LIFETIME ACHIEVEMENT AWARD

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'SHAREHOLDER PRIMACY IS JUST DEAD WRONG.'

Known as a defender of choice for companies under attack, Martin Lipton has also been arguing against short-termism for more than three decades.

That good business is about more than delivering shareholder returns is a theme Martin Lipton has been espousing since the '70s. Over the past three decades, he's been a voice of reason, calling for the eradication of the short termism that has long had a crippling effect on corporate growth and investment.

His campaign culminated in a 2016 article, "The New Paradigm," written at the behest of Klaus Schwab at the World Economic Forum. It set forth a blueprint for recalibrating the relationship between public corporations and investors, one that calls for collaboration among corporations, shareholders and other stakeholders to achieve long-term value and resist short-termism. CBM *recently spoke with Lipton about his call for a meaningful and successful private-sector solution to short termism. Excerpts, edited for clarity and length, follow.*

You've been refuting the idea that shareholder returns should be the only concern of a corporations for a long time. Now your view seems to be gaining momentum.
Well, you have the Business Roundtable adopting shareholder purpose back in August of last year, you have the World Economic Forum doing the same thing. I would say that not only has it gained momentum, it has become the accepted purpose of the business corporation.

What changed and why now? Why are we revisiting the Milton Friedman, shareholders-are-everything theory of the '50s that everyone seemed to embrace?
No, that's not correct. There were people who never embraced it, recognized that it was wrong and argued to the contrary. I wrote an article in 1979 to that effect. Joe Stiglitz, the famous economist, also a Nobel Laureate, had the same position in the '70s. There's no question that it gained the backing of a majority of people, but there was always a strong minority who thought it was absolutely wrong, argued to the contrary and continue to argue. I've been writing in favor of stakeholder governance continuously since the '70s. So this is not new; it is a final recognition that shareholder primacy is just dead wrong.

Still, many directors see fiduciary responsibility to shareholders as still paramount. Also, the messaging from folks like BlackRock and State Street about ESG seems to talk about it in the context of the potential impact on value or risk mitigation over the long term. Is that the same argument that you've been making?
There are all sorts of variations, but I view the fiduciary duty of directors as not to the shareholders but to the corporation. Directors have a fiduciary duty to see that the corporation is, in the long term, profitable and grows sustainable value. So, obviously, financial success is an aspect of stakeholder purpose. Shareholders are stakeholders.

It's really a question of allocation among all of the stakeholders of a corporation to achieve the best possible result. It's not that you cut out the shareholders. It's that you cut in the stakeholders so that you create a long-term sustainable corporation. Without that, in effect, the shareholders are not well served. So, if you don't serve shareholders well, if you don't invest for the future and you don't have a good workforce, if you don't have loyal customers, if you don't have good suppliers.... It's always been a huge mistake to think that you could have a good economy and a good society yet a small number of people profit from the business and the vast majority of people are left out.

So, it goes back to the income and wealth disparity that we've heard a lot more about of late?

That's the very reason why people argued against shareholder primacy—because, here in the U.S., more than half of the people are at or below the poverty line. You can't have a stable society with that.

You've made the point that a purpose beyond financial return was a founding principle of the government allowing corporations to form originally. Can you elaborate on that?

There's a long history to this. Corporations are a creature of government. You can't create a corporation except pursuant to a statute that government adopts. Originally, the government adopted statutes for corporations to build tollways, ferries and canals—to create public benefit. They weren't created originally to enable people to do business in a limited liability protective shell and have perpetual existence.

It was only later that the privilege of corporations was extended to private business. Operating as an individual or as a partnership didn't enable people to raise enough capital and ensure that the business would still be around. So, the corporation, which had been invented for public purposes, was converted into a vehicle for private business.

So, you're suggesting that corporations having sort of a societal obligation is something we gradually somehow moved away from and need to move back to?

That's exactly what happened. Milton Friedman in the 1960s put forth this concept of shareholder primacy that corporations existed to maximize profits for the shareholders. That caught on and led to takeover waves, activism and short-termism. There were those who did not agree with it and argued against it, but there's no question that attitude took hold in both business schools and law schools, and shareholder primacy was the dominant policy.

When I wrote my first article [about this] in 1979, the Chicago School economists all wrote articles criticizing it. And this debate has been going on ever since. Every time I wrote an article, they would write articles refuting it. But I kept true to the basic argument. And I feel the same way today as I did in the 1970s.

Except for a few economists and a few law professors, the overwhelming majority of economists and law professors today agree that shareholder primacy is not the *raison d'être* for corporations and that stakeholder governance is the right approach.

What accounts for that shift? Why are people listening more now, do you think?

People have recognized that we've created a real problem for ourselves, and that absent shifting, we're going to destroy the goose that lays the golden egg. When you get the Business Roundtable, all 181 countries, and the World Economic Forum to say, "We've been doing it the wrong way, and this is the right way," you have a tectonic shift.

In a recent article, you spoke about investors serving as watchdogs, but at the same time, we've had activist shareholders in the past who really pushed short-termism. So, how do we deal with this investment world where activism can be good or bad depending on who's doing it?

I'm not sure I know how to answer that. There are situations in which companies are not well managed, and that should be corrected. If you use activism in the sense of activist hedge funds attacking companies, I think that's the wrong way. I've always argued, as do those who are adopting and arguing for stakeholder purpose today, that the only way the system can work is if there's engagement between the corporations and the investors who have invested in them. Investors need to recognize ESG and stakeholder purpose, and corporations need to recognize that investors are entitled to a return, and they need to engage and discuss strategy and reach neutral agreement as to how the company will operate.

So, a more collaborative process than what we've largely experienced.

The New Paradigm that I created for the World Economic Forum explains exactly how it would work. The companies basically say, "Look, we recognize that we have to operate in a way that is good for everyone. We can't operate only for the management, only for the employees or only for the shareholders."

Stakeholders, particularly big asset managers and institutional investors, have to accept that companies will not operate to maximize shareholder return. They'll operate to grow the business successfully over the long term to build value for all of the stakeholders. The way you do that is both the corporations and the investors fundamentally subscribe to stakeholder purpose and to sustainable long-term investment and come to a mutual understanding about how the company should operate and what its strategy should be. And if management does not fulfill its commitment to stakeholder value, then the other shareholders should be in a position to influence or change management. Not a unique or difficult strategy. It makes all the sense in the world that both sides cooperate to maximize benefit to both sides. Two people getting together to have a very successful business.

Is that largely what's happening in the world based on what you're observing?

We're moving significantly in that direction. Have we totally accomplished it? Of course not. Since 2016, I'd say we've made a huge move. The last five years have seen changes in what all sorts of organizations have been urging, new organizations have been created to promote it. You've got—focusing capital on the long-term global, organized in the last five years or so—the Coalition for Inclusive Capitalism. We have all of the efforts that the UN has put into responsible investment policies. There has been an enormous amount of activity, articles written.

So, from a practical standpoint for directors, what does this mean for them in terms of moving the needle?

They don't really have to do anything other than follow the strategy. They have to encourage management to pursue stakeholder purpose, and the directors have an obligation to exercise their reasonable business judgment to see that there's an appropriate allocation among the stakeholders having in mind that the ultimate goal is increasing sustainable long-term value with a corporation.

> **IF YOU DO THIS THROUGH GOVERNMENT REGULATION, YOU'RE MOVING AWAY FROM MARKET CAPITALISM AND ADOPTING STATE CORPORATISM, WHICH I'M AGAINST."**

So, that means that you're not taking everything away from the shareholders and giving it to the other stakeholders. You're trying to get a balance among all of the stakeholders to maximize long-term value.

Is there a role for regulation in this?

I'm trying to do it without a role for regulation. Yes, you could regulate this, and Elizabeth Warren (D-Massachusetts)'s bill and others have been introduced to, in effect, regulate it. My whole purpose is to do it without regulation and to preserve an open market economy…. And Marco Rubio (R-Florida), by the way, introduced legislation and published a paper last year saying that stockholder primacy was wrong. This is not just on one side of the aisle, there are a lot of Republicans who recognize it.

If you do this through government regulation, you're moving away from market capitalism and adopting state corporatism, which I'm against. I'm in favor of market capitalism that is balanced by both corporate management boards of directors and asset managers and institutional investors working together for the purpose of building long-term, sustainable value.

It's not, in any way, an unusual or extreme concept. It's a pretty simple concept. And it's primarily based on common sense. If you want to create value, you have to get the people who are involved in it to cooperate and work together. And it's not going to work if one of them is trying to take undue advantage of the other.

Take undue advantage, meaning…?

Well, if the shareholders are trying to get all the benefit and you don't have a structure that works in the long-term, you end up with the kind of inequality we've created and you're not correcting it.

In *More from Less*, MIT economist Andrew McAfee wrote about the need for what he called "responsive government," or having some degree of regulation to provide checks and balances.

I call it guardrails. Yes, you have things like the Labor Relations Act and the Environmental Protection Agency and so on. In other words, you have guardrails on the extreme, and you say to business, "You operate within those guardrails. Here are the guardrails. You can't go on either side of the guardrails. So long as you stay within the guardrails, then it's an open market type of operation, but keep in mind, if you guys don't agree and you end up pushing too hard, one way or the other, we're going to have to narrow the guardrails."

If you narrow them too much, you end up with state corporatism. If you keep them too wide, you may end up with shareholder primacy or, if you go too wide the other way, you can end up with worker primacy and also destroy the way business operates. You have to have guardrails so you don't go too far in any one direction. But if you have the guardrails and people operate in a sensible way, cooperatively, to see that all of the stakeholders benefit, then you have, hopefully, a great economy.

What kind of guardrails are sensible without going too far?

Antitrust laws, labor laws and the regulation of the FAA and the regulation of railroads and so on. What's happened, I think our guardrails are not there; they're not creating any problems at the moment. Some people think there's too much regulation. Some people think there's not enough. Basically, you try to have fairly wide guardrails and count on the sense of both investors and companies to not go to the edge of the guardrails but work in the middle and work together cooperatively so that everybody benefits.

How would you characterize our current situation?

I think that we more or less have the right guardrails. They have to be reviewed every now and then and sometimes you see a need to either loosen or tighten them. I'm not sure the guardrails on climate are right. I think maybe they have to be tightened.

I don't know that you'd get a lot of support with the idea of tightening them though, right?

Well, it depends on who you're looking to for the support. I think far more people support it than don't. On the corporate management side, I'm sure you'd also find that if they weren't under intense pressure for short-term profits… That is why you have to have neutral engagement between investors and corporations. It works very well if corporate management, the business operation, works with the investors to a mutually agreed end. And the mutually agreed end is a proper allocation among all of the stakeholders of the benefits of the business operation. And that's achieved through engagement between the investors and the companies.

But for that to work you also need everybody to play ball. If you're trying to operate for the good of multiple stakeholders but you've got a competitor over there who's just operating for the short term, well, you can't compete.

You can use that to excuse anything. I agree with you. In today's technological world and global world, here's where you need government. It won't work without government. You need to eliminate countries taking advantage and luring business with lower taxes, luring business with lower wages and so on. You need intelligent and appropriate global understandings. That's where trade agreements come into play, and you need the right kind of trade agreements in order that everybody is on the same playing field.

Which is trickier than it sounds.

That's true. Stakeholder governance doesn't cover everything. You need to operate a company in order to deal with technological disruption. You need to operate a company that's dealing with globalization. And you have to fit stakeholder governance within the overall ecosystem of domestic business and global business. These are very difficult concepts to achieve.

You don't do it overnight, but one thing that became totally apparent after some 50 years is that Milton Friedman was wrong, Joe Stiglitz was right, and the present shareholder primacy structure doesn't work.

Because it has backfired on us?
Just look at the U.S. today. We have more than 50 percent of the people in the U.S. at or below the poverty line. We've lost all of our good industrial jobs. Workers have not gotten an even shake. Wages have been squeezed in order to increase profits for shareholders. If a small group of people involved in finance end up having 90 percent of the wealth of a country, that's the kind of inequality that creates populism and overturns governments.

The whole purpose of the new paradigm is to rebalance things. It's an implicit agreement between companies and investors. It's not regulation. It's not a contract. It's an implicit agreement that they will be flexible and work together to achieve the appropriate distribution of the benefits of a corporate business being enjoyed by all of the stakeholders, not just by the shareholders.

Given the way our investment markets work—with so many investors pressing for short-term results—can companies afford to work in this way? Because investors will just go after the highest returns that they can get.
This is the question of guardrails. If they can't work within the guardrails, then you're going to have regulation. And the next step would be regulating the mutual funds and the investment managers.

If we can't fix this, the investors are going to be regulated.

Board members and management have grown up in a more short-term focused world. What needs to happen for this to actually play out in the way you're hoping?
The only thing you need is for corporate management and directors to recognize it, as they have. I think the action of the Business Roundtable speaks loudly on that issue. They have recognized it, they are doing it. And the same has to be demonstrated by the investors. Clearly, BlackRock, Vanguard

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and State Street are recognizing it.

Then the question is, will the other investors recognize it? I think they are doing it. The Investor Stewardship Group says that it is. So, now it's a question of everybody has recognized that it's the way to go, and they just have to get to it and make it work.

What are you hoping to see over the next five years? And what are you afraid might happen in terms of the potential paths we may land on?
I think we're on the right path right now. I'm in full agreement with stakeholder purpose, with companies paying attention to ESG matters and with investing for the long term. I'm in full agreement that companies need the appropriate internal corporate governance, that the directors have an obligation to monitor the business and see to it that management is performing properly.

I think investors are recognizing that they have an obligation to engage and cooperate with business. So, I'm hoping that everyone involved will continue to cooperate and work together, and we will achieve an understanding and a *modus vivendi* without more government regulation, and the economy will be significantly improved to the benefit of all the stakeholders, including the shareholders. Clearly, we will have rebalanced the allocation between the shareholders and the other stakeholders. In the past, that allocation has been too heavily in the favor of shareholders, and now it has to be rebalanced so that the other stakeholders have a fair share.

Not a difficult concept. You just have to get everybody to agree to it. And there are people who have been making billions of dollars by not agreeing with it and who are not anxious to see things change, and they are the ones running around criticizing it.

But here's Brian Moynihan, the CEO of Bank of America, leading the effort of the World Economic Forum to develop appropriate metrics to measure ESG. He's one of the leading business people in the world. You have Larry Fink sending out five letters in five years basically saying, the purpose of a corporation is to develop its long-term value by treating its stakeholders appropriately.

But the first year his letter went out, people said he was just grandstanding. It took several years for it to become, "Oh, he really means it."
I started in 1979.

That's how long it takes?
You don't turn the world around overnight. I have the highest regard for Larry Fink. He's done a fabulous job. I know him well. He's totally honest and straightforward in what he's trying to accomplish. You've got great people who are committed to improving things. They're not anxious to undermine progress. They don't want to take advantage of employees. They want to see everything work properly.

Klaus Schwab at the World Economic Forum came to me in 2014; it took about two years to publish "The New Paradigm." I didn't just sit down and write it. I spoke to well over 50 companies and a number of investors and economists, and there wasn't a single one fundamentally opposed to it. A great number of people contributed to it.

Much of what I have reflected is a compendium of the thoughts, articles, speeches, positions of other people—Colin Mayer, Leo Strine, Joe Stiglitz and Steve Pearlstein. I didn't invent all of this. I tried to take into account the ideas that I thought were best.

The entire unanimous International Business Council, 150 of the largest companies in the world, approved it unanimously. There wasn't a single negative vote. So, I don't think you can criticize the business community or the investment community. We're on the right track.

I am quite optimistic. I think we're going to achieve this. **CBM**