AMERICAN ENTERPRISE INSTITUTE ROUNDTABLE

October 6, 2020

"**WAS MILTON FRIEDMAN RIGHT ABOUT SHAREHOLDER CAPITALISM?"**

Condensed comments from MARTIN LIPTON

Pulled from the transcript of the event

Michael Strain, Director of Economic Policy Studies at the American Enterprise Institute—Introduces Marty Lipton.

Marty Lipton is a founding partner of the law firm Wachtell, Lipton, Rosen & Katz, which specializes in advising major corporations on mergers and acquisitions and matters affecting corporate policy and strategy. Widely credited with having invented the poison pill as a way of protecting corporations from market shortsightedness, Marty has been a major public intellectual on the social role of corporations in serving not only their shareholders, but other corporate constituencies.

<u>WHO OWNS THE CORPORATION AND THE NEW PARADIGM?</u>

Lipton: First, I don't view the shareholders as outright owners of the corporation in the way one would own a house or a car. They're investors in the corporation and own the equity, and they are thus important constituents, but they are not the owners of the corporation as a whole. And for that reason, the company should not be run solely in the interest of the shareholders. I think our principal difference has to do with how the stakeholders are viewed and treated in terms of long-run growth in the value of the company.

The New Paradigm basically says that the corporation should be run in the interests of all the important stakeholders, and that includes the interests of the community at large. So, the components of ESG, the environment and social issues, are very important. The company should be run taking those factors into account for the long-term sustainable growth of the value of the company, which ultimately benefits shareholders as well as other stakeholders. At the same time, we would continue to evaluate management according to how well they are achieving long-term growth in the value of the company. If they are doing a very good job and there's no reason to question how their commitments to their customers, suppliers, and employees are designed to promote the best interests of the corporation, then let well enough alone. But if they're not increasing the long-term value of the company, then the shareholders should exercise their power.

So, my approach does not in any way deprive shareholders of their ultimate power to change the management of the company. The New Paradigm provides a set of principles for corporate management that are intended to help institutional investors and asset managers monitor companies. It recognizes that although shareholders do have the right to residual free cash flow, they are not in fact the sole owners of the corporation. It also poses questions like: Do you subscribe to ESG factors in terms of promoting long-term investment in the treatment of employees and other stakeholders and so on? But at the same time, it acknowledges that Europe has gone in the wrong direction with state capitalism and all the mandates that have come with it.

The New Paradigm says that it's up to the management of the corporation and the board of directors to engage with the investors to reach agreement on a sustainable strategy and then to carry out that strategy. And if the corporation fails to do so, it's up to the shareholders to change management. That was essentially the way it was before Friedman. It was generally accepted that the families that founded these companies and the generation or two that succeeded them, and the local people would work with the management of the company to achieve a mutually satisfactory outcome in terms of the growth of the company and dividends paid.

But since we no longer have this historic approach to corporate governance to guide us, we're now running the risks of state corporatism imposed through new legislation and regulation—and that in my view would be very bad, the worst possible outcome. Week after week new proposals are being made to impose very close guardrails on how corporations are operated. Once you get legislation that narrows management flexibility, you're moving into state corporatism, and pretty soon you're in effect taking the competition out of markets, and then you're losing capitalism.

My view is the only way to preserve capitalism and a flexible economy is for the investors who have voting control over companies to work closely with management, eliminate activist pressure for short-term performance, and continue to have open competitive markets. Without it, we're going to move rapidly in the direction of Europe with stricter and stricter limitations on both companies and investors. The EU has already moved to impose ESG mandates on both investors and financial institutions as well as listed and other large companies. To preserve capitalism, we must ensure that companies perform well and increase long-term value by taking into account the interest of all stakeholders, including the public.

<u>THE BUSINESS ROUNDTABLE STATEMENT—PREEMPTING STATE CAPITALISM</u>

Lipton: It's important to keep in mind that corporations are not completely separate from their host societies. Corporations exist only within the overall umbrella of the government and society. No corporation can function unless government is providing infrastructure, rule of law, a currency, and safety net that solves the problem of dislocations in the economy. And because corporations exist as part of and are dependent on society, they must take into account all of the interests of society in order to thrive. They can't succeed only on the basis of maximizing profits for one set of stakeholders in corporations—shifting negative externalities onto society has real and long-term consequences on companies themselves and these consequences have been made stark by the pandemic and the challenges climate change poses to many businesses.

Corporations today basically are the business of society. They're the ones who are producing the services and the products on which our existence depends, and they are part of an overall fabric of society. If you try to separate them out for the sole benefit of shareholders, you are daring society to mandate exactly how corporations should conduct business. And to me, that's the last thing we want.

We've managed to evolve a system, particularly in the United States, where we maintain flexibility in markets and flexibility in management. And every now and then it goes off a bit, but when it does, we have a group like the Business Roundtable who say, "We went off. Let's get back on the right track to accomplish what all of us want to accomplish."

So, I think what the Business Roundtable did was magnificent. They said, "We were wrong to endorse shareholder primacy in our '97 statement, absolutely wrong. This is the way corporations should act, this is what we should do." By making such a statement, the BRT is restating the purpose of corporations in order to effectively preserve the freedom of corporations to work in open markets. Otherwise, corporations are not going to have open markets in which to function; we're going to have state corporatism of one kind or another.

MARKET SHORT-TERMISM

Marty Lipton: I do think that there is a considerable difference between long-term value and short-termism. It's one thing to say that the current stock price should represent the market's view of discounted value over the long run. Nobody disputes that. The difficulty with Friedman is not so much what he said, but how it was interpreted, particularly after he became a god in the business schools following publication of his 1970 New York Times op-ed piece that we are discussing.

It was sort of given that a company should be managed in order to maximize value for shareholders, but maximizing value evolved into a set of short-termist corporate policies and practices, which pressures and incentivizes management to drive up profits, regardless of longer-term costs, and has allowed activists to use the guise of good governance to reap quick and handsome profits. And Friedman's influence coincided with the growth of institutional investor power over corporations. Pretty soon, competition among institutional investors and major asset managers put unusual pressure on companies to produce short-term profits and use cash to buy back stock.

Management faced enormous pressure to produce increasing profits on a quarter-to-quarter basis and to sacrifice the interests of employees and other stakeholders. Corporate managers were pushed to take undue risks in order to meet Wall Street's quarterly expectations. Year after year, we read about companies restructuring, reducing employment by 1,000, by 5,000, by 10,000, and then announcing the expected impact of those changes on quarterly earnings so that they can satisfy Wall Street and the stock price will rise. These changes have resulted in a significant financialization of our economy, which in turn has contributed to what I believe to be the very serious levels of inequality in our society. Whatever Friedman might have intended and wanted to accomplish, his argument for placing shareholders' interests over those of the other corporate stakeholders has resulted in a very serious dislocation in our society.

EVIDENCE OF CORPORATE SHORT-TERMISM: THE CASE OF HEINZ

Lipton: We often see companies reducing investment in R&D, capital investment, and in their employees in order to increase short-term profits to meet the expectations of Wall Street. And this has a cumulative adverse effect on long-run economic growth, employment, commitment to innovation, corporate culture, and consumer welfare—all of which threaten the long-term viability of a business.

Take the case of Kraft Heinz, which is a great example of a company that announced that they were doing zero-based budgeting and reducing investment in marketing and product development, cutting operating expenses, and increasing margins. When companies do that, it catches up with them, and their earnings and value start going down. If you look at the recent history of Kraft Heinz from the time it was taken over by the group that now manages it, both the earnings of the company and its value have been largely diminished.

Now, if we assume that zero-based budgeting is now being practiced by, say, half of all U.S. publicly traded companies in response to short-term pressures, then I would say that corporate America has been sacrificing large amounts of shareholder value by underinvesting in its stakeholders. You can't, in the long run, stop investing, stop R&D, cut your advertising, cut your marketing, cut employment and employee training, and expect to create long-term value. But as shareholders put pressure on corporate management to increase profits on a quarterly basis, that's what you're going to end up with.

And as I said earlier, that is the road to government mandates. Those have never produced a prosperous society. No Communist or socialist society has ever ended up as a utopian society. Almost all of them end up as totalitarian, and those that aren't totalitarian end up as generally being second-rate economies.

Link to AEI October 2020 transcript:

American Enterprise Institute:
https://www.aei.org/wp-content/uploads/2020/09/201006-Web-Event-Was-Milton-Friedman-right-about-shareholder-capitalism.pdf?x91208