Redefining Capitalism: Bosses Eye Purpose Beyond Profit

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Marty Lipton does not have the look of an American revolutionary. At the age of 88, he is seldom seen without a carefully pressed suit and dapper tie.

His resumé reeks of Wall Street power. In 1965 he co-founded Wachtell, Lipton, Rosen & Katz, one of the most prestigious and lucrative American corporate law groups, and he is famous for having invented, in 1982, the "poison pill" – a legal mechanism used by company boards to prevent takeovers.

"I believe in capitalism. I believe in our [financial] system," Lipton tells me over lunch in the Rockefeller Centre Club, an elite venue on the 65th floor of the Rockefeller Centre, where Manhattan power brokers can dine while peering down on the teeming city below.

But it is from elevated perches such as this that Lipton has been waging a decades-long battle with parts of America's establishment. The reason is a paper he wrote in 1979 called "Takeover Bids in the Target's Boardroom", which floated a then-revolutionary idea: that corporate leaders and investors should stop focusing on short-term shareholder returns and instead chase long-term value for "stakeholders" such as employees, clients and communities.

In continental Europe or Japan, which have long embraced a more stakeholder-focused model of capitalism, Lipton's idea might not have seemed so controversial. Yet in the US his paper provoked trenchant attacks from other lawyers, academics and investors. "Nobody wanted to listen," Lipton chuckles over the Rockefeller silverware.

But history can move in unexpected ways. Last month, 181 American chief executives issued a collective "statement on the purpose of a corporation" that abandoned their long adherence to shareholder primacy. Instead, the group – which was organised by the Business Roundtable under the leadership of Jamie Dimon, head of JPMorgan – pledged "a fundamental commitment to all our stakeholders".

That move delighted social and environmental activists. However, it infuriated some economists and investors, who declared that companies would be tossed into legal confusion. Right-wing pundits accused the Business Roundtable of shattering America's vision of free-market capitalism, while on the left politicians such as Bernie Sanders accused the executives of hypocrisy, given their sky-high levels of pay.

Once-heretical vision

The battle leaves many questions hanging. Why is the American establishment questioning capitalism now? Could Wall Street ever really embrace Lipton's once-heretical vision? And if it did, what would this mean for growth, and for the current wave of populism? “I put forward my ideas of stakeholders to save capitalism – not destroy it,” Lipton explains. “But if we don’t act now, I don’t think that capitalism will be around in the next 50 years.”

If you want to understand what is at stake in this debate, it pays to ponder the original meaning of the word “company”. Today, this invokes images of balance sheets and profit margins. However, “company” actually arises from the 12-century French word *compagnie*, a “society, friendship, intimacy; body of soldiers”, which hails from the Late Latin phrase *companio*: “one who eats bread with you”. Commerce, in other words, was initially synonymous with social ties.

That original meaning remained in place for centuries. Thus when Adam Smith, the 18th-century Scottish intellectual, wrote his treatises on the “hidden hand” he saw no contradiction between *The Wealth of Nations* (about markets) and *The Theory of Moral Sentiments* (about moral philosophy).

In the 20th century, however, the meaning of “company” changed. The reason was a man who has been Lipton’s nemesis: the Nobel prize-winning economics professor Milton Friedman. In 1962, Friedman published a book, *Capitalism and Freedom*, which argued that a company had no “social responsibility” to the public or society, but only to its shareholders. Or as he explained in a 1970s essay: “In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business ... his primary responsibility is to them.”

The essay sparked a wider revolution. In politics, Ronald Reagan and Margaret Thatcher used advice from Friedman to launch radical free-market policies. In the corporate sphere, US and UK boards stopped assuming that companies should invest revenues into their business (which had been the C-suite mantra in the early 20th century) and started focusing on dividend payments to shareholders. In universities, economists such as Eugene Fama declared that free markets were the only valid engine of growth and value, while law professors such as Lucian Bebchuk insisted corporate boards had no right to ever overrule investors, however short-term their focus.

On Wall Street, a new army of financiers, lawyers and consultants seized on the new paradigm to create booming businesses managing equities, as a new pension and mutual fund sector emerged. Then a wave of hostile company takeovers and raids got under way, as financiers scooped up the shares of weak companies to extract value. These raiders operated under the flag of Friedman – and Smith, who would probably have been turning in his grave.

Defining moment

In January 1979, American Express launched a hostile $US880 million bid for McGraw Hill, the information conglomerate. Lipton was hired to defend McGraw Hill.

It was a defining moment for Wall Street – and Lipton’s career. He had been born, in Depression-era 1931, into a modest New Jersey family, and when he co-founded his legal practice he seemed poorly placed to shake up Wall Street. But he found a niche advising companies dealing with raiders. That was in part a canny business decision, but Lipton also liked to present himself as the defender of old-fashioned business values: even today Wachtell, Lipton, Rosen & Katz hires its staff “on a handshake” and operates from one office with a mere 270-odd lawyers, who always eat lunch together every Tuesday. It has a flat pay structure by Wall Street standards, albeit with remuneration reportedly averaging well over $US5 million per partner. “Money is not the reason people work here,” Lipton sometimes says.

When Lipton looked at American Express’ hostile bid back in 1979, however, he knew that money did matter. Since the Amex bid offered shareholders a fat, immediate gain, Friedman’s creed implied that shareholders should accept it. But the McGraw Hill board insisted it would smash the long-term value of the company. So was there any way to stop this?

Lipton decided his best route was to attack Friedman directly. In “Takeover Bids”, he asked whether “the long-term interests of the nation’s corporate system and economy should be jeopardised in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares"?

Amex eventually dropped the bid, and in 1985 the Delaware court – which shapes American corporate finance since so many companies are based in the state – issued rulings on cases involving Unocal and Household International that partly supported Lipton’s stance. But any sense of victory was short-lived. The Delaware court made a ruling linked to Revlon that upheld shareholder primacy, and in 1992 the Securities and Exchange Commission introduced rules that reinforced shareholder activists. More important still, institutional investors started to outsource their voting decisions to specialist proxy services whose only mandate was to maximise shareholder returns. In 1994, pension industry reforms further entrenched the idea of shareholder primacy.

Thus by the start of the 21st century, the concept of shareholder primacy seemed ever more entrenched. Lipton’s critics dismissed his crusade as just a self-interested marketing stance and insisted that his desire to defend corporate leaders over all matters – even with their sky-high pay – was undemocratic. “Shareholder rights are essential for keeping managers and directors accountable,” insists Bebchuk, who often exchanged bitter words with Lipton. Moreover, the Friedman camp appeared to have history on its side: America’s vision of capitalism had not only triumphed over Soviet socialism, but it had unleashed much stronger growth than Japan and continental Europe, which respected stakeholders more.

Wild financial boom

Yet as so often in history, the Friedman doctrine’s moment of triumph was when the seeds of doubt were sown. These years saw the eruption of a wild financial boom, driven by cheap credit, deregulation, dealmaking and faith that free markets would solve all problems. The sheer exuberance of the markets left some uneasy, even on Wall Street.

Take the story of Jay Coen Gilbert, Bart Houlahan and Andrew Kassoy. In the 1990s, Gilbert co-founded a basketball apparel company called AND1, which was sold for a hefty sum to American Sporting Goods in 2005. It seemed a classic example of American capitalist success. But Gilbert was horrified to see that once the deal was done, the new owners restructured the company to make quick returns, hurting its long-term strategy.

Could this have been prevented, he wondered? Not under Delaware law, it seemed. Gilbert teamed up with Houlahan and Kassoy to float a novel idea: why not create a new legal structure to protect stakeholders? “We wanted to redefine the company,” Kassoy says.

In 2006 they launched this new legal structure, dubbed a “Benefit Corporation” – or “B Corp” – with the authorisation of the Delaware courts, creating a legal framework for companies that requires managers to not just chase financial metrics (for shareholders) but environmental and social goals too. It seemed terrible timing. During the credit boom few company executives wanted to change the status quo. And after that bubble burst in 2008, even fewer had the energy to fret about legal structures.

But by 2010, Kassoy was noticing something odd: though relatively few large companies actually turned themselves into B Corps, many started to embrace B Corp metrics to assess their performance around non-monetary factors. “Companies suddenly woke up and looked at how they measured themselves,” Kassoy recalls.

Why? One reason was that the 2008 financial crisis had undermined faith in unfettered free markets. Another was that companies and investors were starting to realise that environmental risks could have an impact on their operations and portfolios. However, a third factor was politics: the 2008 crisis had unleashed a popular anger against America’s corporate and political elite. And while most executives initially assumed that this anger would die away when the recession ended, the reverse occurred: even after recovery resumed, resentment grew.

Labour losing

Some of this anger was focused on issues such as immigration and globalisation (later stoked by politicians such as Donald Trump.) However, chief executives could sense they were vulnerable too. Data was emerging that showed decades of shareholder primacy had – unsurprisingly – left labour losing out badly to capital (i.e. investors) and executives. By 2007, chief executive pay was 345.9 times that of the average worker, up from a ratio of 29.7 in 1978 – and labour’s share in the overall economic output in America (i.e. wages) had fallen steadily over the same period, even as corporate profits boomed. Meanwhile, payouts to investors soared: today dividend payouts and net equity issues at companies are worth almost 100 per cent of after-tax profits; in 1972 these payouts were just 24 per cent, since spare cash was being invested or paid to workers.

Nobody had fretted about this during the boom. But the 2008 crisis had prompted a reappraisal of the American success story: in 2017, a poll suggested that 44 per cent of Millennials preferred socialism to capitalism.

Wall Street executives and financiers scrambled for ways to defend themselves. Lynn Rothschild, a former telecoms executive married to a scion of the European banking lineage, was a case in point. In 2014, she created a forum called “Inclusive Capitalism”, with a roster of luminaries – ranging from Prince Charles to Steve Schwarzman to Christine Lagarde – to champion a vision of business based around stakeholders. A decade earlier, that title might have seemed like a contradiction in terms. But Rothschild joined forces with Ernst & Young, and won support from asset managers with $30 trillion behind them. “The people saying the system is broken are not wrong," Rothschild explains. "If we don't have [inclusive capitalism], we can surely expect capitalism to be replaced with something far worse."

Other initiatives – bearing pious names such as "The CEO Force For Good" – emerged too. Then another factor started to change the zeitgeist: it became increasingly clear that climate change could wreak havoc on some company operations, and investor portfolios, in the long term. In January 2018, Larry Fink, head of BlackRock, declared that to "prosper over time, every company must not only deliver financial performance but also show how it makes a positive contribution to society ... [and] benefit all of their stakeholders". Left-wing critics cried hypocrisy and some investors pointed out that BlackRock itself had contributed to the crisis of capitalism since it had promoted passive funds (or computer-driven investing). However, the sheer size of BlackRock made it hard for other investors to ignore the trend. "Suddenly, everyone was saying capitalism had failed," recalls one Wall Street chief executive. "We started worrying about pitchforks."

These days, when Lipton ponders the state of the corporate world, he feels partly vindicated. "The Business Roundtable memo is a real turning point," he enthuses. What makes him equally excited is the explosion in financial and business activity that supports environmental, social and governance (ESG) goals. This idea is certainly not new: socially minded investors (such as nuns or Swedish pension funds) have long used finance to promote social good. But in recent years ESG has moved from being a tiny cottage industry into a mainstream endeavour worth $US31 trillion, according to the broadest definitions.

Critics claim that much of this ESG business is so dangerously ill-defined, fragmented and opaque that it conceals a multitude of ethical sins. Optimists retort that these criticisms were found in the early phases of other waves of financial innovation too, until those sectors matured. "The situation with ESG looks similar to what I saw in the early days of leveraged finance," says Marisa Drew, chief executive officer of the impact advisory and finance department at Credit Suisse. Either way, just as an army of accountants and lawyers once scrambled to turn the Friedman doctrine into a business plan – and fat fees – a race is now on to create a more professional framework for ESG too. "We are finding ways to measure stakeholder issues in accounts," enthuses Ronald Cohen, a luminary of British venture capital who is working with Harvard academics to overhaul accounting systems.

Dangerous power grab

Yet even amid this apparent "success", Lipton remains worried about a backlash. The Council of Institutional Investors, for example, lambasted the Business Roundtable memo, warning that "accountability to everyone means accountability to no one". Luigi Zingales, a Chicago economics professor, dismissed it too as "at best misleading marketing, at worst a dangerous power grab" by overconfident chief executives. Moreover, while few in business will publicly criticise the Roundtable, some fear it will lead to more regulation by government. "It's ridiculous – this is not how capitalism is supposed to work," one prominent chief executive argues.

More worrying still, in Lipton's eyes, is the risk that left-wing politicians could go much further. In the UK, Labour leader Jeremy Corbyn recently proposed an "Inclusive Ownership Fund" to give workers mandatory stakes in big companies. American figures such as Elizabeth Warren are also pushing for a pro-worker corporate overhaul, and for Lipton the lessons are clear.

“The failure to recognise the existential threats of inequality and climate change, not only to business corporations but also asset managers, institutional investors and all shareholders, will invariably lead to legislation that will regulate not only corporations but also investors,” Lipton recently wrote to the CII. “Shareholder primacy was ill-conceived in the first place ... The alternative is state corporatism in the form of legislation such as Senator Warren’s Accountable Capitalism Act.”

Friedmanites – and the CII – disagree: in their eyes it is Lipton who is undermining capitalism. Meanwhile, critics such as Warren might dismiss the battle as just an inward-looking elite fight that excludes workers. But either way, the one thing that is crystal clear is that there will not be a resolution any time soon. “I am going to keep fighting for the rest of my life,” Lipton chuckles. Welcome to the next 50 years.