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The New Paradigm in the C-Suite and the Boardroom

In October of 2015, we issued a paper – *Will a New Paradigm for Corporate Governance Bring Peace to the Thirty Years' War?* – in which we questioned whether the growing recognition by investors of the adverse effects of short-termism and activism on corporate performance, as evidenced by the excessive risk-taking that culminated in the 2008-2010 financial crisis, would mitigate or reverse the acute pressure felt in C-suites and boardrooms to maximize near-term value for shareholders. In reflecting on this question with the benefit of hindsight, it is clear that much has changed since 2015, and there has been real progress toward restoring a more long-term, sustainable orientation. Yet, at the same time, it remains to be seen whether ESG, stakeholder governance and other principles of the new governance paradigm will continue to gain traction and have a concrete, enduring impact on the long-term foundation of our economy and society – including in terms of employee well-being, environmental sustainability, infrastructure and other capital investments, and long-term competitiveness.

Indeed, the concept of shareholder primacy, and the empowerment of shareholders in pursuit of short-term agendas, has deep roots in our business culture. It had been popularized by Milton Friedman in the 1960s, it soon dominated the thinking in the business schools, and it fueled the takeover activity of the 1970s and 80s. Shareholder primacy was embraced by both the Council of Institutional Investors and Institutional Shareholder Services when they were established in 1985, and drove the evolution of corporate governance through the balance of the century and until the financial crisis.

In 2015, we were asked by the World Economic Forum to prepare a paper proposing a new paradigm of corporate governance and investor stewardship that would incorporate the best current thinking about ESG, sustainable investment strategies and principles of stakeholder governance. This new paradigm was designed to be recommended to corporations, institutional investors and asset managers as an intellectual and pragmatic framework for rejecting shareholder primacy and short-termism. In September of 2016, the International Business Council of the World Economic Forum issued *The New Paradigm: A Roadmap for an Implicit Corporate*

Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth.

Since the publication of *The New Paradigm*, the support for ESG and stakeholder governance by major institutional investors and asset managers has continued to increase. In August 2019, the Business Roundtable abandoned the shareholder primacy principles it had adopted in 1997 and embraced stakeholder governance. Although the Business Roundtable's statement was widely applauded by major investors and corporations, it was criticized by the Council of Institutional Investors as well as activist investors and their academic supporters. Six months later, the Covid-19 pandemic was upon us, creating wide-ranging operational and governance challenges for corporations that sharply disrupted settled expectations. And then came the 50th anniversary of Milton Friedman's 1970 *New York Times* article, which prompted further reflections and commentary on the historical trajectory of shareholder primacy and the ways it has shaped American businesses and our economy and society more broadly.

These recent events have brought into sharp focus the continuing importance of restoring and supporting a long-term perspective, and the basic objectives that management, boards of directors and investors must focus on as outlined in the new paradigm.

As a guiding first principle, the new paradigm conceives that 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 the interests of all the stakeholders that are critical to the corporation's success (e.g., shareholders, employees, customers, suppliers and communities), as determined by the corporation and its board of directors using their business judgment. It also requires regular engagement with shareholders, who, having the right to elect the directors, are essential partners in supporting the corporation's pursuit of its purpose. Fulfilling corporate purpose in this manner is fully consistent with the fiduciary duties of management and the board of directors.

The new paradigm's 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 and growth of value for investors.

The requirement of lawful and ethical conduct ensures generally recognized standards of corporate social compliance, including with respect to ESG principles. Going further, the broader mandate to take into account all corporate stakeholders, including local communities as well as society and the economy at large, directs managements and 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. These principles are the essence of the new paradigm.

In addition, the new paradigm outlines basic duties and responsibilities of both management and the board, on the one hand, and investors, on the other hand. The duties of management and the board are essentially no different than they have always been. They are responsible for compliance with law, the basic business strategy, and setting the overall risk tolerance of the corporation and monitoring, mitigating and managing those risks. They are also responsible for engagement with shareholders and calibrating strategy and risks within the parameters that are mutually understood. The only real difference reflected in the new paradigm is its emphasis on sustainable long-term growth in the value of the corporation, instead of maximizing near-term value for the shareholders. The duties of shareholders under the new paradigm are to support principles of responsible investment of the type adopted by the United Nations, the World Economic Forum in the 2020 Davos Manifesto, and the Council on Inclusive Capitalism endorsed by Pope Francis in 2020, and relatedly, to deny support to activist hedge funds and other shareholders who do not embrace the new paradigm. In this regard, we reiterate the observation in our October 2015 memo, which – while not yet fulfilled – continues to be an apt prediction:

> We can all be more confident that if the major institutional investors do embrace this new paradigm of corporate governance, and adhere to it, their influence will be more favorable to the Nation's economy and society than the self-seeking personal greed of the hedge-fund activists. We may well be approaching a peaceful end of the corporate governance war, imposed not by government but the recognition by institutional investors that what is in the best interests of the Nation is in their best interests.

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