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# Embracing The New Paradigm

For the past decade, the debate about the purpose of the corporation and the role of companies and investors in the capital markets has been growing in intensity. What is their role in solving – or contributing to – the problems of short-termism, burgeoning income inequality, environmental degradation and other challenges, and how do governance principles play a role in solving or exacerbating these problems? How can we incentivize them to make the investments that are necessary for sustainable profitability and long-term growth in value? Will a focus on maximizing shareholder value lead to the most efficient allocation of capital, or is a corporation and its stakeholders (including shareholders) best served by articulating a broader sense of the corporation's purpose?

More recently, there have been a number of actions by or on behalf of companies, asset managers and investors that have embraced the principles of The New Paradigm, which we developed for the World Economic Forum and was issued by it in September 2016. This momentum accelerated last year, with a number of significant developments that suggest the essential thesis and animating purpose of this new paradigm is now being espoused by numerous major companies as well as the most influential asset managers and investors. In 2019 alone, this group included the three major index fund managers – BlackRock, State Street and Vanguard – as well as Hermes Investment Management, the Investor Stewardship Group, the Business Roundtable, the British Academy, the World Economic Forum and the UK Financial Reporting Council. As to economists and other academics, the case for the new paradigm is persuasively made in a *Financial Times* article by famed economics commentator Martin Wolf, "How to Reform Today's Rigged

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Capitalism," in which Wolf's suggestions to preserve our capitalist society are yet another validation of the new paradigm.

In effect, the core objective of the new paradigm is to forge a shared understanding and consensus that, working together, companies, asset managers and investors must make a concerted effort to prioritize and support the long-term growth and sustainability of companies. In furtherance of that objective, the new paradigm rejects shareholder primacy and short-termism, and is instead premised on the idea that stakeholder governance and attention to environmental, social and governance (ESG) matters are in the best interests of all stakeholders. While it recognizes a pivotal role for boards of directors in harmonizing the interests of shareholders and other stakeholders, it also assumes that shareholders and other stakeholders have more shared objectives than differences – namely, they have the same basic interest in achieving sustainable, long-term growth in the value of the company. In this framework, the board of directors must exercise its business judgment in seeking to implement the company's objectives, and the company and its shareholders need to engage on a regular basis to foster a mutual understanding and alignment as to corporate purpose and strategy.

The framework of this new paradigm is divided into three buckets:

First, *governance* is about the relationship between a company and its shareholders (asset managers and institutional investors) and between the company's management and board of directors. Companies are embracing core principles of good governance and demonstrating that they have competent, engaged, thoughtful boards overseeing reasonable, long-term business strategies.

Second, *engagement* is the exchange of information, opinions and perspectives between a company and its shareholders. Engagement is about

dialogue, not dictates. Engagement connotes a mutual commitment between companies and shareholders to engage with each other proactively on issues and concerns that affect the company's long-term value, and provide each other with the access and information necessary to cultivate long-term relationships. Companies are responsive to the issues and concerns of shareholders, while shareholders proactively communicate their preferences and expectations.

Third, *stewardship* principles reflect a commitment on the part of asset managers and institutional investors to be accountable to the beneficial owners whose money they invest, and to use their power as shareholders to foster sustainable, long-term value creation. In embracing stewardship principles, asset managers and investors develop an understanding of a company's governance and long-term business strategy, and pursue constructive dialogue as the primary means for addressing suboptimal strategies or operations. In this framework, if a company and its board of directors are diligently pursuing well-conceived strategies that were developed with the oversight of independent, competent and engaged directors, and its operations are in the hands of competent executives, then asset managers and investors will support the company and reject activists seeking to force short-term value enhancements without regard to long-term value implications.

Although there are a number of specific principles in each of these three categories, the new paradigm is not about introducing yet another corporate governance checklist, nor is the point to encourage companies or investors to endorse a specific list of action items. Instead, the new paradigm is a recalibration of the corporate governance system and a shift in the mindset and expectations of its stakeholders – so that long-term value is not sacrificed at the altar of near-term profits, shareholder value is realized by (rather than at the expense of) a thoughtful balancing of the stakeholder interests that are critical to the success of the

corporation, and corporations are animated by a sense of purpose that extends well beyond a myopic focus on profits.

Led by activist hedge funds and a handful of law professors, there has been a reactionary effort to reject the new paradigm and preserve shareholder primacy, activism and short-termism. This group has sought, among other things, to cast doubt on the legal permissibility of stakeholder governance. Yet, stakeholder governance is fully consistent with well-established principles of corporate law and the existing fiduciary duty framework for directors. There is no legal impediment to embracing stakeholder governance. Instead, the board has a fiduciary duty to promote the best interests of the corporation, and in fulfilling that duty, directors exercise their business judgment in considering and reconciling the interests of various stakeholders and their impact on the business of the corporation. Moreover, in exercising their duties of care and loyalty, directors are afforded the safe harbor of the business judgment rule in seeking to promote sustainable, long-term investment and ESG principles in a manner designed to enhance the long-term value of their companies. Indeed, the special genius of Delaware law in particular, and one of the primary reasons why it has become the indisputably preeminent jurisdictional choice of most major U.S. public companies, is that it has been animated by a fundamental sense of pragmatism and its fiduciary duty framework has afforded corporations the breathing room they need to address evolving business challenges as well as expectations of shareholders. *See* Stakeholder Governance – Issues and Answers.

Accordingly, companies and investors alike have been rethinking the ways in which they engage and have been providing robust and increasingly tailored disclosures about their approaches to strategy, purpose, and mission; board involvement, composition and practices; board oversight of strategy and risk

management; the business case for long-term investments, reinvesting in the business and retraining employees, pursuing R&D and innovation, and other capital allocation priorities; sustainability, ESG and human capital matters; stakeholder and shareholder relations; corporate governance; corporate culture; and other matters that are integral to the new paradigm.

As we begin the new decade, it is clear that corporate governance will play a profound role in shaping the outcome of many of the most pressing challenges we must face together. In this context, there has been an awakening to the idea that corporate governance is not just about the allocation of decision-making authority and accountability as between corporations and shareholders; instead, it is being reconceived in light of the broader purpose and role of corporations as engines of the economy, ladders of socioeconomic mobility, innovators of technological progress and key stakeholders in environmental sustainability. As this new paradigm of corporate governance continues to take root and shape the gestalt of the business world, corporations will be better positioned to create sustainable, long-term value and avoid heavy-handed legislative initiatives.

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