How Will Stakeholder Considerations Impact Shareholder Primacy as a Company's Mandate:

An Analysis of Whether Market Forces or Mandatory Compliance May Lead to Systemic Changes in American Corporate Governance

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Suzanne Antoniou (suzanne_antoniou@brown.edu)
Laurie Finkielsztein (laurie_finkielsztein@brown.edu)
Emily Winston (emily_winston@brown.edu)

Primary Advisor: Lawrence A. Rand
Visiting Professor of Economics

Secondary Advisor: David Weil
James and Merryl Tisch Professor of Economics

Brown University
Providence, Rhode Island

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Abstract

Our paper will analyze the long-established shareholder primacy theory and how the possible shift for companies to consider other stakeholders may impact an enterprise's ability to enhance long-term value creation. Specifically, the paper will explore the historical roots of shareholder primacy tracing back to the Chicago school of thought and Milton Friedman's doctrine that the sole role of a commercial enterprise is to generate financial rewards to its owners.

Through primary and secondary sources, we have determined that American corporate governance is at a critical point in which stakeholder concerns are becoming more ingrained within companies and the public at large. For example, a watershed event occurred this past summer when the Business Roundtable, perhaps reacting to various policy proposals of politicians and the traction those ideas engendered, addressed a need to reevaluate the ways in which companies think about doing business. We will explore changes to the system through both a legal/regulatory prism as well as market pressures to ultimately defend our perspective on what this movement may imply for American capitalism.

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CHAPTER 1: INTRODUCTION

On August 19, 2019, the Business Roundtable, one of the most powerful American corporate coalitions, published its "Statement on the Purpose of a Corporation" that highlighted the concept that companies should include stakeholders (i.e., constituencies other than "owners" or "shareholders/investors") as a key component in determining the mission of the enterprise. This Statement marked the first time that the Business Roundtable took such a position, and differed greatly from its Principles of Corporate Governance for public companies, that the group endorsed since 1978.

Clearly, the business environment has changed. Scandals, including those at Enron, WorldCom, and Tyco among others, the Great Recession of 2008-2009, and the attendant public reaction to the "bailout" have directed public attention to the question of whether the "profits above all" motive should be the primary function of a corporation. Indeed, the issue of income inequality in society has become an increasingly vocal rallying cry, with the wealth and income gap only becoming more apparent since the recession.

Perhaps this issue became most visible when a small group of New Yorkers mobilized to create the Occupy Wall Street movement, a protest that soon spread throughout a number of major financial centers across the country and that generated substantial media coverage. While not necessarily being the specific catalyst for change, the movement did raise the consciousness of consumers, who became more careful of the products they are purchasing and the companies they are invested in. Some companies also took proactive steps to promote how they were dealing with ethical issues, their environmental impact, and social and governance factors, as demonstrated by the rise in "ESG" reporting accompanying traditional financial metrics.

Under accepted and often legal and regulatory compliance, publicly held companies operate by a defined structure. There is a board of directors, which has fiduciary duties to the corporation and its stockholders and that is charged with specific oversight responsibilities. These include oversight of management, an entity that is responsible for developing (with the board's assent) the strategic direction of the company, and in executing against that strategic plan with the goal of generating shareholder value. However, some progressive politicians now propose making radical changes through new legislation that will impact the structure and role of the board. In contrast, others believe that change is possible through market pressures alone. We will analyze the effectiveness of both methods as they pertain to how companies can create value in this environment by gathering insights from primary and secondary source materials. We will use the German governance system as a proxy for the case where changes are made through legislative fiat, as we support our view that fosters corporate governance changes that rely mainly on market pressures.

Shareholder Primacy Theory

The University of Chicago professor of economics and Nobel Laureate Milton Friedman championed the shareholder primacy view and paved the way for its general acceptance as the raison d'etre for any "for profit" enterprise. Most notably, his "Friedman Doctrine" clearly proscribes profit maximization as the primary goal of corporations. Therefore, actions undertaken in pursuit of any other aim, such as to alleviate some social ill or minimize a corporation's effects on the environment, are deemed irresponsible and outside the purview of a company's mandate by its bylaws of its obligation to its investors. Friedman further reiterates this point in stating that individuals may have social responsibility but corporations may not.[1] And, if executives attempt to carry out their social responsibilities through their corporations, their various stakeholders will be worse off: stockholders would be met with lower returns, employees would receive lower pay, and consumers would encounter higher prices.[2] Whereas social responsibility places faith in political mechanisms, Friedman and his acolytes to his shareholder theory rely on market mechanisms.[3] In essence, Friedman equates emphasis on stakeholder value and having a "social conscience" in business to support of socialism.[4] As his writing came out during the height of the Cold War, CEOs were highly incentivized to avoid any appearance of Communist sympathizing.

This theory was cemented into legislation via Dodge v. Ford. Yet, some question whether or not the case truly bears the significance it has been given. It is popularly presented as a case that dealt with management's role to maximize profits, but it can also be interpreted as an issue of controlling shareholders' obligations to minority shareholders.[5] And, some historical events, particularly the "Takeover Frenzy" in the 1980s, cast doubt upon the claim that inefficient management will be punished via market mechanisms. For example, a previously prevailing view was that companies targeted for takeovers were underperforming, but empirical review reveals that assumption as false.[6] Proponents of stakeholder considerations argue that market mechanisms are not as powerful as Friedman contended.

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[1] Milton Friedman, "The Social Responsibility of Business is to Increase its Profits," The New York Times Magazine, September 13, 1970, 2.
[2] Ibid.
[3] Ibid, 3.
[4] Ibid, 1.
[5] Lynn A. Stout, "Why We Should Stop Teaching Dodge v. Ford," *Cornell Law Faculty Publications,* Paper 724 (2008).
[6] Jeff Smith, "The Shareholders vs. Stakeholders Debate," MIT Sloan Management Review, July 15, 2003.

Methodology

Our paper will shed light on the pressures placed on corporate governance and some of the proposals to reform the current system. We will offer our views and recommendations on the issue, based on the primary and secondary research we have conducted.

<u>CHAPTER 2: WHY ASK THIS QUESTION NOW?</u>

Fallout from the Great Recession

The economic recession of 2008 affected parties in the moment, such as the bankruptcy of Lehman Brothers, with effects still impacting society today.[7] Even more than ten years since the recession, many people believe what transpired was an anomaly caused, in part, by the creation of sub-prime mortgage and credit practices, and by esoteric financial instruments that Wall Street created. They buttress their view by noting that today the impact from the financial crisis is history and point to the record highs in the stock market and the historic low in our nation's unemployment rate as evidence. Yet, data shows that we have seen a one percentage point drop in adults between the ages of 25-54 who are employed or looking for a job.[8] Economist Danny Yagan, from University of California Berkeley, argues that the "intensity of the recession...squeezed workers out of the labor market."[9] From an employer perspective, the middle class has continued to shrink—the job market has become biased towards those with high school degrees but less than college degrees.[10] Employers also took advantage of the recession to cut costs by firing employees and replacing them with technology. A study by the National Bureau of Economics has shown that as a result, male participation has declined due to the decrease in middle class jobs, demonstrating that workers have chosen to succumb to unemployment rather than taking jobs in "fast-food or big-box retail".[11]

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[7] Nick Lioudis, "The Collapse of Lehman Brothers: A Case Study," Investopedia, November 26, 2019.
[8] U.S. Bureau of Labor Statistics, Civilian Labor Force Participation Rate: 25 to 54 Years, Federal Reserve Bank of St. Louis.
[9] Annie Lowrey, "The Great Recession Is Still With Us," The Atlantic, December 1, 2017.
[10] Ibid.
[11] Christopher Foote and Richard Ryan, "Labor-Market Polarization over the Business Cycle," NBER Macroeconomics Annual, University of Chicago Press, vol.29(1), 371-413.

Immediate Recession Aftermath on Americans

It is clear that the change in supply and demand in the labor market in the aftermath of the recession has widened the income inequality gap. An example of this is seen by comparing the economic geography of areas that have recovered from the recession with those that have not. Yagan found that "tech-heavy, coastal and already rich areas snapped back quickly," whereas areas in California, Nevada, Arizona, and Florida, whose economy heavily relied on rising home values, continued to struggle with the aftermath of the recession.[12] Another example is "distressed communities," such as areas in the rural South and Midwest. A report by the Economic Innovation Group has shown that these communities experienced a "6% decline in employment and 6.3% drop in business establishments" which lasted years beyond the recession itself.[13] Post-recession, wealthier people gained access to capital by benefitting from extremely high credit ratings, and from using leverage from those scores to buy, build, and invest in their assets, such as real estate, art, and other collectibles, which further increased in value. By contrast, poorer people saw their credit scores drastically decline and many lost their homes without the option to buy another house. Hence, the wealth gap expanded and the inequality chasm widened.

The Birth of Occupy Wall Street

From the heightened income inequality came the well-known movement: "Occupy Wall Street." The movement started in 2011 in New York City after a Canadian anti-consumerist magazine called for an occupation which led to individual activists taking on their own actions.[14]

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[12] Lowrey, "The Great Recession Is Still With Us."
[13] Rob Williams, "Economic Growth Is Spread Unevenly Among Cities," Economic Innovation Group, September 25, 2017.
[14] Brian Greene, "How 'Occupy Wall Street' Started and Spread," US News, October 17, 2011.

Activists camped out and protested in lower Manhattan to raise awareness about social and economic inequality, bribery, and the impact of corporations and financial services firms on the government. Initially they focused on Zuccotti Park but after they were forced out, they turned to occupy financial services firms in the financial district as well as college campuses. Their slogan became “We are the 99%” to heighten the difference with the richest 1 percent in the United States and the movement expanded to cities across the country including Chicago, Los Angeles, San Francisco, and Boston.

Notable Responses to Occupy Wall Street

Due to the amount of noise that Occupy Wall Street caused around the world, it garnered a great deal of responses from high profile individuals. President Barack Obama remarked, “I think it expresses the frustrations the American people feel...seeing some of the same folks who acted irresponsibly trying to fight efforts to crack down on the abusive practices that got us into this in the first place.”[15] The 2012 Republican Presidential candidate Mitt Romney expressed sympathy with the protestors and “underst[ood] how those people feel.”[16] Other notable figures including Jon Stewart, Nancy Pelosi, Chris Hedges as well as celebrities like Kanye West and Alec Baldwin endorsed the Occupy Wall Street movement.

Evaluating the Effectiveness of Occupy Wall Street

While Occupy Wall Street gained a lot of media support and endorsements, the movement was never able to accomplish anything beyond garnering headline attention, particularly within the financial district of Manhattan.

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[15] Ibid.

[16] Kim Geiger and Maeve Reston, “Mitt Romney sympathizes with Wall Street protestors,” Los Angeles Times, October 11, 2011.

A big criticism of Occupy Wall Street is that it never had a clear goal and mission. It was fighting to end income inequality but never had clear objectives. Many believed it stood to make statements against Wall Street as the group lost traction before it could attempt to implement legislative action.[17]

Another key criticism of Occupy Wall Street is that it lacked adequate minorities and thus representation of all of the "99%." Only 1.6 percent of Occupy Wall Street's protestors were African American, yet unemployment for African Americans was 7 percent higher than that for whites at the time.[18] Moreover, its leaders and protestors also included anti-Semitic rhetoric, which the movement failed to condemn.[19]

While Occupy Wall Street desired to bring awareness to income inequality, the group was ultimately not successful in enacting change. Had the group been more organized and clearer with their objectives, mission, and member base, perhaps they would have made more of an impact.

Inequality Worsens Post-Recession

Income inequality, wealth inequality, and inequality of access to financial institutions all contribute to a feeling of tension and neglect in the U.S., and are prime fodder for the stakeholder inclusion movement. Inequality is not just unjust, but it is also dangerous: inequality both exposes society to and paves the way for populism.[20] It leads to a deterioration of trust and affects everyone. Additionally, it has been linked with an assortment of psychological issues:

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[17] Daniel Indiviglio, "5 Reasons Why 'Occupy Wall Street' Won't Work," The Atlantic, October 3, 2011.
[18] The Week Staff, "Why is Occupy Wall Street 'overwhelming white'?" The Week, November 28, 2011.
[19] Jennifer Rubin, "Occupy Wall Street: Does anyone care about the anti-Semitism?" The Washington Post, October 17, 2011.
[20] Lipton, Martin, Phone call with Suzanne Antoniou, Laurie Finkielsztein, Emily Winston. November 4, 2019.

"feelings of inadequacy, depression, envy and other negative emotions."[21] The high stress that many Americans feel is not found in other highly developed, but more equal, countries.[22] Thus, research has shown a negative correlation between income inequality and wellbeing for both adults and children.

The drastic income and wealth inequality, despite overall gains in total income and total wealth, exacerbate issues. Many feel abandoned by a government that appears to just make a wealthy class richer at the expense of the poor. Such a dynamic is often explained as a necessary byproduct of free market capitalism. Yet, many see the call to advocate for stakeholders as a way to mitigate this issue.

Income Inequality

Concerns regarding income inequality have been mounting for years and the situation has grown increasingly bleak. Income inequality is currently the highest it has been since the metric was first tracked in 1967.[23] The inequality has also worsened in almost every state since 2013, and affects rural, suburban, and urban areas.[24] Whereas the top one percent's share of income fell following the Great Depression, it grew after the 2008 recession.[25] This reversal exacerbates inequality. It likely results from a stagnant minimum wage combined with soaring CEO pay. In 1965, CEOs earned 20 times that of a typical worker, but in 2016 the ratio was 271:1.[26] As of 2016, the top 10 percent of income earners took in half of the total U.S. household income pie.

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[21] Pedro Nicolaci da Costa, "Opinion: These 5 charts show inequality is bad for your health—even if you are rich," MarketWatch, February 20, 2019.
[22] Ibid.
[23] Taylor Telford, "Income Inequality in U.S. is at a five-decade high, census started tracking its data shows," The Washington Post, September 26, 2019.
[24] Carmen Reinicke, "US income inequality continues to grow," CNBC, July 19, 2018.
[25] Ibid.
[26] Ibid.

The middle 50-90 percent of earners had 37 percent of the pie, and the bottom 50 percent of earners only had 13 percent.[27] Clearly, income is starkly unequal in the U.S.

Income inequality also falls along racial lines. Those at the 90th percentile for black earners are still only earning 68 percent of what white earners are earning at the 90th percentile. Hispanic earners at the 90th percentile take home an even smaller 65 percent.[28]

Wealth Inequality

Wealth, too, is not distributed equitably in the United States. This is illustrated by the unfortunate statistic that "the wealthiest 1 percent of families in the United States hold[s] about 40 percent of all wealth and the bottom 90 percent of families hold less than one-quarter of all wealth."[29] The wealthiest families have a greater percentage of wealth than the highest paid ones have of income.[30] The bottom 90 percent's share of wealth has grown smaller over time: in 1989 it was 33 percent, but it shrunk to be 23 percent in 2016.[31] Also, the percent of families with negative net worth rose from 7 percent in 1989 to 10 percent in 2016.[32] This pervasive and lasting wealth inequality can make something like the 'American Dream' seem unattainable since income generation is not necessarily correlated with wealth accumulation.

Inequality of Access

There is inequality of access to financial markets that is a byproduct and cause of both income and wealth inequality. Access to these markets facilitates the processes of obtaining

[27] Ana Kent, "What Wealth Inequality in America Looks Like: Key Facts & Figures," Federal Reserve Bank of St. Louis, August 14, 2019.
[28] Rakesh Kochhar and Anthony Cilluffo, "Key findings on the rise in income inequality within America's racial and ethnic groups," Pew Research Center, July 12, 2018.
[29] Greg Leiserson, Will McGrew, and Raksha Kopparam, "Distribution of wealth in the united states and its implications for a net worth tax," Washington Center for Equitable Growth, March 21, 2019.
[30] Ibid.
[31] Ibid.
[32] Kent, "What Wealth Inequality in America Looks Like: Key Facts & Figures."

housing and participating in the consumer economy.[33] Lack of access, to what some have dubbed "the passport to [the] modern economy," makes economic success quite difficult.[34]

Currently, investments in the stock market produce fairly consistent and sizable returns. Individuals can directly invest their money in such markets, or have their money indirectly invested through entities like mutual funds or 401(k)s.[35] From 2001 to 2008, the average percentage of Americans with either direct or indirect stock ownership was 62 percent.[36] Ownership fell progressively following the 2008 recession. By 2019, the percentage with ownership fell to 55 percent.[37] Because these markets can generate economic success, their declining use means that there is inequality perpetuated by many individuals' lack of access.

Additionally, many individuals do not have proper access to financial institutions for savings accounts and the ability to take out loans. The latter issue is linked to the fact that one needs a credit score to take out a loan, yet 53 million Americans do not have credit scores.[38] These individuals are dubbed "credit invisibles."[39] Credit invisibles lose out because they do not have access to loans, but financial institutions do too because they miss out on potential customers. Many banks, including Goldman Sachs and credit issuers such as Discover, have begun utilizing other metrics to determine credit worthiness. Such metrics include magazine subscription history, discount store shopping activity, voter registration status, and an

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[33] Michael Barr, "Access to financial services in the 21st century: Five Opportunities for the Bush Administration and the 107th Congress," Brookings, June 1, 2001.
[34] Ibid.
[35] Lydia Saad, "What Percentage of Americans Owns Stock?" Gallup, September 13, 2019.
[36] Ibid.
[37] Ibid.
[38] AnnaMaria Andriotis, "Need Cash? Companies Are Considering Magazine Subscriptions and Phone Bills When Making Loans," Wall Street Journal, September 12, 2019.
[39] "Data Point: Credit Invisibles," The CFPB Office of Research, May 2015.

individual's ratio of grocery store to restaurant spending.[40] Incorporation of broader metrics is helpful in terms of providing access, but it feels problematic that for some, acquiring that access necessitates divulging personal information.

[40] Andriotis, "Need Cash? Companies Are Considering Magazine Subscriptions and Phone Bills When Making Loans."

CHAPTER 3: POLITICAL CHANGES

The Trump Tax Cuts and Jobs Act

President Trump's 2017 Tax Cut and Jobs Act (TCJA) has had a major impact not only on corporate taxes, and by inference, corporate profits, but, perhaps more importantly, on corporate free cash flow, and how that new found cash will be used. Thus, it is not surprising that TCJA has elicited strong reactions within the political and corporate arenas.

The TCJA reduced corporate taxes from a 35 percent rate to a flat 21 percent rate. It also virtually ended the so-called double taxation policies on U.S. companies that wanted to repatriate profits which multinational American companies earned abroad.[41] As a result of TCJA and the cash windfall it created, many investors benefited.

Companies used their new found wealth to pay special dividends or substantially increase share buybacks--Warren Buffett's favorite vehicle to enhance shareholder value through financial engineering. The math is relatively simple: by reducing the number of shares outstanding the EPS increases, and a higher EPS usually translates into a higher stock price, and unlike a cash dividend, which is fully taxed as earned income, there is no tax to pay until the stock is sold, at which time the tax is at the lower rated "long term capital gains" figure. It is of no surprise, except perhaps to the President who said that he hoped the cash generated from the tax act would be used to build facilities in the U.S. or for higher wages for the middle and lower classes, that stock buybacks have increased in popularity over the years, peaking in 2007 and again in 2018, as mapped in Figure 1. Following the TCJA, buybacks increased 52.6 percent from 2017, while capital investment increased only 8.8 percent and R&D investment increased

[41] Anne Marie Knott, "Why The Tax Cuts and Jobs Act (TCJA) Led to Buybacks Rather Than Investment," Forbes, February 21, 2019.

12.5 percent.[42] Meanwhile, only 6 percent of tax savings were spent on workers.[43] As corporate executives and investors reap the benefits of Trump's bill, other stakeholders and company interests felt left behind. As shown in Figure 2, business investments decreased and turned negative after the enactment of the TCJA. Some of the critical views towards the TCJA, including potential policy responses to reform the system, are described below.

The Progressive Pushback: Bernie Sanders, Elizabeth Warren, and the Squad

Reforms to corporate America are reflected in policies and proposals by Democratic presidential candidates. Bernie Sanders and Elizabeth Warren proposed changes to the current system to reduce the income and wealth disparity in society.

Bernie Sanders takes a strong stance against the TCJA, claiming wealthy and ultra-wealthy individuals, as well as corporations such as Amazon (a Business Roundtable signor) and Netflix avoid paying taxes while maximizing profits. In response to the TCJA, Sanders proposed a restoration of the corporate tax rate to 35 percent and the banning of stock buybacks which he describes as "stock price manipulation." Sanders wants to introduce a *Corporate Accountability and Democracy Plan* that would, "give workers an ownership stake in the companies they work for, break up corrupt corporate mergers and monopolies, and finally make corporations pay their fair share."[44] He would create "Democratic Employee Ownership Funds," in which employees are guaranteed a percentage of the dividends paid out by a corporation. The plan also seeks to "democratize corporate boards," granting employees 45 percent representation on the board of directors of any publicly traded corporation and private

[42] Ibid.
[43] Peter Cary and Allan Holmes, "Workers barely benefitted from Trump's sweeping tax cut, investigation shows," The Guardian, April 30, 2019.
[44] "Corporate Accountability and Democracy," Bernie Sanders.

companies with over $100 million in revenues. It will also diversify corporate boards so that they are representative of underrepresented groups. Employee representation on boards mirrors corporate governance practices in Germany, whereby corporations are required to have 50 percent employee representation on supervisory boards. Another component of Sanders's plan is to require "stakeholder" charters for large companies, incorporating the interests of all stakeholders in a company.

Elizabeth Warren also opposes the TCJA, which she believes, "delivers massive tax cuts to millionaires and giant corporations and kicks working families to the curb."[45] She, like Sanders, wants to raise tax rates to pre-TCJA levels. She also wants to impose an "ultra-millionaire" tax of 2 percent on households whose net worth is greater than $50 million and 4 percent for net worth greater than $1 billion.[46] Warren introduced her *Accountable Capitalism Act* in August 2018, which stipulates that corporations with over $1 billion in income have 40 percent employee representation on boards and receive a "federal charter of corporate citizenship." The charter "obligates company directors to consider the interests of all corporate stakeholders--including employees, customers, shareholders, and the communities in which the company operates."[47] The *Accountable Capitalism Act* also restricts sales of company shares within five years of receiving them or within three years of a stock buyback.[48]

In addition to presidential candidates, there is pressure from progressive politicians to reform the current system. "The Squad" consists of Representatives Alexandria Ocasio-Cortez of New York, Ilhan Omar of Minnesota, Ayanna Pressley of Massachusetts, and Rashida Tlaib of

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[45] "Warren Statement on Trump Tax Reforms," Elizabeth Warren, September 27, 2017.
[46] "Ultra-Millionaire Tax," Elizabeth Warren.
[47] "Accountable Capitalism Act," Elizabeth Warren.
[48] Ibid.

Michigan, and its membership is intended to extend to include people who "share the values and believe in creating a more equitable and just world."[49] The group's moniker was coined by Representative Ocasio-Cortez, a reference to millennial culture. President Trump and other politicians have targeted the Squad's constituents and their views.

The Squad's members endorse policies that are of interest to a younger voting demographic. Representative Ocasio-Cortez advocates for reducing inequality and has proposed "A Just Society" to improve the government's anti-poverty efforts, including a higher minimum wage and universal family care. She addresses economic disparity, recognizing that, "We are at our richest point that we've ever been, but we've also been our most unequal."[50] Under "A Just Society," her "Uplift Our Workers Act" would designate a "worker-friendly score" for federal contractors. The score, created by the Department of Labor and Office of Management and Budget indicates the degree to which employers are responsive to employees' concerns. Some of these elements include whether employers provide paid overtime over 40 hours per work week, guarantee paid sick leave and parental accommodations, pay employees at least $15 an hour, provide predictable scheduling, and subsidize healthcare for employees.

[49] Anna North, "How 4 congresswomen came to be called "the Squad"" Vox, July 17, 2019.
[50] Tracey Ross, "Rep. Alexandria Ocasio-Cortez Unveils Bold Vision For Addressing Poverty," Essence, October 3, 2019.

CHAPTER 4: THE BUSINESS ROUNDTABLE

The Business Roundtable (BRT), chaired by J.P. Morgan Chase Chairman and CEO Jamie Dimon, is a guiding force for corporate governance. Since 1978 it issues its Principles of Corporate Governance for public companies, identifying the responsibilities of boards and providing recommendations for management. Its August 2019 Statement on the Purpose of a Corporation, with the support of 181 executives, overturned previous declarations that, "the principal objective of a business enterprise is to generate economic returns to its owners" and "the paramount duty of management and of board of directors is to the corporation's stockholders…"[51] Rather, it now includes "stakeholders" and addresses shareholders last in a list of constituents.[52] It states a commitment to:

> "Delivering value to our customers…"
> "Investing in our employees…"
> "Dealing fairly and ethically with our suppliers…"
> "Supporting the communities in which we work…"
> "Generating long-term value for shareholders…"

As a result, politicians and executives are divided on the statement's ability to incentivize change for corporations. Some argue it has gone too far, while others believe the statement holds only nominal significance. For Ward Nye, CEO of Martin Marietta Materials, the statement is "more aspirational" than it is "wholly practical in the immediate near-term," as he recognizes that ultimately, "the long held aim of a corporation is to maximize profits and there is a great deal of case law confirming that duty. However, maximizing profits, done thoughtfully, can

[51] Business Roundtable, "Statement on the Purpose of a Corporation," August 19, 2019.
[52] Ibid.

benefit all stakeholders."[53] Frank Zarb of Proskauer Rose LLP shared views on the BRT Statement, that "it is unclear" what it will mean.[54]

The BRT Statement provokes more questions than answers: *To what extent did CEOs approach boards prior to signing the statement? In adhering to the statement, do CEOs violate their fiduciary duty to shareholders? Who qualifies as a "stakeholder" and which of their concerns should be prioritized? How can the incorporation of stakeholder concerns be measured? Is government involvement necessary to facilitate change or are businesses capable of accomplishing this on their own?* We will analyze this final question in depth in the following chapter.

To Dimon, the BRT Statement reflects the fact that, "Major employers are investing in their workers and communities because they know it is the only way to be successful over the long term."[55] Yet, advocating for stakeholders is not unprecedented. Constituency statutes were enacted in response to the takeover frenzy of the 1980s, requiring a board of directors to pay attention to the interests of all corporate stakeholders when making decisions. In addition, Benefit Corporation legislation expands the fiduciary duty of directors to include stakeholders as well as shareholders. Recently, Dimon and Warren Buffett cautioned against short-termism, encouraging the shift away from quarterly earnings-per-share reporting. They acknowledged that this reporting "often leads to an unhealthy focus on short-term profits at the expense of long-term strategy, growth and sustainability."[56] The BRT Statement, backed by executives including those

[53] Nye, Ward, Phone call with Suzanne Antoniou, Laurie Finkielsztein, Emily Winston. November 1, 2019.
[54] Zarb, Frank, Phone call with Suzanne Antoniou, Laurie Finkielsztein, Emily Winston. October 23, 2019.
[55] Lila MacLellan, "Nearly 200 CEOs just agreed on an updated definition of "the purpose of a corporation," Quartz, August 19, 2019.
[56] Michael Rapoport, "Buffett, Dimon Team Up to Curb 'Unhealthy Focus' on Quarterly Earnings," The Wall Street Journal, June 7, 2018.

from Amazon, Apple, BlackRock, Goldman Sachs, Salesforce, and Walmart amongst others, has again fueled debate around the need to think long-term about shareholders and stakeholders.

In response to the BRT, the Council of Institutional Investors (CII) publicly voiced its disapproval, viewing the statement as a public relations event that would dampen managerial accountability. The CII articulated that, "Accountability to everyone means accountability to no one," and is concerned the statement would "diminish shareholder rights," without suggesting "new mechanisms to create board and management accountability to any other stakeholder group."[57] Opponents also caution that the statement might incentivize corporations to prioritize certain stakeholders at the extent of others. For instance, a company that invests heavily in coal may demonstrate its commitment to the environment by reducing its investments, which would in turn incur additional costs to consumers and result in job losses for those employed by the industry.

Martin Lipton of Wachtell, Lipton, Rosen & Katz, endorses the BRT decision, sharing that, "universal adoption of stakeholder governance" can potentially "significantly reduce inequality."[58] He rebukes the views of the CII, and believes that, "Inequality and climate change will not be mitigated without adherence to the BRT governance principles not just by members of the BRT, but by all business corporations." [59] Lipton proposes *The New Paradigm* for corporate governance, a framework for corporations and institutional investors to collaborate and resist short-termism. It is created with the intention of fostering long-term sustainability *without* requiring government regulation and legislation.

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[57] "Council of Institutional Investors Responds to Business Roundtable Statement on Corporate Purpose," Council of Institutional Investors, August 19, 2019.
[58] Lipton, Martin, Phone call with Suzanne Antoniou, Laurie Finkielsztein, Emily Winston. November 4, 2019.
[59] Martin Lipton, "Stakeholder Corporate Governance Business Roundtable and Council of Institutional Investors," Harvard Law School Forum on Corporate Governance and Financial Regulation, August 21, 2019.

Salesforce was one of the 181 companies whose executives signed the BRT Statement. The importance of stakeholder rights to Salesforce is evidenced by recent statements made by its Chairman and Co-CEO, Marc Benioff, who attributes its financial performance to the value placed on both stakeholders and shareholders. In a New York Times op-ed Benioff proclaims that, "Capitalism, as we know it, is dead"[60] and in an interview with CNBC he states the need for, "a new capitalism…that's more fair, more equitable…that values not only all shareholders but also all stakeholders."[61] Unlike Lipton, Benioff proposes that governments intervene and require public disclosure on how companies are acting to benefit stakeholders. He advocates for shareholder reports to measure shareholder returns and a similar report to measure stakeholder returns.

Salesforce is also one of the top five companies identified by Just Capital's 2020 rankings. Under the leadership of Paul Tudor Jones, Just Capital aggregates the most important non-financial corporate issues for the largest publicly traded companies ranked by Americans. Jones advocates reforming capitalism, recognizing that while, "Our capital markets are working for some folks…there's a whole bunch of people…that are being left behind."[62] He notes that many shareholders and CEOs fail to address the issue, although wealth inequality is five times higher than it was fifty years ago.[63] Just Capital does not rely upon governmental intervention but rather market forces to enforce change. Through a "stakeholder scorecard," Just Capital benchmarks a company's commitment to stakeholder concerns, showing a company's current

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[60] Marc Benioff, "Marc Benioff: We Need a New Capitalism," The New York Times, October 14, 2019.
[61] Kevin Stankiewicz, "Marc Benioff: CEOs won't keep jobs 'very long' if they don't adopt a new approach to capitalism," CNBC, October 16, 2019.
[62] Bloomberg Markets and Finance, "Paul Tudor Jones on JUST Capital, U.S. Recession, and Gold." June 2019. YouTube video, 00:50. Posted June 13, 2019. https://www.youtube.com/watch?v=whva1AVXScA.
[63] Ibid, 3:18.

performance and improvement goals for issues that relate to workers, customers, products, environment, jobs, communities, and leadership. Just Capital's 2020 report found that Business Roundtable signatories perform well when compared to their Russell 1000 peers, outperforming on matters concerning employees, environment, community, and shareholders.[64]

[64] Andrew Nusca, "The Business Roundtable, Ranked: How Well Apple, IBM, and Amazon Actually Serve Stakeholders," Fortune, November 12, 2019.

CHAPTER 5: RAMIFICATIONS OF "THE SHIFT"

Market Pressure Response: Theory of Friedrich Hayek

Economists like Friedrich Hayek would be expected to support the adoption of stakeholder considerations based on market pressures, as opposed to government intervention. This is due to qualms that many have with increasing government power and disrupting normal market activity.[65] With this mindset, stakeholders would not be legally given rights, but it would be in a company's best interest to account for stakeholders in its decision-making. This process would occur purely as a reaction to the shifting preferences of the market. For example, because many make investment decisions, at least partially, based off of the ESG characteristics of a company, CEOs will become incentivized to take up more sustainable practices. Such a scenario is quite possible given that it is becoming more and more commonplace for individuals to expect companies to "behave justly."[66] This approach represents a slow, but likely stable solution. For those who feel unheard and even harmed by the current market situation, such a gradual transition may not be drastic enough.

Successful M&A that Considers Stakeholders in Aftermath

When companies decide to merge, it is up to management of both companies to execute the merger. Procter & Gamble's (P&G) acquisition of Gillette is an ideal example of companies merging with synergies, while prioritizing the execution of the transaction. In 2005, P&G bought Gillette for $5.7 billion, further diversifying P&G's dominance in its consumer brands. The

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[65] Lawrence White, "The Second World War and Hayek's *Road to Serfdom*." In *The Clash of Economic Ideas: The Great Policy Debates and Experiments of the Last Hundred Years*. Cambridge: Cambridge University Press, 2012, 155-173.
[66] Just Capital, "The New North Star: Stakeholder Capitalism," October 23, 2019.

transaction gained a lot of support, as Gillette's largest shareholder, Warren Buffett commented, "the merger is going to create the greatest consumer products company in the world".[67]

A key component that made the transaction so successful was the way that management from both companies decided to proceed. P&G executives spearheaded a series of innovative changes to retain talent from Gillette and to properly integrate both companies together. They established over 100 global integration teams comprised of executives who had similar roles at each company such that each employee could comfortably share their own company processes.[68] Stakeholders were encouraged to communicate their thoughts through various avenues: town-hall style meetings and training programs between company employees. P&G also waited a full year to deliver performance reviews to Gillette employees, giving them ample time to adjust and assimilate into one merged company. Lastly, stakeholders around the world were also given the responsibility to coordinate the merger themselves. For example, in Brazil, the P&G manager decided to shuffle all the seating arrangements such that employees from both companies were sitting next to each other throughout the entire building.[69]

Ultimately, by the end of its first year, P&G retained 90 percent of Gillette's executives and they achieved their revenue and cost goals. While there were many synergies with this merger to maximize revenue and cut costs, part of its success is also attributed to the way both companies executed the merger. By prioritizing stakeholders from both companies and ensuring that it was communicating and feeling included into the merged company, P&G capitalized on human capital and met its goals within the first year to continue growth.

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[67] Chris Isidore, "P&G to buy Gillette for $57B," CNN Money, January 28, 2005.
[68] Rosabeth Moss Kanter, "Mergers That Stick," Harvard Business Review, October 2009.
[69] "What You Can Learn from Successful mergers & Acquisitions," Aperian Global.

Government Response: Theory of John Maynard Keynes

The establishment of stakeholder rights via government action through legislation or regulatory mandate would likely be supported by individuals such as John Maynard Keynes. Compared to Hayek, he held more trust in the motives of others and had fewer reservations about giving the government greater power. He contended that increasing government power would "be safe if those carrying it out are rightly orientated in their own minds and hearts to the moral issue."[70] This method would result in companies being legally required to take stakeholder considerations into account in their decision-making. As a result, if a company wanted to merge with another, the deal could be blocked by labor representatives advocating for employees who would be laid off. This path would yield faster attention to stakeholders, but with potential unintended consequences on the market.

Government Restrictions May Not Benefit M&A

In 1998, the German auto company, Daimler-Benz, purchased the American company, Chrysler, for $36 billion, a transaction that was dissolved in 2007. Initially, the deal was expected to give cost and revenue synergies to both sides. Daimler was intended to help Chrysler decrease their production costs by providing them with car parts and architecture. In return, Chrysler was helping Daimler expand internationally into North America. Though, "Daimler was an all-too-willing, if uninformed, partner...The company underestimated the competitive forces...never did due diligence before it bought Chrysler".[71] It is clear that from the beginning the deal was pursued purely from a potential synergy perspective rather than for digging deeper into the merger's execution by both sides.

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[70] White, "The Second World War and Hayek's Road to Serfdom."
[71] Jim Mateja, "How Chrysler marriage failed," Chicago Tribune, May 15, 2007.

Not only did Daimler not do their due diligence on Chrysler, but also neither company attempted to bridge the gaps between the two companies that operate in different countries, speak different languages, and have cross-cultural barriers. There was no attempt to make stakeholders from both sides feel like they were part of a merged company. This did not help incentivize the sides to work together. “The two organizations never were integrated into anything that approached a cohesive whole. The potential synergies that were used to justify the deal went unrealized.”[72] While the failure of the merger cannot solely be attributed to the lack of consideration for stakeholders, it is certainly a component that should be acknowledged in the disappointing merger.

[72] Michael Watkins, “Why DaimlerChrysler Never Got Into Gear,” Harvard Business Review, May 18, 2007.

CHAPTER 6: CONCLUSION

Recommendation

Many find the legalization of stakeholder rights to be an apt solution. This is clearly the path espoused by a number of liberal and progressive politicians and academics who trust in government to “do the right thing.” By contrast, there are those who believe that market forces, including demands from the general public, will create positive change in the American governance and capital system. They see a market-based method as a better solution to closing the inequality gaps and to including stakeholder concerns along with shareholder interests.

We tend to agree with the latter point of view. Our investigation of the issue reveals that a significant shift is well underway. In sum, we argue that stakeholders should not be given legal rights. Instead, their interests will be advocated for by growing market pressures.

Consideration of Stakeholders Inherently in Role of CEO

Being the CEO of a company naturally comes with a great deal of responsibility as a CEO becomes the internal and external leader of the company. As a result, CEOs need to be prepared to manage all of their duties, just some of which include delivering value to shareholders, making corporate decisions, and managing operations, employees, and other stakeholders. All of the components of a CEO’s responsibility are pivotal for the success of a company.

As a result, considering and acting on the interests of employees and other stakeholders becomes increasingly important as diversely talented employees are critical. Companies need to be able to recruit, hire, and retain top talent in order to execute their business ideas and operations. As President and CEO of Martin Marietta, Ward Nye says, “When you’re living in a world where unemployment rates are low, if you don't take care of people and respect them, you lose your talent. And if you lose your talent you're not going to be competitive and if that happens, you'll lose shareholders. So, there's a trickle-down effect."[73] Caring about employees and other stakeholders is a critical part of a CEO's job, and as Nye suggests, it is correlated with how much value can be delivered to shareholders. Similarly, former CFO and current senior advisor to Perella Weinberg Partners, Alexandra Pruner, comments, "All good management teams focus initially on improving and enhancing value to stakeholders...if they do this, all of these factors will contribute to a strong company which *should* increase shareholder value."[74] There is no need to institute government-imposed requirements on CEOs to include stakeholder interests as their interests are already inherently included in day-to-day duties in order to effectively and efficiently deliver value to shareholders.

Social Missions Seen as Necessary

It is becoming increasingly necessary for companies to have social missions, which translate into consideration of stakeholder outcomes. It is common for individuals to buy from companies that have similar values to theirs.[75] Market climate surveys show that consumers believe businesses should have social responsibility and respond to "current social movements" in some way.[76] Even if companies take up social missions solely as a marketing tool, they represent a change. Companies realize that consumers care about social issues. Younger generations care about these issues to a greater degree, paving the way for greater market based forces in the future.[77]

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[73] Nye, Ward, Phone call with Suzanne Antoniou, Laurie Finkielsztein, Emily Winston. November 1, 2019.
[74] Pruner, Alexandra, Phone call with Laurie Finkielsztein. November 14, 2019.
[75] Toby Cox, "How Corporate Social Responsibility Influences Buying Decisions," Clutch, January 7, 2019.
[76] Ibid.
[77] Ibid.

Corporate Boards of Directors

Corporate boards of directors are the drivers of change within the corporate system and those boards that recognize the importance of ESG issues are better suited to handle future challenges. Nichelle Maynard-Elliott, herself a board member of a publicly traded company, notes that a board's attention to ESG factors "depends on the culture of the company and the diversity of its board."[78] She notes that "some [boards] are focused on metrics, financial performance," while "other companies have a culture whose core values include sustainability, community awareness."[79] We argue that it is this latter group of boards that is reforming corporate governance, that ESG issues will ultimately not just be considered by some but rather be valued by all. We also realize that much of the pressure for changes comes from younger board members and executives, reflecting a wider cultural and value shift. A founding partner of Wachtell, Lipton, Rosen & Katz, Martin Lipton recently released an end of the year memo for his firm's board of directors where he wrote:

> At this point, much of the focus on stakeholder governance has shifted from the question of *whether* a board of directors should take into account the interests of other stakeholders, to *how* a board should do so. In the coming year, directors will need to grapple with a host of questions about the practical implications of this new paradigm – such as how to adjust existing board functioning to reflect stakeholder governance, questions about the contours of the board's legal obligations, and what, if any,

[78] Maynard-Elliott, Nichelle, Phone call with Emily Winston. November 15, 2019.
[79] Ibid.

modifications should be made to communications and engagement efforts with shareholders and other stakeholders.[80]

From Mr. Lipton's memo, it is evident that the priorities of boards have already changed over time due to market pressures, just in the last couple of months since the BRT's decision. We expect that these shifts will only accelerate as today's conscious consumers become tomorrow's leaders.

Institutional Investors Demanding ESG

A recent Harvard Business Review study found that ESG was "almost universally top of mind for [institutional investment firm, large asset owner, and government pension fund] executives."[81] This is important because these executives influence vast amounts of capital and if they invest that capital in ESG investments, stakeholders will be better off. The trend of considering ESG criteria is growing. "In 2006, when the UN-backed Principles for Responsible Investment (PRI) was launched, 63 investment companies (asset owners, asset managers, and service providers) with $6.5 trillion in assets under management (AUM) signed a commitment to incorporate ESG issues into their investment decisions. By April 2018, the number of signatories had grown to 1,715 and represented $81.7 trillion in AUM."[82] Additionally, a 2018 survey found that the majority of asset owners globally consider the ESG characteristics of their investments.[83]

[80] Martin Lipton, Steven Rosenblum, Karessa Cain, and Kathleen Tatum, "Some Thoughts for Boards of Directors in 2020," Wachtell, Lipton, Rosen & Katz, December 9, 2019.
[81] Robert G. Eccles and Svetlana Klimenko, "Shareholders Are Getting Serious About Sustainability," Harvard Business Review, April 26, 2019.
[82] Ibid.
[83] Ibid.

Avoiding Bad Press

Companies are incentivized to behave responsibly with regard to stakeholder considerations in order to avoid negative publicity. Such publicity would hinder their ability to attract employees as well as customers. With regard to the former, bad press surrounding a company can disincentivize individuals to seek employment there. On college campuses, students may shy away from working at or even applying to companies that they or their peers believe to be bad actors.[84] Smaller applicant pools could result in less qualified talent, an obviously undesirable outcome. Bad press can also push consumers to shop elsewhere and negative coverage can spread rapidly through social media. As a result, companies are motivated to not behave in any way that could generate controversy.

Summary of Findings

Milton Friedman's writing, as well as subsequent case law, cemented shareholder primacy theory as a tenet of corporate America. Acceptance of this ideology was so commonplace as to be expected. The 2008 recession however, brought issues to the forefront that exposed a dark underbelly of this theory. How could so many be struggling to recover from the recession, while others exceeded their pre-recession standing? Was the narrow focus on profitability for shareholders producing stark inequalities? Should shareholder primacy be abandoned altogether?

Issues of inequality plague the U.S. and ignoring them would be foolish. Yet, we argue that attempting to fix them by imposing mandated stakeholder rights requirements is similarly foolish. Instead, we contend that stakeholder considerations should be brought into corporate

[84] Shirin Ghaffary, "At UC Berkeley, Brown, and Yale, Students Are Fighting to Keep Palantir off Campus over Its ICE Contracts," Vox, September 26, 2019.

decision-making via market pressures. This exact process has begun: hedge funds have specific impact funds, many individuals invest based off of ESG characteristics, a social mission is becoming important for corporate success, and the fear of bad press, as well as the subsequent inability to attract top talent, is powerful. The conscience of American society at large will inevitably turn social considerations into profitable ones.

<u>APPENDIX</u>

Figures

Figure 1

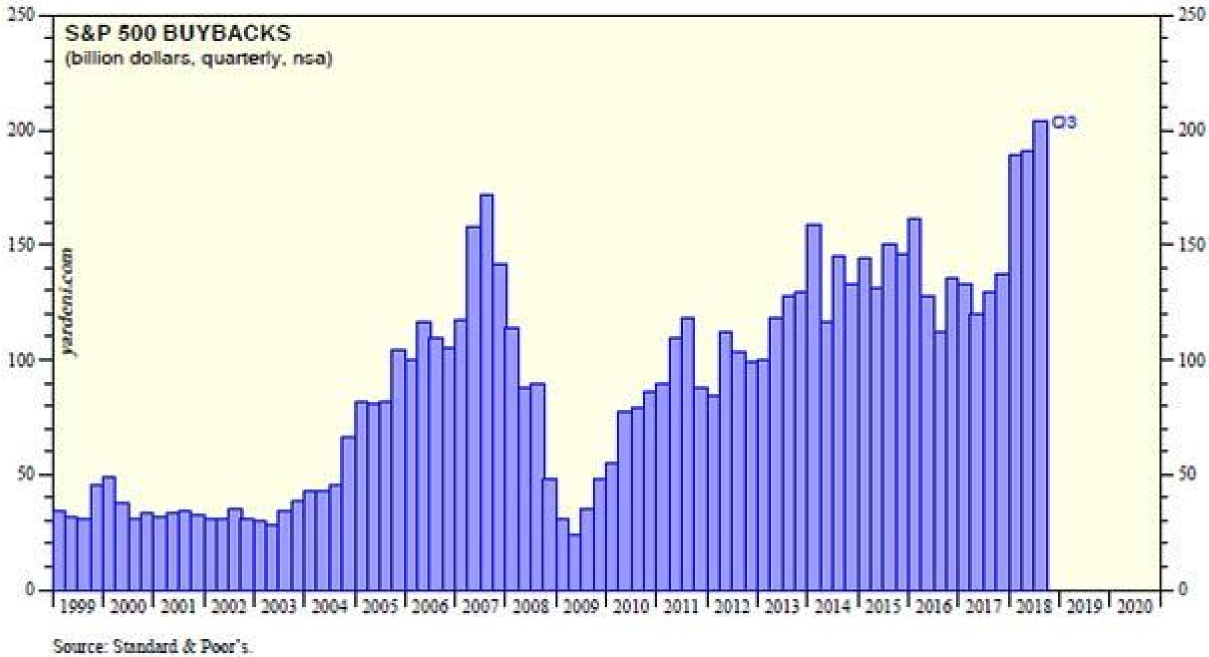

Figure 2

List of Interviews Conducted

Alexandra (Alie) Pruner, Senior Advisor, Perella Weinberg Partners and Independent Director

Ari Gabinet, Brown University Adjunct Lecturer in International and Public Affairs

Barry Rosenstein, Founder, JANA Partners

Frank Zarb, Partner, Proskauer Rose LLP

Martin Lipton, Founding Partner, Watchell, Lipton, Rosen & Katz

Nichelle Maynard-Elliott, Board Member, Element Solutions Inc.

Ward Nye, Chairman, President and CEO, Martin Marietta Materials

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