September 17, 2020 (Revised)

The Friedman Essay and the True Purpose of the Business Corporation

From a practical standpoint, the most significant part of the 1970 Milton Friedman essay in the *New York Times* was the headline: "*The Social Responsibility Of Business Is to Increase its Profits*." For a half-century, that phrase has been used to summarize the essay, and alongside Friedman's similar views in a 1962 treatise, also used in support of "shareholder primacy" as the bedrock of American capitalism. "Shareholder primacy" and "Friedman doctrine" became interchangeable. The Friedman doctrine was a precursor to, and became a doctrinal foundation for an era of short-termism, hostile takeovers, extortion by corporate raiders, junk bond financing and the erosion of protections for employees, the environment and society generally, all in support of increasing corporate profits and maximizing value for shareholders. This concept of capitalism took hold in the business schools and the boardrooms, became ascendant in the eighties and continued as Wall Street gospel until 2008, when the perils of short-termism were vividly illuminated by the financial crisis, and the long-term economic and societal harms of shareholder primacy became increasingly urgent and impossible to ignore. Since then, acceptance of and reliance on the Friedman doctrine has been widely eroded, as a growing consensus of business leaders, economists, investors, lawyers, policymakers and important parts of the academic community have embraced stakeholder capitalism as the key to sustainable, broad-based, long-term American prosperity. This is illustrated by the World Economic Forum's request that I prepare a new paradigm for corporate governance which it published in 2016 and its issuance of the 2020 Davos Manifesto embracing stakeholder and ESG (environment, social and governance) principles, as well as the 2019 abandonment of shareholder primacy and adoption of stakeholder governance by the Business Roundtable. So too, has corporate purpose and stakeholder and ESG governance been embraced by index fund managers BlackRock, State Street, Vanguard and other major investors.

It should be noted that some well-known business people, economists and lawyers reject stakeholder governance and adhere to the Friedman doctrine. Also in commemoration of the 50th anniversary of the essay, four prominent senior fellows of the Hoover Institute, George P. Shultz, Michael J. Boskin, John F. Cogan and John B. Taylor published an article in the Hoover Digest, the title of which aptly summarizes their opinion: *Cheated by Collectivism: Businesses do good by benefitting their shareholders, not pursuing a phantom of "social responsibility."* In an article entitled *The Illusory Promise of Stakeholder*

Governance, Lucian Bebchuk and Roberto Tallarita of the Harvard Law School called the Business Roundtable embrace of stakeholder governance naïve and marshalled a litany of empirical, historical and human greed arguments in derogation of stakeholder governance. As might be expected, compelling arguments rejecting the Bebchuk arguments soon appeared. Alison Taylor and Dina Medland in an article entitled *The Illusion Of Reasoning*, sum up the arguments for stakeholder governance and against preserving Milton Friedman's fifty-year-old doctrine:

> In fact, simplistic prioritisation of shareholder interests ceased to be an option some time ago. Shareholders today are not a monolithic interest bloc, and business leaders have some choices about which owners they seek to attract. Many shareholders today argue enthusiastically for longer time horizons and more substantive measurement of environmental, social and governance issues.
>
> More broadly, the value of intangible assets such as reputation, innovation and network effects now constitute 61% of the value of the S&P500. Return on investment takes longer, and is harder to measure. Any attempt to navigate successfully through this new environment is inherently "contestable", too. It is the idea that a focus on shareholder value negates any need to consider complex trade-offs that is naïve and unrealistic, not the BRT statement.

In addition to these reasons for rejecting the Friedman doctrine, the fundamental structure of the corporate world has changed dramatically since the 1960s. Today the three index fund managers control on average in the aggregate about 20% of the shares of the listed corporations. Together with ten other asset managers, they have voting control of most corporations. Also, Friedman assumed that shareholders wanted primacy and had no concern for the other stakeholders. Clearly that is not the situation today. Stakeholder and ESG governance and sustainable long-term investment are today embraced by the holders of a clear majority of the shares of most corporations.

Recent events — notably including the pandemic, its disparate impact on various segments of society, and the focus on inequality and injustice arising in the wake of the death of George Floyd — have accelerated the conversation on corporate purpose and the debate about stakeholder governance. The result has been substantial, salutary reflection about the role that corporations play in creating and distributing economic prosperity and the nexus between value and values.

For my part, I have supported stakeholder governance for over 40 years — first, to empower boards of directors to reject opportunistic takeover bids by corporate raiders, and later to combat short-termism and ensure that directors maintain the flexibility to invest for sustainable long-term growth and innovation. I continue to advise corporations and their boards that — consistent with Delaware law — they may exercise their business judgment to manage for the benefit of the corporation and all of its stakeholders over the long term. That it is the corporation, qua corporation, that commands the fiduciary duty of its board of directors.

In looking beyond the disruption caused by the pandemic, boards and corporate leaders have an opportunity to rebuild with the clarity and conviction that come from articulating a corporate purpose, anchored in a holistic understanding of the key drivers of their business, the ways in which those drivers shape and are shaped by values, and the interdependencies of multiple stakeholders who are essential to the long-term success of the business.

This opportunity leads me to reiterate and refine a simple formulation of corporate purpose and objective, as follows:

> The purpose of a corporation is to conduct a lawful, ethical, profitable and sustainable business in order to ensure its success and grow its value over the long term. This requires consideration of all the stakeholders that are critical to its success (shareholders, employees, customers, suppliers and communities), as determined by the corporation and its board of directors using their business judgment and with regular engagement with shareholders, who are essential partners in supporting the corporation's pursuit of its purpose. Fulfilling this purpose in such manner is fully consistent with the fiduciary duties of the board of directors and the stewardship obligations of shareholders.

This statement of corporate purpose is broad enough to apply to every business entity, but at the same time supplies clear guideposts for action and engagement. The basic objective of sustainable profitability recognizes that the purpose of for-profit corporations includes creation of value for investors. The requirement of lawful and ethical conduct ensures generally recognized standards of corporate social compliance. Going further, the broader mandate to take into account all corporate stakeholders, including communities, is not limited to local communities, but comprises society and the economy at large and directs boards to exercise their business judgment within the scope of this broader responsibility. The requirement of regular shareholder engagement acknowledges accountability to investors, but also the shared responsibility of shareholders for responsible long-term corporate stewardship. Essentially, this is *The New Paradigm* for corporate governance issued in 2016 by the World Economic Forum.

Fulfilling this concept of purpose will require different approaches for each corporation depending on its industry, history, regulatory environment, governance and other factors. I expect that board committees — focusing on stakeholders, ESG issues and the stewardship obligations of shareholders — will be useful or even necessary for some companies. But for all the differences among companies, there is an important unifying commonality: corporate action, taken against the backdrop of this formulation of corporate purpose, will be fully protected by the business judgment rule, so long as decisions are made by non-conflicted directors acting upon careful consideration and deliberation.

Executed in this way, stakeholder governance will be a better driver of long-term value creation and broad-based prosperity than the shareholder primacy model. Directors and managers have the responsibility of exercising their business judgment in acting for the corporate entity that they represent, balancing its rights and obligations and taking into account both risks and opportunities over the long term, in regular consultation with shareholders. Directors will not be forced to narrow their focus and act as if any one interest trumps all others, with potentially destructive consequences, but will instead have latitude to make decisions that reasonably balance the interests of all constituencies in a manner that will promote the sustainable, long-term business success of the corporation as a whole. Most important of all, *The New Paradigm* will obviate the need for legislation regulating corporations and institutional investors and asset managers that would quickly lead to state corporatism. For a fuller discussion of avoiding legislation and saving American capitalism, see my 2019 essay, *It's Time To Adopt The New Paradigm*.

Martin Lipton