to drive the sustainable, long-term growth that our clients need to meet their goals.

In 2017, equities enjoyed an extraordinary run – with record highs across a wide range of sectors – and yet popular frustration and apprehension about the future simultaneously reached new heights. We are seeing a paradox of high returns and high anxiety. Since the financial crisis, those with capital have reaped enormous benefits. At the same time, many individuals across the world are facing a combination of low rates, low wage growth, and inadequate retirement systems. Many don't have the financial capacity, the resources, or the tools to save effectively; those who are invested are too often over-allocated to cash. For millions, the prospect of a secure retirement is slipping further and further away – especially among workers with less education, whose job security is increasingly tenuous. I believe these trends are a major source of the anxiety and polarization that we see across the world today.

We also see many governments failing to prepare for the future, on issues ranging from retirement and infrastructure to automation and worker retraining. As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges. Indeed, the public expectations of your company have never been greater. Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

Statement on the Purpose of a Corporation

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to <u>all</u> of our stakeholders. We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.

- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.

- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.

- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.

- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

Corporate Governance | Geo-economics | Governance for Sustainability

Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution

A general view shows the mountain resort of Davos, Switzerland, January 25, 2019 Image: REUTERS/Arnd Wiegmann - RC149B671960

02 Dec 2019

Klaus Schwab
Founder and Executive Chairman, World Economic Forum

A. The purpose of a company is to engage all its stakeholders in shared and sustained value creation. In creating such value, a company serves not only its shareholders, but all its stakeholders – employees, customers, suppliers, local communities and society at large. The best way to understand and harmonize the divergent interests of all stakeholders is through a shared commitment to policies and decisions that strengthen the long-term prosperity of a company.

Have you read?

Why we need the 'Davos Manifesto' for a better kind of capitalism

i. A company serves its customers by providing a value proposition that best meets their needs. It accepts and supports fair competition and a level playing field. It has zero tolerance for corruption. It keeps the digital ecosystem in which it operates reliable and trustworthy. It

Predictions for 2030: What if we get things right?

Harvard Law School Forum on
Corporate Governance and Financial Regulation

It's Time to Adopt the New Paradigm

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Monday, February 11, 2019

Tags: Asset management, Boards of Directors, Corporate culture, Corporate Social Responsibility, Engagement, Long-Term value, Management, Shareholder activism, Shareholder voting, Short-termism, Stakeholders, Stewardship
More from: Amanda Blackett, Karessa Cain, Kathleen Iannone, Martin Lipton, Sabastian Niles, Steven Rosenblum

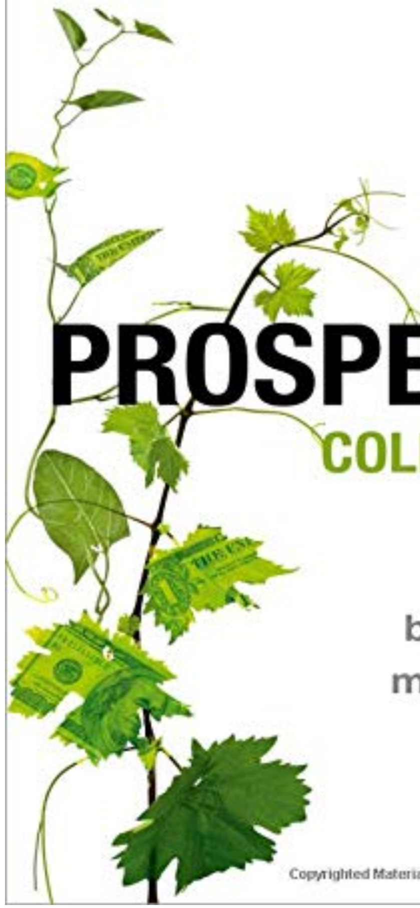
Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton publication by Mr. Lipton. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, Karessa L. Cain, Sabastian V. Niles, Amanda S. Blackett, and Kathleen C. Iannone.

Capitalism is at an inflection point. For the past 50 years, corporate law and policy has been misguided by Nobel Laureate Milton Friedman's ex-cathedra doctrinal announcement that the sole purpose of business is to maximize profits for shareholders. Corporations have also been faced with technological disruption, globalization and the rise of China, capital markets dominated by short-term trading and focused on quarterly profits, and unrelenting attacks and threats by activist hedge funds. In response to these pressures, corporations focused primarily on increasing shareholder wealth in the short-term, at the expense of employees, customers, suppliers, long-term value and the local and national communities in which they operate. The prioritization of the wealth of shareholders at the expense of employee wages and retirement benefits, with a concomitant loss of the Horatio Alger dream, gave rise to the deepening inequality and populism that today threaten capitalism from both the left and the right.

Action by corporations, asset managers, and investors is imperative. We have developed *The New Paradigm*—a roadmap for an implicit corporate governance and stewardship partnership—based on the idea that corporations and shareholders can forge a meaningful and successful private-sector solution to attacks by short-term financial activists and the short-termism that significantly impedes long-term economic prosperity. *The New Paradigm* is structured to obtain its benefits without the ill-fitting encumbrance of legislation and regulation. It is flexible and self-executing by corporations notifying their investors that they have adopted it and by investors notifying the corporations in which they have invested that they have adopted it. It is not a contract and can be unilaterally modified.

The Changing Landscape

After the 2008 fiscal crisis, the role of the corporation began to receive closer examination. This was fueled by, among other things, recognition of short-termism as a cause of the fiscal crisis, a growing concern about climate change, the failure of wages to keep pace with inflation, and a recognition in academia that Friedman's shareholder primacy, the related Chicago School theories of an efficient market (Eugene Fama), and agency cost (Michael Jensen and Fama) were fueling discontent and systemic imbalance. Within a few years after 2008, many corporations and investors, and most



PROSPERITY

COLIN MAYER

better business makes the greater good

Study on directors' duties and sustainable corporate governance

FINAL REPORT

This report has been prepared by EY for the European Commission DG Justice and Consumers.

For information about this document please contact: Claudia Gallo

July 2020

Driver	Options		
	Non-legislative/Soft		Legislative/Hard
	Option A	Option B	Option C
#1	**Commission-led/funded awareness-raising campaign** aimed at: 1. Clarifying that, when acting in the interests of the company, **directors should properly balance the following interests, alongside the interest of shareholders:** long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large 2. Promoting the principle that **identifying and mitigating sustainability risks and impacts**, both internal and external, is part of directors' duty of care	**Commission recommendation that provides a uniform interpretation of directors' duties and company's interest** to the Member States and recommends them to: 1. Clarify in their respective national frameworks that, when acting in the interests of the company, **directors should properly balance the following interests, alongside the interest of shareholders:** long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large 2. Introduce in their respective national frameworks an **explicit directors' duty to identify and mitigate sustainability risks and impacts**, both internal and external, connected to the company's business operations and value chain	Commission proposal for a **new EU directive providing an EU-wide formulation of directors' duties and company's interest**, requiring directors to: 1. **Properly balance the following interests, alongside the interest of shareholders**, when acting in the interest of the company: long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large 2. **Identify and mitigate sustainability risks and impacts**, both internal and external, connected to the company's business operations and value chain
#2	**Commission green paper** to stimulate public debate on how to **foster long-term shareholder engagement** and **longer shareholding periods** **Commission led/funded campaign to discourage** listed companies to **publish earnings guidance** and returns on a quarterly basis	**Commission recommendation** for Member States to amend their national regulatory frameworks and provide for mechanisms to **incentivise longer shareholding periods** **Commission led/funded campaign to discourage** listed companies to **publish earnings guidance** and returns on a quarterly basis	**Commission proposal to amend the Shareholder Rights Directive II** to introduce binding rules requiring Member States to **introduce mechanisms to incentivise longer shareholding periods** **Commission proposal to amend the Transparency Directive to prohibit both earning guidance and quarterly reporting** for listed companies
#3	**Commission guidance document for boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy**, to **identify and set** as part of the business strategy **measurable, specific, time-bound, and science-based sustainability targets** aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), and to **disclose** appropriate information. The guidance document would be accompanied by a dissemination **campaign.**	**Commission recommendation for Member States** to introduce in their respective national frameworks: 1. A requirement for boards to **integrate sustainability aspects (risks, opportunities, impacts) into the business strategy** 2. A requirement for boards to **identify and set** as part of the business strategy **measurable, specific, time-bound, and science-based sustainability targets** aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), 3. A requirement to **disclose** appropriate information.	Commission proposal for a **new EU directive requiring corporate boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy**, to **identify and set** as part of the business strategy **measurable, specific, time-bound, and science-based sustainability targets** aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), and to **disclose** appropriate information.

How to understand the debate?

- "For whom is the corporation managed?" is, at least, four different discussions:
  - Law:
    - What does the law permit or require?
    - What is the best description of the "corporation" as an enterprise form?
    - When an entrepreneur considers how to organize a new business, what are the characteristics of the corporate form a compared to an LLC, a Benefit Corporation, a Limited Partnership, a general partnership?
  - Finance: how to think about the firm?
    - Theoretical
    - Empirical
  - Management: how to build successful companies?
  - Politics:
    - What are the social responsibilities of large business entities?
    - Can Corporate Governance substitute for political gridlock and dysfunction?
- Participants often do not make it clear in which debate they are intervening.
- These debates will play out differently in different countries

My preliminary answers

- **Law:**
  - Best understood as a question about the **characteristics of the corporate form** and how it differs from other enterprise forms that are used to organize business activity
  - Allows us to discuss key questions like: what is the best enterprise form for a purpose-driven business?
  - In the US and UK: "Shareholder primacy" (defined broadly) is an accurate description of the **default** settings of the legal form.
  - Clearly NOT the case in Germany.
- **Finance:**
  - "shareholder primacy" is still generally accepted as an accurate approximate description of what firms in the US and UK do.
  - Interesting question: true in systems with co-determination?
- **Management:**
  - "Shareholder primacy" is typically a terrible management strategy when the key goal is to get everyone to work together
    - In doing so, firms must look after "stakeholders"
  - But sometimes, when change is needed, "shareholder primacy" sharpens the focus (e.g., private equity driven turnarounds).
- **Politics:**
  - Large business entities have social responsibilities
  - "Shareholder primacy" is not a winning political strategy
  - Explicit concern for stakeholders (a la BRT statement or the New Paradigm) MAY be
    - A winning strategy (forestalling intrusive mandatory corporate governance regulation)
    - A losing strategy (paving the way for intrusive mandatory corporate governance regulation)
- Analytically and conceptually, the best answers to the "law" and "finance" question may be different than the best answers for the "management" and "politics" questions.

“Business purpose” v. “corporate objective”

- Key conceptual claim:
  - “Business purpose” is a management concept: “a concrete goal or objective for the firm that reaches beyond profit maximization.”
  - “Corporate objective” relates to the legal (enterprise) form
- The oft-used “corporate purpose” is deeply ambiguous and confusing
  - Sometimes used as a synonym for “business purpose” (e.g., Colin Mayer)
  - Sometimes used as a synonym for what I am calling “corporate objective”
- A key implicit “political” move: define or redefine “corporate objective” in order to push management and investors to give greater attention to stakeholder interests
- An interesting question: does it make sense to entrench a particular “business purpose” in a corporation‘s constitutive documents? If so, how best to do so?

The best **description** of “corporate objective” in “traditional” jurisdictions (e.g., Delaware)

Restatement of Corporate Governance § 2.01. The Objective of the Corporation [pre-preliminary draft]

The objective of a corporation is to promote the value of the corporation for the benefit of the shareholders, within the boundaries set by law. In doing so, a corporation may consider:

(a) the interests of the corporation’s employees;

(b) the need to foster the corporation’s business relationships with suppliers, customers, and others;

(c) the impact of the corporation’s operations on the community and the environment;

(d) the desirability of the corporation maintaining a reputation for high standards of business conduct;

(e) the need to act fairly as between shareholders of the corporation;

and

(f) other appropriate matters.

Key elements: “shareholder primacy”

- Ultimate beneficiaries: shareholders
- Within boundaries of the law
- Huge flexibility during “normal” midstream management to take into account interests of other stakeholders (protected by the “business judgment rule”), so long as there is a rational connection with shareholder benefit
- Limitations at end game and other boundary cases
  - Sale of the company
  - Wholly owned subsidiaries
  - Conflicts between common stock/preferred stock/creditors

Why I think Draft 2.01 restates the law, at least in Delaware: “shareholder primacy”

- The Delaware GCL scheme: of all the stakeholders
  - Only shareholders get to vote (§§ 109, 211, 215, 242, 251, 271, 275)
  - Only shareholders sue (§ 327)
  - Only shareholders are the residual beneficiaries (§ 281)
- The Delaware case law: when interests conflict, shareholder interests are primary
  - Sale of company
  - Wholly owned subsidiaries
  - Common/preferred/creditor conflicts
- Reform efforts assume “shareholder primacy” accurately describes (default) form in Delaware
  - 1980s: multi-stakeholder constituency statutes
  - 2010s: benefit corporations

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The Other Debates: Finance

- “Shareholder primacy” still remains a good first order approximation
- Should the BRT statement change how Finance economist do empirical work?
  - No.
  - Much of empirical corporate finance assumes shareholder primacy (e.g., stock price in CAR studies).
- But if the law changes? If Senator Warren’s Accountable Capitalism Act becomes law?

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The Other Debates: Management

- Should the BRT statement change how managers manage the firm?
  - “Shareholder primacy” was NEVER a (sensible) management strategy
    - “It is a dumb idea . . . The idea that shareholder value is a strategy is insane. It is the product of your combined efforts – from the management to the employees”. Jack Welch Interview, Financial Times (March 12, 2009).
  - But this can be forgotten:
    - Joseph L. Bower & Lynne Paine, THE ERROR AT THE HEART OF CORPORATE LEADERSHIP (Harvard Business Review May/June 2017)
      - “A widespread belief holds that ‘maximizing shareholder value’ is the number one responsibility of boards and managers. But that’s confused as a matter of corporate law and a poor guide for managerial behavior—and it has a huge accountability problem baked into it.”
- NOTE: to the extent that treating stakeholders well or pursuing a business purpose is a way to build great companies, it is consistent with “shareholder primacy”

How to understand the debate?

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Politics

- Large corporations are the focus of sustained political attention, and restrictive legislation is a real threat
  - Elizabeth Warren
  - Marco Rubio
  - EU/EY Report
- One analysis of the politics of corporate governance:
  - Shareholder primacy is gone
  - If we don’t adopt The New Paradigm, or the equivalent, we will get restrictive legislation.
  - Restrictive legislation is a threat to investors and to companies.
- The counter-argument
  - There is no stable “intermediate” solution
  - Risk: Half measures pave the way for restrictive legislation: e.g., Sen. Elizabeth Warren’s response to the BRT statement.

Generalizing: At the intersection of the four debates

- Some argue that we should change the traditional answer to the “law” question in order to change how firms operate (the “management question”), increase firms’ legitimacy (the politics question) and avoid intrusive mandatory regulation.
- Three key issues:
  - Would changing our answer to the “law” question change how firms operate (the “management question”), increase firms’ legitimacy (the politics question) and prevent mandatory regulation?
  - Relatedly: Would NOT changing our answer to the “law” question lead to intrusive mandatory regulation?
  - What harm would flow from changing the answer to the “law” question to, e.g., a version of the BRT statement?~

A Dangerous Temptation

- Very tempting to use corporate LAW to try to improve the management of corporations in a way that also makes them more politically legitimate.
- But corporate law, when it works well, does a FEW things WELL:
  - Defines the enterprise form (and a menu of other enterprise forms: general partnerships, limited partnerships, LLCs, benefit corps, LLPs, etc), providing options for organizing economic activity
  - It allows participants to make credible long term commitments (“capital lockin”)
  - Controls agency costs
- The corporate form as a vehicle for wealth creation has been wildly successful
  - And the accountability structure introduced by “shareholder primacy” is a big part of the story of why.
- The risk of tampering with it: if you ask corporate law to do too much, it will end up not doing anything at all.~