Harvard Law School Forum on Corporate Governance

Some Thoughts on the Business Roundtable's Statement of Corporate Purpose

Posted by John F. Cogan (Hoover Institution), on Wednesday, October 7, 2020

Tags: **Business Roundtable**, **Corporate purpose**, **Corporate Social Responsibility**, **ESG**, **Institutional Investors**, **Shareholder primacy**, **Shareholder value**, **Stakeholders**
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Editor's Note: **John F. Cogan** is the Leonard and Shirley Ely Senior Fellow at the Hoover Institution. This post was authored by Mr. Cogan; **George P. Shultz**, Thomas W. and Susan B. Ford Distinguished Fellow at the Hoover Institution; **Michael J. Boskin**, the Tully M. Friedman Professor of Economics and Senior Fellow at the Hoover Institution; and **John B. Taylor**, the Mary and Robert Raymond Professor of Economics at Stanford University. Related research from the Program on Corporate Governance includes **The Illusory Promise of Stakeholder Governance** by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum **here**); **For Whom Corporate Leaders Bargain** by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum **here**); and **Toward Fair and Sustainable Capitalism** by Leo E. Strine, Jr (discussed on the Forum **here**).

From time to time in the last 150 years, a socialist impulse has taken hold among a significant segment of the U.S. population. This impulse was a primary driver behind the 1880s populists' movement and among progressives in the 1910s. It was dominant ideology among socialists in the 1930s and among young radicals and intellectuals in the 1960s. Today, there is a similar collectivist sentiment running through America. Although most Americans do not favor government control over the means of production, a significant portion of the population appears to prefer that government, rather than the private sector, be given primary control over the U.S. economy or important parts of it. In a recent poll, 44% favored government control over health care, 35% favored government control over wages of workers, and 33% favored economy-wide government controls.

Today, as in the past, the collectivist sentiment is fueled by resentment against a system that they see as having treated them unfairly, distrust of public and private institutions, and a utopian belief that human nature can be changed to make the world a better place. The American left has developed a strong anti-business sentiment and progressive politicians are calling for extensive regulation of business activities, confiscatory taxes on the wealthy, and a general redistribution of income.

Into this environment, the Business Roundtable, the CEOs of many of America's largest companies recently issued a statement fundamentally changing its view of the basic purpose of U.S. corporations. The BRT has scrapped its longstanding view (since 1997) that "the paramount duty of management and of boards of directors is to the corporation's stockholders…The interests of other stakeholders are relevant as a derivative of the duty to stockholders." In its place, the BRT stipulates that U.S. companies should consider the interests of numerous stakeholders – including employees, customers, and communities in which the company operates, along with shareholders when making corporate decisions. Underlying the Roundtable's new view is its belief that companies have a social responsibility that transcends their role as producers of goods and services in a freely competitive economy.

The Business Roundtable's examination of the conduct of U.S. corporations is welcome, but wrong-headed. The organization consists of highly respected leaders both within and outside of the business community. Their collective views carry a large weight in public policy deliberations in Washington D.C.

But we believe the BRT's new statement of corporate purposes that places shareholders as an "also ran" alongside other stakeholders, especially an ill-defined group of "communities," is misguided. The statement lends credence to an incorrect view of the way American businesses operate in today's economy; it fundamentally misunderstands the role that business plays in a free market economy; and it fails to consider the practical, real world, adverse consequences of demoting shareholders' interests.

How American Businesses Maximize Shareholder Value

The critique of the goal of maximizing shareholder value is based on the erroneous belief that *in order to* maximize this value, businesses must *mistreat* employees, *short-change* suppliers, *take advantage* of customers, and take actions that *damage* the community and its surrounding environment. In fact, the exact opposite is true. Maximizing long-term shareholder value requires companies to make sure that employees and suppliers are in a strong position to make the business successful. Investing in employees increases a firm's human capital, honest dealings with suppliers add value to the physical capital they provide, maintaining good community relations creates "intangible" capital. Customers are, of course, the ultimate evaluators of a company product or service. Mistreat any of these stakeholders and shareholder value will decline. Competition from companies who take account of all of their stakeholders ensures this outcome.

The Importance of the Duty to Maximize Shareholder Value

U.S. Corporations have played a central role in improving standards of living in the U.S. and around the globe. In the basic U.S. corporate structure, investors are shielded from direct legal liability for corporate actions and investors hire corporate executives to run the company. Investors supply capital by purchasing company stock and, in return, become part owners in the company and in its success or failure. This structure has been crucial in allowing companies to raise funds efficiently through capital markets.

But this arrangement creates a potential "agency problem", wherein company executives have different objectives than the owners. The maximization of shareholder value as the paramount duty of corporate executives addresses this problem by aligning management's objectives, strategies, and decisions with owners' interests. It also provides owners with a relatively clear, straightforward way to assess executives' performance and, thereby, to ensure accountability. The value of this arrangement, along with corporate governance rules that require executives and board members to own their company's stock, has proven itself over and over again as public corporations have been a dynamic engine behind improving living standards.

Milton Friedman and Corporate Responsibility

Nearly 50 years ago, Milton Friedman made the quintessential case against the idea that corporations have a more general social responsibility. As Professor Friedman argued, in our system, corporate executives are hired to carry out the corporation's responsibilities. They are employees of the company's owners and are responsible to them. Executives conduct their business according to the wishes of the owners, not the desires of others. This conduct is, of course, subject to all parties adhering to applicable laws, customs, and society mores. In economic terms, corporate executives act as agents of owners who are the principals. When executives spend corporate funds, they are spending the owners' money.

Requiring corporations to behave in a "socially responsible" way, if it means anything, it is that when the interest of a corporation's owners diverges from a "social" interest, however defined, executives should act in a way that is not in the interest of the owners. If executives choose to pay some employees a higher wage to "reduce inequality," hire less qualified workers

to "reduce poverty," or buy higher priced inputs from local suppliers to "support the community," they are spending someone else's money; including the hard-earned money of retirees, workers, and ordinary investors throughout the economy. When the impact of such actions is to lower shareholder returns, it's the company owners' money. When the impact is a higher price to consumers, it's the consumers' money.

Taking other people's money without their consent and using it to achieve social purposes is properly viewed as a governmental function. To ensure that this function is applied to publicly preferred social purposes with a minimum financial burden, our government has an elaborate set of checks and balances that operate through representatives chosen by the people through fair and open elections. A policy of corporate social responsibility, on the other hand, gives corporate executives, or corporate "stakeholders," the authority to choose which social goals to achieve and how much of other people's money to allocate to them. This policy circumvents the safeguards provided by the governmental system of checks and balances and effectively places the power to tax in the hands of unelected persons. This as Milton Friedman wrote nearly 50 years ago, is "pure and unadulterated socialism." He could have also said that is "undemocratic."

The Harmful Consequences of the BRT Standard

As a practical matter, it is hardly possible that social policy decisions under the BRT standards would be left to corporate executives whose employment is determined by a board of directors consisting solely of owners. More likely, boards would be required to be composed of members representing each of the stakeholders, i.e., company employees, consumer groups, suppliers, and community officials. Indeed, Elizabeth Warren has already proposed requiring 40 percent of board seats be occupied by representatives of the company's employees and requested support from the BRT for this requirement.

The new BRT standard will result in corporate decisions that, on balance, sacrifice shareholder value in return for achieving other yet to be specified social objectives. Lower values will cause investors to reduce their inflow of new capital to the sector. Initially, the price will be paid by current investors, including millions of retirees and those preparing for retirement when share values drop. Ultimately, as capital inflows continue to decline, the price will be paid by the entire society as economic growth slows and living standards stagnate.

The damage doesn't end there. Under the BRT standard, executives would no longer serve as the agent of a single principal, the company's owners. They would instead serve simultaneously as an agent of the various stakeholders. Each of these masters will have their own goals. Conflicts and trade-offs are inevitable. Employee representatives will seek higher pay and pension benefits at the expense of shareholder value, much in the same way as public employees currently do. Consumer groups will oppose price increases that may well be justified in competitive markets. Representatives of local communities will oppose plant closings in their communities despite company-wide efficiency gains from relocating production facilities from their community to another.

The BRT's proposed standard of multiple masters and numerous objectives is a recipe for a lack of corporate accountability. With few ways to measure and assess how much shareholder value has been sacrificed to meet some only vaguely defined social goals, and with conflicting valuations by the various stakeholder groups, boards will be unable to properly evaluate executives' performance.

The multiple masters and competing objectives will embroil companies in a legal morass as conflicts over goals and disagreements over the appropriateness of actions to achieve those goals produce legal wrangling and litigation. Today, even with a relatively clear paramount duty for corporate executives serving a single master, a drop in a company stock often produces shareholder lawsuits. Imagine the legal quagmire that a system with a multitude of masters with conflicting goals will create.

The lack of accountability, endless legal wrangling, and litigation will slow down companies' decision making and lengthen their response times. Ultimately, the dynamism of U.S. companies which has been so crucial to our rising standard of living will diminish.

Like Milton Friedman, we see little benefit, and considerable harm, from attempting to make corporations pursue "socially responsible" policies. The pursuit of shareholder value as the paramount duty is more often than not accomplished by investing in employees, delivering value to customers, and treating suppliers fairly. As Adam Smith informed us two-and-half centuries ago, the pursuit of private value is the best way to promote the broader interests of society: "It is not from the benevolence of the butcher, the brewer, or the baker that we can expect our dinner, but from their regard to their self-interest."

Achieving socially responsible outcomes should be left to individuals pursing their own ends and to elected public officials charged with properly carrying out governmental responsibilities. It must be remembered that corporate executives and shareholders, along with other members of society, are private citizens and, as such, are free to meet their personal responsibilities to their families, charities, and communities. When each of society's members spend their time and energy to meet their chosen responsibilities, they are applying their own efforts. Maximizing the resources society's members have available to meet these responsibilities is best achieved by maintaining the paramount duty of U.S. corporations to maximize shareholder value.

The business community would have been far better served had the Business Roundtable reaffirmed its 1997 statement and articulated the important role U.S. corporations have played in improving the quality of life in the U.S. and abroad. Attempts to placate progressive politicians will only encourage further efforts to use U.S. corporations for their own social purposes.
