

Rehabilitating Corporate Purpose

Malcolm S. Salter

Working Paper 19-104



Rehabilitating Corporate Purpose

How the Evolution of Corporate Purpose Has Contributed to a Widening Breach Between Capitalism and Justice . . . and What to Do about It

Malcolm S. Salter

James J. Hill Professor of Business Administration, Emeritus

Faculty Associate, Edmund J. Safra Center for Ethics

Harvard University

Working Paper 19-104

Copyright © 2019 by Malcolm S. Salter

Working papers are in draft form. This working paper is distributed for purposes of comment and discussion only. It may not be reproduced without permission of the copyright holder. Copies of working papers are available from the author.

Abstract

In this essay, I address how the ascendance of the theory of shareholder value maximization into the central consciousness of public corporations and its canonization as the only legitimate expression of corporate purpose has contributed to both a widening breach between American-style capitalism and justice and increased alienation of the public from capitalism as a system of economic governance. Despite the vast academic literature and many management testimonials advocating a broader conception of corporate purpose—one that addresses the interests of firms' multiple constituencies and the well-being of their employees, customers, and operating environment—shareholder value maximization remains the de facto expression of corporate purpose and guide for decision making for most publicly owned firms in the United States (and the United Kingdom). I argue that narrowing the compatibility gap between capitalism and justice and reversing declining public trust in contemporary capitalism requires a very different conception of corporate purpose—one reflecting established moral and economic principles that challenge those underlying the shareholder value maximization doctrine. To this end, I start by discussing the vulnerability of contemporary capitalism, which is largely rooted in the social and moral disengagement of firms operating under this doctrine. I then explain how the emergence of the doctrine over the past four decades has led to this social and moral disengagement, what the theoretical underpinnings of the shareholder value maximization doctrine are, how this doctrine has become so deeply ingrained in our capitalist system, and the conceptual and practical problems presented by this doctrine and related theory of the firm. Next, I propose an alternate, principle-based guideline for corporate purpose that blends Aristotle's theory of reciprocal justice with considerations of corporate purpose, along with Chester Barnard's compatible theory of business organizations as cooperative systems. Aristotle stresses the ethicality of cooperation in transactional settings; Barnard stresses the efficiencies and adaptive benefits flowing from cooperation. Both see utility in truly reciprocal, cooperative relationships, which is not a priority in a shareholder value maximization regime. This alternative approach—referred to as *ethical reciprocity*—not only provides the basis for a rebuttal of the shareholder-primacy doctrine based on principles of justice and economic efficiency, but also offers a practical guideline for balancing the interests of shareholders and other corporate constituencies in the conduct of everyday business affairs. After presenting ethical reciprocity as a justice-sensitive guideline for corporate purpose, I turn to two practical questions related to its implementation: (a) whether “reciprocity practitioners” can compete in a world dominated by shareholder value maximizers, and (b) if so, what asset holders and asset managers, corporate directors, and educators can do—and, in some instances, are currently doing—to foster increased attention to both the principle and spirit of ethical reciprocity in the definition and pursuit of corporate purpose.

Table of Contents

Introduction	4
I. What's at Stake?	6
• Capitalism as a System of Economic Governance	
• Capitalism's Current Vulnerability	
• Declining Public Trust in Corporations and Capitalism	
• Asset Managers Hear the Message	
II. Social and Moral Disengagement Under the Shareholder Value Maximization Doctrine	12
• Forms of Disengagement and Social Injury	
• Reversibility	
III. The Evolution and Degradation of Corporate Purpose	16
• The Shareholder Value Maximization Doctrine	
• The Embedding of Shareholder Value Maximization in Business Culture	
• Conceptual and Practical Issues with the Revisionist Theory of the Firm and Corporate Purpose	
IV. Rehabilitating Corporate Purpose: Ethical Reciprocity as a Guiding Principle	25
• Aristotle's Theory of Reciprocal Justice	
• Ethical Reciprocity	
• Ethical Reciprocity and Corporate Efficiency	
• The Promise of Reciprocity Theory: A Summary	
• Objections	
V. Can Ethical Reciprocity Survive Under Value-Maximizing Capitalism?	38
• The Free-Rider Problem	
• Overcoming Free-Rider Risk	
VI. Fostering Change in Corporate Purpose and Governance	41
• What Asset Holders and Asset Managers Can Do	
• What Corporate Directors Can Do	
• What Educators Can Do	

Introduction

This essay is motivated by the enduring question of how capitalism and justice can be made more compatible. In addition to begging definitions of what we mean by *capitalism* and what we mean by *justice*, the question invites not only discussion of issues that currently challenge the compatibility of capitalism and justice, but also an explanation of how these issues and resulting compatibility gaps have arisen and how they can be narrowed.

My central thesis is that one of the major factors contributing to the widening breach between American-style capitalism and justice—and the corresponding increase in the public’s alienation from and distrust of capitalism as a system of economic governance—has been the canonization of *shareholder value maximization* as the sole legitimate expression of corporate purpose. The privileging shareholder value maximization is routinely revealed by the metrics corporations use to measure corporate performance, allocate scarce resources, and otherwise guide corporate strategy. Despite the vast academic literature and many management testimonials advocating a broader conception of corporate purpose—one that accommodates the interests of stakeholders or those who can affect or are affected by a company’s actions—shareholder value maximization remains the de facto expression of the institutional purpose that guides the decision making of many managers.¹ This is especially true for publicly listed companies in the United States and United Kingdom, where shareholder value maximization is the only protection from a relatively unconstrained market for corporate control and activist investors seeking above-average, short-term returns through the capture of seats and related decision rights on target companies’ board of directors.²

My argument about the role of shareholder value maximization in widening the gap between capitalism and justice is compatible with critiques of shareholder supremacy based on the claim that the pursuit of shareholder value maximization has led to the moral and social disengagement of many corporate actors. However, my approach differs in that I rebut the shareholder value maximization doctrine on grounds of established moral and organizational principles rather than on political or legal grounds, as prior critiques have done.

To this end, I advance the idea that blending Aristotle’s theory of reciprocal justice into considerations of corporate purpose, along with with Chester Barnard’s authoritative theory of business organizations as cooperative systems, constitutes a compelling rebuttal, while also offering a practical guideline for balancing the interests of shareholders and other constituencies in definitions of corporate purpose and everyday corporate governance. Aristotle stresses the ethicality of cooperation in transactional settings, while Barnard stresses the efficiencies and adaptive benefits flowing from cooperation. Both see utility in truly reciprocal, cooperative relationships, which is not a priority in a shareholder value maximization regime. I refer to this alternative conception of corporate purpose as being anchored in the principle of *ethical reciprocity*.

According to the ethical reciprocity principle, shareholders remain a dominant constituency of the public corporation, with expectations of a return on their investment commensurate with the financial risks they bear. This return is, of course, shareholders’ reserve price for participating in the enterprise. But shareholders are not the only parties with a legitimate claim to fair exchange and mutuality with the corporation. Other parties participating in the cooperative system—employees, suppliers, customers, creditors, neighbors—have their reserve prices, too, related in part to the risks that they bear through their participation in the enterprise. Their continued participation depends on a surplus of benefits in exchange for their support or, at the very least, a level of benefits above breakeven. Depending on their risk, shareholders may demand a reserve price higher than the minimum rate of return on investment. However, where shareholders actually achieve such elevated returns, the principle of ethical reciprocity suggests that they should be prepared to negotiate and honor increases in other participants’ reserve price for continued cooperation if the value of the goods and services they offer shifts upward due to redefined work requirements or if a new set of needs and preferences emerges.

Defined in this way, Aristotle's reciprocity principle is not a direct substitute for shareholder value maximization as an expression of corporate purpose. Rather, it is a practical guideline for the development and articulation of a wide range of possible corporate purposes that are both socially just and economically sustainable.

Aristotle's principle evokes an old-school view of the corporation in society, which includes a more pluralistic conception of corporate purpose than shareholder primacy. It reflects the belief that institutions of all kinds, including for-profit corporations, can only be successful—in the words of sociologist Philip Selznick—by pursuing and satisfying multiple ends that reflect not only the motivations and competencies that exist within the organization, but also those external expectations that “determine what must be sought or achieved if the institution is to survive.”³

I have organized my proposal for an alternative, justice-based guideline for corporate purpose—and rebuttal of shareholder value maximization—into six parts:

Part I identifies what I see as the stakes involved in a reassessment and reform of the shareholder value maximization theory of corporate purpose. These are no less than saving capitalism as a socially valued system of economic governance from the self-inflicted wounds that have led to unprecedented levels of alienation and distrust of the general public and an expanding cohort of shareholders and their investment managers.

In Part II, I remind readers how the well-reported social and moral disengagement of public corporations in recent decades is linked to the broad acceptance within the business community of shareholder value maximization as the only legitimate expression of purpose for the public corporation.

Part III describes the emergence of the shareholder value maximization doctrine on the corporate scene during the 1970s and 1980s, the conception of corporate purpose it espouses, the reasons the doctrine became so deeply ingrained in the public company segment of our capitalist system, and the conceptual and practical problems it presents.

In Part IV, I discuss how this problematic vision of corporate purpose can and should be rehabilitated by adopting *ethical reciprocity*—an exemplary kind of social cooperation in a transactional setting—as a guiding principle. I will argue that this approach provides a practical guideline for balancing the interests of shareholders with other corporate constituencies and opening up the public corporation to diverse expressions of corporate purpose and governance that are both morally and economically sustainable.

In Part V, I address the question of whether or not practitioners of ethical reciprocity can survive, let alone prosper, under the current regime of value maximizing capitalism. I answer in the affirmative, while at the same time stressing that great business discipline is required on the part of reciprocity practitioners.

I conclude in Part VI by discussing of how ethical reciprocity can be best advanced as a guide to corporate purpose for asset owners and managers, who can have enormous influence over the governance of listed firms; for corporate leaders and their boards of directors, who are in a strong position to accelerate the integration of ethical reciprocity as a guide to corporate purpose and governance; and for educators, who instruct and train many of our nation's business leaders and influence a larger public through their research and writings.

My hope is that offering a justice-based rebuttal of shareholder primacy and shareholder value maximization as the only legitimate expression of corporate purpose will energize public discussion of how best to work our way out of a historical and moral conundrum caused by the cross-currents of dramatic increases in economic productivity, technological innovation, and high levels of average incomes delivered by market capitalism, on the one hand, and the potentially catastrophic effects of unattended challenges to the justness of market capitalism, on the other.

I. What's at Stake?

British historian Arnold Toynbee concluded his 25-year study of 21 civilizations with the observation that “Great civilizations die from suicide, not by murder.”⁴ Toynbee observed that each civilization—or cultural system—has within itself the seeds of its own change and destruction, and that even the most prosperous and sophisticated civilizations are vulnerable to self-inflicted ruin. This is a warning that merits attention by all successful civilizations, including our own.

Civilizations are identified by some mode of thought and organizing principles. These are expressed not only in art, music, literature, social relationships, and ethical norms, but also by the society's systems of political and economic governance. In the United States, these two governance systems—democracy in the case of political systems and capitalism in the case of economic systems—coexist, overlap, compete for power, and transform each other over time.⁵ They have become intricately intertwined, with democratic capitalism becoming our espoused governance model.

As our system of capitalism continues to evolve, both creating and responding to new challenges, Toynbee's body of work reminds us how important it for us to ask how we can keep *our* cultural system, so deeply rooted in capitalist ideology and practice, from gradually destroying itself like many before it. In the four decades during which the shareholder value maximization doctrine has gained ascendancy in corporate boardrooms and become the sole legitimate expression of corporate purpose for most publicly listed companies, US capitalism has become increasingly vulnerable to self-inflicted ruin caused by the public's rising alienation from and distrust of our system of economic governance.

The ascent of shareholder value maximization into the central consciousness of public corporations has had malignant side-effects. It has crowded out more pluralistic and cooperative views of corporate purpose—and created a great deal of dysfunction in our society that is now becoming increasingly apparent to civil society. It has led executives to heavily discount the importance of non-shareholder concerns and costs. It has distracted many managers and directors from the interests of the wider mix of participants in the enterprise whose contributions and support can only be counted on if their benefits are commensurate with the value of their contribution, whether that be in the form of risk capital, credit, labor, expertise, or permission to affect a community's local environment. It has diverted attention away from the broader purpose of the corporation—namely, making things that benefit customers and the larger community—and contributed to a self-centered winner-take-all culture that invites a variety of corrupt behaviors, social injustices, and system inefficiencies.⁶ In brief, it has welcomed a kind of social and moral disengagement that diminishes executives' sense of responsibility for community and public interests, contributed to a widening compatibility gap between capitalism and social justice, and increased public distrust of capitalism and corporate conduct.⁷

Of course, today is not the first time that US capitalism has been vulnerable to increased alienation from the public and escalating risks of self-inflicted ruin. In the decades from the 1880s through the 19030s, the US witnessed malpractices driven by profit maximization in the banking sector that caused significant social and economic injury to investors and the general public. During the same period, major strikes by railway, mine, steel, and textile workers revealed major employee safety and wage injustices. And the long list of both early and ongoing environmental disasters in the chemical, mining and minerals, oil, and other industries has contributed directly to the public's declining trust in capitalism and demonstrated capitalism's capacity for self-inflicted damage.

Eventually, this history of social and moral disengagement led (after the fact) to the enactment of rules and regulations by Congress that reduced the adverse effects of socially disconnected capitalism and mitigated risks of a Toynbee-like collapse. However, what makes the adverse consequences of shareholder value maximization today so different from the earlier threats to US capitalism is that, in the absence of any likely changes in state or federal law pertaining to corporate governance, the choice of

purpose by public companies will remain a private matter for shareholders and their corporate directors, not subject to state intervention and regulation. The stakes involved in these private choices are high.

Capitalism as a System of Economic Governance

Although it is a defining feature of the American civilization, capitalism is often misunderstood typically starting with a highly oversimplified conception of capitalism as a system of voluntary exchanges in free or unencumbered markets coordinated by incentives embedded in the price mechanism. This is a deeply flawed view. It overlooks the all-important role that political authority and societal values play in both chartering firms and shaping the markets in which the invisible hand of the pricing mechanism operates. Ignoring how political authority and related political processes (such as law making and rule making) influence the workings of markets diverts our attention away from important features of contemporary capitalism that regularly invite claims of social injustice and corruption.

Capitalism is best viewed as a multilevel system of economic governance. At the top, political authority permits economic actors to raise capital and employ other resources so that they can compete with one another according to laws enacted (in democracies) by legislative bodies and defined by one or more regulatory agencies.⁸ In addition, political authority in the form of legislation and court validation defines and enforces the principle of private property and its attendant attributes: the right of a corporation to own property, make contracts, sue and be sued; to set its own internal rules that lie beyond the law of the land; and, most importantly, to turn its governing authority and property toward the pursuit of profit.⁹ In democracies, the political authorities involved in developing and administering such rights and regulations (Congress, in the United States) derive their authority from political markets or elections, to which they are ultimately accountable. In this way, political authority guides the design of market frameworks—or competitive rules of the game—that reflect visions of the public good as well as the benefits of private property and conveys legitimacy to corporate entities.¹⁰

The middle level of this governance system is made up of the regulatory agencies and other institutions created by the political authority. Their role is to enforce competitive rules that comprise the market frameworks noted above. Specialized regulators oversee behavior in various industries such as food, drugs, and transportation, while others focus on the protection of societal resources such as the physical environment and workplace safety.

At the bottom level are the economic actors in markets. At this level, firms seek to assemble and configure resources (labor, capital, technology) in ways that serve their customers and otherwise exploit profit opportunities—all within market frameworks and rules established by the legislature and enforced by regulators and courts.¹¹ The aspirations and conduct of privately and publicly owned firms vary widely depending on what expressions of purpose they adopt. Firms governed according to the principle of shareholder value maximization behave quite differently from those determined to be more responsive to a broader set of interests associated with parties that can affect and are affected by the enterprise. It is this at this level that the culture of a capitalist system is revealed by the balance between these two visions of corporate purpose and governance.

Defining capitalism as a multilevel system of economic governance reminds us that, throughout history and in its various forms, capitalism is a man-made system of relationships and rules governing the behavior of economic actors. It should not be thought of as some sort of “natural” occurrence. Above all, it is a social construct, negotiated by a wide variety of parties with both differing and overlapping interests. This construct involves far more than the facilitation of equilibriums in markets; it also involves a set of purposes or a political vision (property rights, freedom of choice, economic growth, the public good, social responsibilities) that are baked into the design of market frameworks and, by implication, expressions of corporate purpose.¹² As social constructs, corporations have not only rights delegated by political authority, but also obligations to political authority and the polity it represents. This is not a

widely accepted vision of capitalism, but it is certainly consistent with the conception of capitalism as a multilevel system of economic governance.

Another common misperception about capitalism is that it is an unchanging system. But it is not static; we should expect national forms of capitalism and the role of corporations to evolve or change over time as the body politic and its political vision changes.

Capitalism's Current Vulnerability

From the end of World War II until the 2008 financial crisis, US capitalism consistently delivered attractive annual rates of GNP growth (3.2% on average). Job expansion kept pace. Rates of technological innovation and new business formation were unprecedented. The high level of average incomes was, and is still, the envy of the world. According to data assembled by the OECD, World Bank, and International Monetary Fund, the average per capita annual income for Americans reached just over \$56,000, compared with \$9,850 for Russia and \$8,250 for China. And along the way, important economic and individual freedoms had been strengthened. But now, in the wake of the governance scandals of the early 2000s, the 2008 financial meltdown, and financial misdeeds, the country has seen increasing concentration of wealth, rising shortages of attractive employment opportunities, a decline in the much-vaunted upward mobility of American labor, and recurring incidents of ethical drift in the conduct of business. Given these conditions, the question of whether, or to what extent, American-style capitalism is promoting a just society has become more pertinent. Can capitalism be brought more in line with long-established principles of justice before a public push-back seriously challenges capitalism's legitimacy and compromises its vitality?

Different sectors of our capitalist economy will inevitably have different issues to overcome in achieving such a rapprochement. Perhaps the most challenged sector is publicly traded corporations, which have to find a way to live with unrelenting demands of investors seeking above-average returns. Of the more than 6 million companies operating in the United States, there are just over 3,600 publicly owned corporations listed on the NYSE, AMEX, and Nasdaq exchanges—down from more than 8,000 in the mid-1990s. (Another 15,000 public companies are traded over the counter, meaning that their shares are not traded on one of the major exchanges.) The largest contributor to this decline in listings has been the extremely large number of mergers in recent years, followed by the decline in IPOs.¹³ One result is that the size of publicly listed firms has grown rapidly. From 1975 to 2015, the average market capitalization and median market capitalization accounting for inflation increased by a factor of 10.¹⁴ As I will argue below, many of these firms have become increasingly untethered from common-sense principles of fairness and justice in the conduct of their affairs during this 40-year period.

To be sure, some public corporations have at various times staked out ethical positions by promoting a vision of social justice. The iconic case is Johnson & Johnson, whose credo and statement of purpose—starting with “We believe that our first responsibility is to the people who use our products”—has sustained the company through three generations. It is credited with guiding the company through the 1982 Tylenol crisis, when poison was introduced into bottles of the company's best-selling product, causing a number of deaths. Before senior management had time to react, junior managers had independently decided to recall the product (an industry first), while promising stores full recompense, at an estimated cost of over \$100 million. Not only did the company rapidly regain its market share (and its share price), but J&J's CEO was awarded a Presidential Medal of Freedom, which was accepted on behalf of the company's workforce. J&J's swift and ultimately successful response to the crisis would not have happened without a great deal of prior work with executive leadership groups addressing the firm's ethical principles and espoused purpose.

Other companies at various times have staked out ethical positions that curb economic opportunity or invite political disfavor while promoting their vision of social justice. General Motors and Pepsi pulled out of South Africa in response to public protest of its apartheid regime. Apple, Disney, and Xerox were pioneers in extending health-care benefits to gay and lesbian couples. Corporate leaders have recently

banded together to protest laws targeting transgender rights in Indiana, North Carolina, and Texas. And an increasing number of corporations have voluntarily adopted green strategies. But such examples are still more the exception than the rule.

In addition to building new businesses and narrowing the compatibility gap between capitalism and justice, established public corporations have tended to be increasingly preoccupied with the distribution of gains from their continuing operations. It is in this distribution phase of capitalism (and the corporate life-cycle), where an economic pie is constantly being divided up, that the opportunities for private gain are the greatest and interest in a “fair” distribution of benefits are the lowest. As the great 1948 film *The Treasure of the Sierra Madre* so brilliantly depicts, rapacious greed easily sets in when there is a fortune to be divided. And, as with the lustful quest for a larger share of the gold mined in the hills of Mexico, it is in the distribution phase of the corporate life-cycle that wanting more than someone else—and more than is consistent with norms of fairness—that social injury naturally occurs.

While Milton Friedman’s famous claim that “life is not fair” and that we need to “recognize how much *we* [italics added] benefit from the very unfairness we deplore” may still have currency in some quarters, his ethical claim that all voluntary exchanges in markets make society better off cannot be true in any practical sense.¹⁵ We know that under competitive capitalism there are many who get left behind; and those involuntarily unemployed people are clearly not the “we” who are referenced in Friedman’s claim. We also know that many “lawful but corrupt” business practices—such as earnings management, cronyism, gaming society’s rules, and value extraction in executive pay—also create socially unjust or oppressive conditions. Herein lie practical problems that cannot be ignored.

The untethering of contemporary capitalism from common-sense principles of fairness is undoubtedly the result of many forces. But it is becoming increasingly clear that a persistent belief in shareholder value maximization (and profit maximization) as the only legitimate basis for guiding corporate strategy and measuring corporate performance has contributed directly to this ethical drift. When firms govern themselves according to the principle of shareholder value maximization, they reveal their de facto corporate purpose, whatever vision they publicly espouse. This “revealed purpose” has its greatest impact on business policy and practice in firms where a large proportion of senior executive pay is tied to share price and shareholder returns, which is the case in most S&P 500 corporations.^{16, 17} Add to this our current epidemic of short-termism, and the scene is set for a self-induced decline in the promise of American-style capitalism.

Short-termism refers, of course, to excessive focus by executives of publicly traded companies on achieving short-term gains in reported earnings and share price. This short-term focus is the inevitable result of a comparable shrinking of time horizons for investment returns held by investment fund managers, institutional investors, and various types of traders—best indicated by the decline of the average holding period of US equities across all investor groups from seven years to about seven months from 1970 to 2010¹⁸ and the corresponding increase in the turnover ratio for the US stock market (the total value of shares traded divided by the average market capitalization) from 182.8 in 2000 to 348.8 in 2006.¹⁹

There are many contributors to the shrinking of investment time horizons and the radical decline in the holding period of company shares. But, in parallel to management’s increasing addiction to shareholder value maximization, the tying of large portions of executive pay to annual increases in corporate earnings and share price, as is currently the rule, has created a huge incentive for executives to pursue immediate gains—even if it means cutting corners. While large, short-term incentives do not inevitably lead to unscrupulous or uneconomic behavior, it is fairly clear that an important relationship exists between the structure of pay and corrupt management practices—and there is a great deal of academic research related to this point.²⁰ In addition to executive compensation practices, the combination of growing takeover activity and active investing by private equity funds has made it increasingly difficult for directors to ignore the immediate interests of influential short-term investors.

The effects of this poisonous cocktail of value maximization spiked with institutionalized short-termism are now visible (and palpable) to both investors and the general public—suggesting that the time is ripe for reexamining the espoused purposes of public companies before irreversible damage is done to the social contract and public trust supporting American-style capitalism. A large proportion of the public (including an expanding cohort of investors) apparently agrees.

Declining Public Trust in Corporations and Capitalism

While some public firms are successful in giving their employees a meaningful sense of purpose and ensuring that their executives properly take responsibility for ensuring that employees get satisfaction from what they do, many are not like this—thereby contributing to an undeniable decline in the public’s opinion of American-style capitalism. This decline helps explain not only the emergence of anti-establishment groups on both the left and the right, but also the results of a variety of opinion polls and surveys revealing that capitalism, in all its variants, is experiencing unprecedented levels of alienation from and distrust by the public. Less than 20% of those surveyed in a 2016 Gallup poll have a “great deal of trust” or “quite a lot of trust” in US big business. Only 38% of US respondents between the ages of 18 and 24 support capitalism, according to a recent Institute of Politics poll at Harvard. This survey has been reinforced by the findings of Frank Lutz, a well-known right-of-center pollster, who reports that people in the United States are increasingly fed up with CEOs “prioritizing the bottom line and treating earnings as a key metric” and more generally fed up with capitalism.²¹ Throughout the industrialized world, 53% of 33,000 persons surveyed in 2017 by Edelman Trust Barometer across income and education groups believe the current system of political economy and its major political and economic institutions are failing them; only 15% believe that that the system is working. According to the same barometer, trust of the “informed public” in US business institutions declined by 20 percentage points from 74% to 54% from 2017 to 2018. This decline was by far the largest among all industrial nations.²² While the public trust numbers have been bouncing up and down for decades, the general trend in the United States has definitely been downward.

It is, of course, difficult to unpack and weight all the factors contributing to the current breakdown in public trust as represented by these polls: Is it low wage growth? Inadequate health-care and retirement systems? Institutionalized corruption in both the public and private sectors? The dramatic fall-off in white-collar prosecutions by the Justice Department? Dismay and dislike arising from the social costs created by single-minded pursuit of shareholder value maximization? Shifting public expectations of what constitutes a just society? Whatever the contributing factors to the decline in public trust in our current form of economic governance, the social costs and systemic risks of the value maximization doctrine are becoming more widely acknowledged, and an increasing number of business people are calling for corporate governance reforms.

Asset Managers Hear the Message

In his 2018 annual letter to CEOs, Chairman Larry Fink of BlackRock—an investment company with \$6 trillion under management—was the first global-scale asset manager to warn potential portfolio companies that they must both deliver financial performance *and* contribute to society or risk losing the support of the world’s largest asset manager. The time had come, Fink wrote in his annual letter on corporate governance, for a new model of corporate governance:

Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance but also show how it makes a positive contribution to society. Companies must benefit all their stakeholders, including shareholders, employees, customers and the communities in which they operate.²³

Fink has lots of company in calling for more attention to the social purposes and obligations of public corporations. Other investment managers who take socially related issues into account in

constructing their investment funds have successfully assembled another \$6 trillion of assets under management (out of a total \$70 trillion of assets under management worldwide).²⁴ One of the most prominent first movers is Generation Investment Management. Founded in 2004 by David Blood, former CEO of Goldman Sachs asset management division, and former US Vice President Al Gore, it has now grown to \$18.5 billion under management. Generation pioneered integrating environment sustainability factors into fundamental equities analysis with the goal, according to Blood, of making “better investment decisions.”²⁵ Another firm, Fidelity International with over \$500 billion under management, offers a “sustainable family” of six funds that takes into account so-called ESG issues considered important to the overall sustainability of a business: *environmental* issues (like carbon efficiency and air/water pollution), *social* issues (like labor standards and gender diversity), and *governance* issues (such as executive compensation and lobbying practices). As a matter of course, Fidelity International rates more than 3,000 issuers of securities on ESG factors in coming to its overall investment ratings. In recent years, the performance of institutionally managed ESG funds has been on a par with traditional investment.²⁶ In fact, according to Morningstar and Fidelity, 54% of ESG funds were in the top two performance quartiles in 2017. The appearance and growth of institutionally managed funds such as Generation’s and Fidelity’s obviously reflect the growing interest of individual share owners in fostering sustainable business policies and practices, especially when they do not have to sacrifice performance or price when choosing investments that make what they consider to be a positive impact on society.

But how we should we think about what Fink calls a corporation’s “social purpose?” Or, more precisely, what principles are relevant to defining a socially responsible purpose for the public corporation? In this essay, I suggest two complementary principles—one drawn from an ancient theory of justice and the other drawn from a more modern theory of organizational efficiency. Taken together, these two principles—and their implementation in practice—offer contemporary capitalism a way of escaping a Toyne-like decline.

With respect to justice, I have already called attention to Aristotle’s theory of reciprocal justice. This theory is often considered to be part of a larger cluster of theories referred to as *fairness* theories of justice.^a Aristotle—often described as the philosopher of common sense—has many wise things to say about what constitutes ethical transactions and markets and how to facilitate agreement between parties with nonidentical goals and preferences. Readers will instinctively understand that predictable reciprocity is one of the necessary preconditions for maintaining trust in just about every relationship, let alone public trust in corporate capitalism.

With respect to efficiency, I have also already referred to Chester Barnard’s foundational principle of organization efficiency, which focuses on reducing the costs of coordinating an organization’s activities through the creation, transformation, and exchange of utilities (personal satisfactions) sufficient to ensure the continued cooperation of various parties.²⁷ Barnard’s contribution is central to the survival of any

^a *Fairness* theories of justice contrast markedly with the *freedom* principle of justice associated with the thinking of John Locke, Friedrich A. Hayek, Milton Friedman, and Robert Nozick. Many in the freedom school totally reject fairness as a social doctrine. As one leading example, Milton and Rose Friedman ask in their 1980 manifesto *Free to Choose* (New York: Harcourt Brace Jovanovich, 1980) who decides what is “fair” in the first instance, and why should “fairness” be a social ideal in any case? The Friedmans raise these questions in the context of their critique of our constitutional commitment to equality of opportunity; namely, they hold that our original and worthy commitment to equality of opportunity has mutated over time to a social commitment to opportunity of outcomes, which they see as a perversion of our original egalitarian principle of equality. They attack the policy drift toward equality of outcome (driven, they claim, by the left) as a clear conflict with liberty. They argue that government measures promoting “fair shares for all” reduce liberty and that “it is important to recognize how much we benefit for the very unfairness we deplore.” While I have no idea of who the “we” are in the Friedmans’ final warning, I accept the importance of their doubts about their rendition of fairness as a standard for economic behavior and society as a whole. Yet it seems extraordinarily philistine to completely deny the importance of fairness when interpreted as the prevention of social injury (such as by knowingly making people worse off, especially the least advantaged and the least powerful). Reflecting this value judgment, I adopt the ancient Aristotelian principle of fairness, enhanced by John Rawls’s writings on the fairness principle (*Justice as Fairness: A Restatement*, ed. Erin Kelly (Cambridge, MA: Harvard University Press, 2001]), as a credible point of departure in assessing the compatibility of democratic capitalism and justice.

exchange relationship embedded in a market economy—where an organization’s efficiency and differentiation (of product or service) relative to that of competitors determine success or failure.

The standards of justice and organizational efficiency associated with Aristotle and Barnard complement each other nicely, despite their different disciplines. Both thinkers adopt the idea of *cooperation* as embodying both moral and economic attributes. This is not a radical idea, but rather one that has fallen increasingly out of favor in our capitalist economy. For Aristotle, not only does reciprocity ensure “fair” commercial transactions, but also low “contracting costs”—especially for repeat transactions. Similarly, for Barnard, an exchange of satisfactions within an organization sufficient to maintain a willingness to cooperate among that organization’s members serves to stabilize organizations, lower future coordination costs, and minimize the domination of employees by superiors who would otherwise have to turn to fear of reprisal as a management tool. Taken together, Aristotle and Barnard offer a model of cooperative efficiency that showcases the kind of standards of fairness and economic good sense that can help us rethink, and perhaps rehabilitate, the concept of corporate purpose and the promise of democratic capitalism after years of social and moral disengagement under the value maximization doctrine.

II. Social and Moral Disengagement Under the Shareholder Value Maximization Doctrine

Social and moral disengagement is a process whereby people switch their ethicality on and off.²⁸ It is typically triggered by the framing effects of incentives, such as those tied shareholder value maximization. Today, we are experiencing various forms of social and moral disengagement that have been shaped by powerful financial incentives for corporate executives and fund managers tied to shareholder value maximization. Examples of such disengagement include a continuing inattention by the leaders of public corporations to such matters as environmental degradation; increasing income inequality due to heavily lobbied tax policy and high-reaching executive pay; embedded cronyism; widespread gaming of our legislated rules of the game that may benefit shareholders but offer few compensating public benefits; pervasive cheating or misrepresentations in the reporting of companies’ true financial condition; lack of accountability for corporate misdeeds; and the plight of what I call *capitalism’s losers*.

Readers may want to add to or otherwise modify this characterization. But the important point is that most of us harbor intuitions about what injustices and social injuries have flourished in the world of incentives associated with shareholder value-maximizing capitalism and its narrow vision of corporate purpose.

Forms of Disengagement and Social Injury

Environmental Degradation. This is very old news. For many decades now, one of the most troubling examples of social and moral disengagement has been the environmental degradation accompanying the industrialization of our economy. Ever since the publication of Rachel Carson’s *Silent Spring* in 1962, national consciousness of the costs of this negligence and inattention by firms and political authorities has been on the rise. Over the past half-century, contesting politics (and scientific claims) have kept environmental protection at the contentious summit of the societal agendas of almost all industrialized nations. Through legislative lobbying, regulatory rule making, and presidential action, the United States has occasionally shown itself to be a leader in environmental protection, but more recently, an obscurantist and reactionary strategy is reversing some of these gains. At the level of the firm, many enterprises have been slow to invest in environmental protection measures, and this obstinacy and moral disengagement—and single-minded focus on the current market value of the corporation—continues to endanger Planet Earth and its population in irreversible ways.

Income Inequality. Another form of moral disengagement that has taken place under shareholder value-maximizing capitalism (in the United States and other rich countries) is the apparent disregard by many corporations and elected officials for the astonishing increase in income inequality and wealth

concentration over the past four decades. This development is the most publicly understood and personally experienced challenge to the justness of US capitalism. At the national level, the top 1% of households saw their income grow by 186% between 1979 and 2013, while the increases were 65% for the next 19% of households, and only 28% for the remaining four quintiles of households.²⁹ As a result of these differential growth rates, in 2019, the wealthiest 1% of Americans control 20% of the nation's income and nearly 40% of its wealth—more than the bottom 90% combined.³⁰

In large part, this increasing inequality owes its existence to heavily lobbied policies and preferential treatment for the business community, such as tax cuts for wealthy citizens and the carried-interest tax break for private equity sponsors. But skyrocketing executive pay—a result of the increasingly widespread practice of listed companies tying a large proportion of executives' earnings to share price and awards of stock options and stock grants—has also played a significant role. In a bull market, the effects have been astonishing and controversial.³¹ From 1978 to 2013, CEO pay rose 937% compared with a mere 10.2% growth in worker compensation over the same period, according to the Economic Policy Institute. In 1980, the average pay of corporate CEOs was 40 times that of their average employee; by 2015, CEOs earned 354 times the salary of their average employee.³² In 2017, the average total annual compensation of CEOs of S&P 500 companies in 2017, including both cash and stock, was just under \$11.5 million.^b Not surprisingly, the high levels of executive pay and expanded ratio between average CEO and employee pay have triggered public outrage and claims that the high level of executive compensation (much of it driven by expanding stock-based awards) represents a form of value extraction resulting in long-run costs to shareholders.³³

Another aspect of increasing income inequality attributable to corporate behavior is revealed by looking at labor's share of GDP, which has been declining since 1970. According to the Bureau of Economic Analysis, employee pay and benefits fell to 52.7% of US GDP in 2018 from a high of 59% in 1970 and 57% in 2001. While labor's share has been falling, business profits have been on the rise, climbing from less than 12% of GDP in the 1980s to more than 20% today.³⁴ There are several possible explanations for these trends: workers' weakening ability to negotiate wage increases as union representation has fallen; technological innovation; industry globalization offering manufacturers cheap labor alternatives; and, most directly, the low priority given by global corporations to the economic well-being of their employees in the pursuit of shareholder value maximization.

Cronyism (“*crony capitalism*”). Cronyism in this context refers to the collusion among firms, their regulators, and Congress resulting in policies, regulatory enforcement, investments, and subsidies that serve private interests at the expense of the public interest. It involves manipulating the political process and shaping society's rules of the game by powerful business interests to the detriment of those without commensurate power. Financial incentives linked to shareholder value maximization provide enormous incentives to pursue this form of economic discrimination and social injury.

Crony capitalism is a special type of moneymaking that economists call *rent seeking*. Rent seekers pursue privileges that typically show up as targeted exemptions from legislation, advantageous rules by regulatory agencies, direct subsidies, preferential tariffs, tax breaks, preferred access to credit, and

^b Total annual compensation, according to Equifax and Market Watch, includes salary, bonus, other annual cash payments, total value of restricted stock granted, total value of stock options granted (using Black-Scholes), and long-term incentive payouts. Lest we think this level of pay for S&P 500 CEOs is an outlier, the compensation of chiefs of leading, *publicly owned* buyout firms was many times that average. Stephen Swartzman, chief executive of the Blackstone Group, took home \$689 million in 2014; similar but lesser amounts were taken home by the heads of the Carlyle Group and KKR, also publicly owned. Of Swartzman's \$689 million total pay, \$570.5 million came from dividends stemming from his 20% stake in the firm and the remaining \$128.5 million from a salary of \$350,000 and fund payouts. In recent years, the compensation of successful top hedge fund executives—who take home well in excess of \$1 billion dollars a year in cash alone—has far exceeded the cash-plus-stock compensation of corporate executives. In fact, the 25 top-earning hedge fund managers collectively raked in an astonishing \$11 billion in 2016 despite mediocre returns, according to *Institutional Investor*, which estimated these managers' percentage of their firm's management and performance fees, and also considered their own investments in the fund.

protections from prosecution. The ultimate goal of rent seekers is grabbing a bigger slice of the (economic) pie rather than making the pie bigger.

The fiscal costs of cronyism, according to the libertarian Cato Institute, run about \$100 billion annually in tax breaks and subsidies alone. Most of these “gains” result from campaign contributions and extensive lobbying by corporations and industry groups, which according to Open Secrets, amounted to \$2.4 billion in 2016. The number of business lobbyists supported by these monies outnumbered the combined labor, consumer, and public interest lobbyists 16-fold. In dollar terms, this has given business and trade groups nearly a 60-to-1 business advantage.³⁵ More than ever before, those who spend the money get to write the rules—with their own interests, rather than public interest, inevitably in mind.

Gaming. Gaming refers to subverting the intent of socially mandated or legislated rules in order to gain advantage over rivals, maximize reported earnings, maintain high credit ratings, preserve access to capital on favorable terms, and reap personal rewards without resorting to blatantly illegal acts. Gaming society’s rules is a common form of lawful-but-corrupt behavior that undermines the justness and efficiency of democratic capitalism. The drivers of gaming are similar to those of cronyism—financial incentives linked to single-minded shareholder value maximization. Like cronyism, it is a pervasive form of social and moral disengagement from standard norms of fairness.

Gaming takes one of two forms: (a) lobbying decision makers on the writing of society’s laws and regulations, with the goal of creating loopholes, exclusions, and ambiguous language that give firms opportunities to work around the rules’ intent in the future; and (b) actually circumventing the written rules by exploiting those loopholes, exclusions, and grey areas of the law (especially with respect to tax law, securities law, and accounting and financial reporting rules) when it pays to do so. The first is a rule-making or influence game; the second is a rule-following or compliance game. By influencing the rule-setting processes of Congress or regulatory bodies in ways that advance the interests of shareholders rather than the common good, gaming the rule-making process leads to firm-specific advantages, while at the same time subverting the efficient functioning of markets and firms. And both forms of gaming weaken the social contract between citizens and the political authority that authorizes corporate activity.³⁶

Pervasive Cheating. Beyond gaming on the spectrum of corruption lies out-and-out cheating. Cheating is common in virtually every economic system where there are high institutional and personal rewards for doing so. In the US context, cheating has largely centered on the lawful-but-corrupt practice of earnings management and, more broadly, misrepresenting a company’s true financial condition through the manipulation of revenues, costs, or earnings. Public companies have a special incentive to cheat because the costs of not meeting investor expectations and compromising shareholder wealth maximization are so high (and so swift in coming). Since the millennium, there has been an explosion of accounting scandals and securities fraud by a wide range of companies listed on our stock exchanges.^c Hundreds of corporations have been forced to restate their earnings or net worth and restate the (backdated) grant dates on executive stock options (Steve Jobs was among those executives penalized). Since the 2002 passage of the Sarbanes-Oxley Act, requiring CEOs to sign financial statements, there has been a slowdown in accounting fraud, but nothing close to a shutdown. Major non-accounting fraud cases currently capturing prosecutorial attention include Volkswagen, Bosch, and Wells Fargo.

Lack of Accountability for Corporate Misdeeds. What’s so troublesome about such pervasive cheating—and the unmoored drive to boost reported earnings and current stock price in the name of shareholder value maximization—is the lack of executive accountability for these corporate misdeeds. With the exceptions of executive firings at Wells Fargo and the clawback of \$75 million in past executive

^c Notable examples include WorldCom, Enron, Dynergy, Adelphi, Global Crossing, HealthSouth, Adelphia Communications, Quest, Rite-Aid, Sunbeam, Computer Associates, Hollinger International, Xerox, Bauch & Lomb, Symbol Technologies, Ahold, Pamalab, Tyco, News Corp, Sears, Citigroup, Goldman Sachs, JPMorgan, Countryside, Washington Mutual (WAMU), Royal Bank of Scotland, Lloyds, Deutsche Bank, Fannie Mae, Freddie Mac, GlaxoSmithKline, Merck, J&J, Royal Dutch, Satyam Computers, and BAE Systems.

compensation (and the firings of the CEOs at Barclay's and Deutsche Bank and the revoking of the knighthood of the Royal Bank of Scotland's CEO), few bank boards have held their senior executives and material risk-takers personally accountable for the misdemeanors, criminal fraud, and social injuries perpetuated by large financial institutions leading up to and following the 2008 financial crisis. With \$235 billion (and still counting) in fines and settlements paid by the world's top 20 banks for misleading investors on mortgage-backed securities and derivatives, LIBOR manipulation, interest rate collusion, money laundering, and circumvention of Iran sanctions, the lack of reckoning or payback by the leaders of offending institutions has many observers mystified, and angry. The offending banks' shareholders paid this bill. Few senior executives were asked to "fork over."³⁷ To the contrary, the massive inflow of government support to the banks was accompanied in several well-publicized cases by bonuses paid to bailed-out bankers. The optics and reality of this situation have been toxic: the bankers appear to have been rewarded for their incompetence, excessive risk-taking, and lack of judgment. Similarly, few corporate executives outside of banking have been held financially or criminally accountable for their frauds (VW's former CEO is a recent exception) or the environmental degradation their companies have caused. Predictably, in the presence of such a widespread lack of accountability, it is not surprising that popular trust in capitalism is so diminished.

Inattention to Capitalism's Losers. A final form of social and moral disengagement is the lack of attention paid by value maximizers and their political spokespeople to the disenfranchisement of members of the enterprise other than shareholders who, like shareholders, bear considerable firm-specific risk. I refer to these parties as *capitalism's losers*.

Capitalism's losers are the forced unemployed and their communities—victims of plant closures or radical downsizing due to domestic and global competition, the outsourcing of components and manufactured end-products, technological obsolescence, and efficiency-seeking takeovers. Both Karl Marx and Joseph Schumpeter wrote at length about capitalism causing large-scale employment loss. Marx argued that capitalism's tendency for self-destruction would eventually lead to its end. Schumpeter was more optimistic: "Capitalism . . . is by nature a form of or method of economic change and not only never is but never can be stationary . . . The fundamental impulse that sets and keeps the capitalist engine in motion comes from new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates."³⁸ This is Schumpeter's famous "creative destruction of capitalism," which involves company closures and job losses that are, in the end, good for the long-term well-being of the country.

Schumpeter was, of course, on to something important. Creative destruction *can* lead to new opportunities for investors, entrepreneurs, and job seekers (if they have the right mix of skills). But when taken to an extreme, creative destruction can be a justification for a Darwinian society in which selfish interests of capital crowd out concerns for the larger polity.

Since Schumpeter's time, much of the destruction of jobs has shifted from new product ideas and technologically advanced production methods to outsourcing and corporate takeover transactions, especially during the 1980s and 1990s. While the international outsourcing of manufacturing continues, there are compensating, domestic benefits through overall industry and employment growth (consider the Apple iPhone or Nike sportswear). This is generally *not* the case in takeovers. Here, we know that companies targeted by buyout firms and other private equity investors tend to show a net employment contraction and higher job destruction and firm exit than non-targeted companies.³⁹ Under the worst-case circumstances, whole communities can be essentially wiped out, as in the case of the Anchor Hocking Company in Lancaster, Ohio (a town that Forbes once celebrated as the epitome of American free enterprise), which saw employment drop by 80% from 1987 to 2016 after a series of takeovers.^d

^d Anchor Hocking was founded in 1905, and 60 years later, was the world's largest maker of glass tableware and the second-largest maker of glass containers, employing 5,000 of Lancaster's 29,00 inhabitants. Starting in 1987, the company was subjected, in rapid succession, to waves of debt-financed takeover attacks: a "greenmailing" raid by Carl Icahn; a sale to a larger

In marked contrast to investors and takeover sponsors who can spread their risks through portfolio diversification, most of Anchor Hocking’s employees had no recourse to risk-mitigating strategies in their working lives. Rather than diversifying their portfolio of personal skills, many corporate employees seek to do the opposite—develop and improve their company-specific skills to make them more attractive to the companies for which they work. In the face of involuntary unemployment, the employees’ ability to transfer these skills to new jobs (if they exist) and to absorb the shock of layoffs is limited. The number of people affected by this dynamic is large: In the course of the enormous churn of job destruction and creation in today’s economy, the number of workers laid off or dismissed in the United States during a normal year averages 21 million.⁴⁰ This number is bound to increase hugely over the next 15 years as AI-driven automation forces millions of people to find new employment.

This “human churn,” and the social injuries it suggests, is not an unexplored problem. Adam Smith, Thomas Paine, Milton Freidman, and even the Nixon administration have all considered alternative ways of easing the plight of capitalism’s inevitable victims. Today, with the exception of experiments in “universal basic income” under way or terminated in Finland, the Canadian province of Ontario, and the city of Stockton California, there is little consideration for capitalism’s losers. Both polling data and the political markets are telling us that these “forgotten” folks are angry.

Reversibility

Forms of social and moral disengagement such as these make it unlikely that the decline in public trust of American-style capitalism and the fraying social contract that it represents can be easily reversed. But the purpose and form of the corporation has changed many times through the ages and we have seen that corporations are capable of doing so again when it makes good business sense to do so. Today, the incentive to pursue further change in corporate purpose and practice is no less than saving democratic capitalism from self-inflicted damage.

This rescue operation requires, as a first step, a solid understanding of the theoretical basis of the shareholder value maximization doctrine and how this doctrine or belief system has led to the degradation of corporate purpose and practice over the past forty years. Second, it requires an awareness of how this doctrine became so deeply embedded in our business culture. Third, it is important to understand the serious conceptual and practical problems inherent in this new doctrine and theory of the firm. And, fourth, it requires alternative conceptions of corporate purpose based on proven moral and economic principles that makes good business sense to consider and adopt. The next two parts of this essay addresses each of these four requirements.

III. The Evolution and Degradation of Corporate Purpose

For over two thousand years, corporations have steadily changed their purposes and functions. The earliest corporations, created in Roman Empire times and later during the Middle Ages by the Catholic church and municipalities, were set up to perform such *public* services as administering towns, satisfying

corporate buyer (Newell Corporation); and breakup transaction; a resale to a private equity firm (Cerebus Capital Management); bankruptcy; a recapitalization and sale to a second private equity firm (Monomer Capital Partners), which paid itself exorbitant management fees as the company filed for bankruptcy a second time; and one more recapitalization and ownership change (Oneida Group). During this time, Anchor Hocking saw a dozen CEOs come and go, and employment in Lancaster drop to 1,000 out 39,000 townspeople by 2016. Certainly, there were competitive forces at work that required an apparently complacent management to adjust its modus operandi, including foreign competitors and price pressure from big retailers like Walmart that cut into profits, which in turn forced cuts in employee salaries and benefits, and eventually large layoffs that triggered an inevitable decline of Lancaster’s downtown, municipal infrastructure, and social cohesion. But, in this case, most of the transactions noted above—made in the name of maximizing shareholder and investor returns—were actually *value transfers* from the owners of Anchor Hocking to the corporate raiders and private equity investors rather than *value gains* for shareholders, employees, and the local community. See Brian Alexander’s *Glass House* (New York: St. Martin’s Press, 2017) and an interesting interpretation by Roger Lowenstein (“Why They Voted for Trump,” *Wall Street Journal*, February 18–19, 2017).

spiritual as well as material needs, and providing seats of knowledge and learning. The key requirement of these corporations, whether chartered by the church or a political authority, was that they bind people together for long periods of time—in contrast to entrepreneurial ventures (usually partnerships) that had funding of limited duration. Over the centuries, corporations evolved from serving the purposes of towns, guilds, and hospitals to building and operating canals, railroads, lending, insurance, and finally financial trading businesses through partnerships. In other words, the purposes and functions of the corporation evolved to include not only the original public mandate, but also *private* interests. In due course, and certainly by the beginning of 20th century, the corporation was progressively losing its public sense of purpose as it began raising private capital and allowing the trading of capital in ways that the earlier corporations and partnerships had not.⁴¹ And, as we will see, by the 1930s, the conversation about the purpose and role of the emergent, large-scale private corporation exploded. With the development of the investor-owned corporation came the separation of ownership (by disbursed shareholders) and control (by hired managers) and hot debate about what purposes this remarkably transformed institution should serve going forward.

For startups, of course, the answer to this question always seemed clear. Entrepreneurs who created new companies knew their *raison d'être* from the outset. This purpose tended to be intensely personal, if not exclusively economic. However, when new ventures successfully passed through the phase of personal entrepreneurship and increased in size and organizational complexity and began to tap into external sources of financial backing, their leaders typically found themselves trying to manage internal debates and external commitments related to the future course of the company. At this point, an explicit definition of corporate purpose served two important functions: it defended the company from the risks of improvisation, and it substituted an compass for correcting organization drift. But what should that purpose be?

Until a very recent revolution in economic thinking, firms' purposes had normally been expressed in terms of opportunities to be exploited and problems to be solved for the benefit of a wide range of interested parties—starting, of course, with potential customers and clients. The management philosopher Peter Drucker famously argued in 1955 that the purpose of business in general is to create a customer, while making sufficient profit to cover the risk of business activity and avoid losses.⁴² Earlier statements of purpose also tended to express a set of values promoted by the corporation—such as product or service leadership, or fair employment practices, or even responsibility for its societal impact. In recent years, however, corporate purpose has increasingly become defined, whether by explicit statement or revealed conduct, as maximizing the market value of the company's shares. This definition naturally ignores the interests of other non-sharing collaborators who make the company's very existence and continuing operations possible. Nevertheless, this narrow definition has become, in recent decades, fairly standard for publicly listed companies.

The Shareholder Value Maximization Doctrine

The promotion of shareholder value maximization as the only appropriate expression of corporate purpose and standard of corporate performance can be traced directly to the development and promotion of the “shareholder primacy” theory of the firm during the 1970s and 1980s. Put most simply, this theory proposes that shareholders own their corporations and that corporate employees should therefore run the corporation in their interest; in other words, employees' primary mandate is to maximize the value of the company's shares. And since shareholders are the residual bearers of risk in corporate activity—meaning that they could lose all their money without any recourse or appeal—managers have a moral obligation to protect shareholders from the “unusual degree of exposure” that they have to the corporation.⁴³

This idea has deep roots in many decades of discussion in the economics literature about a general theory of profit maximization⁴⁴ and theories of managerial discretion.⁴⁵ Much of this literature adopts the idea of *maximization*, which first appeared in the work of the 18th-century English philosopher and political radical Jeremy Bentham. Bentham coined the term to convey the idea that in a world where

human beings are assumed to be self-interested—seeking everywhere their own advantage in matters of pleasure and profit—such behavior will be calculating and calculable. It can also be pursued without limit. According to the intellectual historian David Wooten, this perception of mankind has led to an emergent view of morality as a strategy for achieving one’s interests—a vision markedly different from older, more traditional conceptions of honor and virtue in the conduct of human affairs, which required restraint, moderation, self-abnegation, and self-sacrifice. It didn’t take long for this new moral philosophy to find broad acceptance in Bentham’s fast-industrializing, entrepreneurial world, not least because it set no limit on entrepreneurs’ self-interested conduct other than avoiding self-defeating behavior. In the ensuing centuries, this concept of self-interest and self-maximizing behavior has played a central role in the development of the discipline of economics.⁴⁶

By the 1970s, there was increasing agreement among economists and finance scholars that what managers sought to do was to maximize not only their own self-interests but also the value of the firms for which they worked. But was maximizing firm value actually the case in practice? Were managers truly loyal to shareholders, or did they revert to maximizing their own self-interests as predicted by the theories of managerial discretion? And, equally as important, how *should* managers behave with respect to shareholders?

Stephen Ross suggested in a 1973 paper, “The Economic Theory of Agency,” that answers to such questions could be teased out only by better understanding the “agency relationship” that existed between shareholders and managers as agents of the shareholders.⁴⁷ In 1976, Michael Jensen and William Meckling published “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” a landmark paper addressing this agency relationship, laying out a theory of the firm based on agency theory, which, among other major contributions, made an economically elegant case for shareholder value maximization as the only legitimate expression of corporate purpose and the most effective tool for managing the agency relationship between shareholders and managers.⁴⁸

Jensen and Meckling’s paper had a rich intellectual background. Their “model of man” is a direct descendant of that posited by Bentham. It is also intimately connected to work begun in the 1930s when the economics profession began studying the economic nature of the corporation and the conditions that lead to the formation of firms. In this respect, the new metaphor for the firm spelled out by Jensen and Meckling was embedded in the work by Nobel Laureate Richard Coase (“The Nature of the Firm”), where the modern corporation was characterized as a “nexus of contracts,” or series of transactions bound by “contracts” with suppliers, customers, and other parties that agree to work together for mutual benefit.⁴⁹ In the words of Jensen and Meckling,

It is important to recognize that most organizations are *simply legal fictions which serve as a nexus for a set of contracting relationships among individuals . . .* The private corporation or firm is simply one form of a *legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.*” [italics in original]

The authors go on to claim that

. . . it makes little or no sense to try to distinguish between those things which are “inside” the firm (or any other organization) from those things that are “outside” of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.⁵⁰

What’s most notable about this theory or metaphor of the firm is that it stands in sharp contrast to the older conception of the corporation as an entity co-created by public authority (through state charter), which grants corporations and their managers the right to make money and operate within the constraints

of certain rules of game. Indeed, as a “legal fiction,” the firm that Jensen and Meckling describe is completely detached from the history and rules of corporate law.⁵¹

According to this new theory, firms are created when internalizing contracts between owners and various factors of production into a hierarchy is efficient—that is, when the benefits of coordinating these implicit and explicit contracts and related activities in a hierarchy are greater than the costs of coordinating them through market-based transactions and when the value of the goods and services sold by the firm exceed the costs of the inputs used. Presumably, when a firm is thus created and where capital markets are efficient, a corporate shareholder gets a fair valuation of the internalized contracts that comprise the firm and the firm’s future returns.

This basic idea about the nature of firms was at the core of the Jensen and Meckling theory, and was enhanced and publicized very effectively thereafter by Jensen in a series of academic papers and management articles spanning 20 years of original thinking and scholarship.⁵² Jensen posits that the efficient performance of this contractual firm requires the recognition that the primary interest of shareholders (*principals*) is the maximization of their wealth by professional managers (*agents*)—to whom significant decision rights have been delegated. The theory also argued that efficient performance requires that firms adopt a system of internal governance and control that supports this primary interest.

According to Jensen, the objective of such an internal governance and control system is minimizing whatever agency costs exist when agents (directors and managers) behave in opportunistic ways that do not fully satisfy the interests of the principals (shareholders). These agency costs—equal to the sum of the costs of monitoring managers incurred by principals, the costs of bonding managers’ interests to those of shareholders incurred by the agents, and the residual losses from agency costs that cannot be controlled—arise naturally because in real organizational life, managers of publicly owned firms with dispersed shareholders who possess substantial decision and control rights over corporate resources are rarely “perfect agents” for the owners. This is because they do not receive the full benefits of the profits earned and therefore have incentives to extract perquisites from the firm at the expense of the firm’s true owners. In other words, the incentives of managers and owners are not naturally aligned. Minimizing such agency costs therefore logically involves paying corporate managers in ways that tie their pay increases with share value, thereby aligning management incentives with the primary interests of shareholders—namely the value of their investment expressed in stock price.

Agency theory immediately attracted enormous attention. In 2006, 30 years after its publication, the Jensen-Meckling article was the third most cited in major economics journals. Today, more than 2,000 papers on the Social Science Research Network have “agency” in their title.⁵³ The most significant management implication of this elegantly argued theory—that long-term value maximization for shareholders needs to be the primary metric for assessing the performance of business enterprise—also found a great deal of support in the financial and business communities and among faculty members in many leading business schools, including my own. Despite Jensen’s observation—25 years after his pioneering work appeared—that value maximization is not a vision or even a purpose and that value maximizing says nothing about how to create a superior vision or strategy (it only tells us how to measure corporate success), the semantics of his early work certainly reflected shareholder primacy with respect to corporate governance and control.⁵⁴

* * * * *

To fill out the intellectual history of the shareholder primacy view of the firm and the value maximization doctrine, I should point out that this doctrine not only extends Coase’s foundational work, but also builds on the 1932 treatise by Adolf Berle and Gardner Means, *The Modern Corporation and Private Property*.⁵⁵ Berle, a lawyer, and economist Means put forth three carefully researched ideas: (a) that capital in the United States had become heavily concentrated in a relatively small number of companies with enormous power; (b) that, as these companies grew, it was increasingly difficult for the original owners to maintain majority control as ownership expanded to include an ever-larger number of

smaller shareholders; and (c) that the consequence of this dispersal of ownership and control, and the diminishing interest of individual shareholders in monitoring and controlling the corporation, was the usurpation of corporate control by the company's managers whose interest were not necessarily in line with those of the shareholders; for example, while shareholders may want more dividends, managers may want to reinvest corporate profits or pursue, more sinisterly, self-aggrandizing projects or compensation. To counteract the unaccountability of corporate officers and directors, Berle and Means argued that shareholders needed to take a more active role in the management and oversight of their property and that the primary concern of corporate management *should* be to ensure profits for the shareholder. Berle and Means hoped that replacing corporate regimes that were controlled by professional managers—that is, where shareholders were merely passive recipients of dividends with little substantive input and no effective claim to ownership rights—would restore capitalism's dynamism and improve social welfare. In this respect, Jensen was a direct descendant of Berle and Means.

Although Berle and Means are best known for their analysis of lack of corporate accountability to shareholders, they were also concerned about managers' lack of accountability to society in general. This concern was powerfully elaborated and broadcasted in an article published more or less simultaneously (1932) by Merrick Dodd in the *Harvard Law Review*. Dodd famously argued that corporations were not simply vehicles to produce-shareholder returns, but rather vital societal entities whose interests were shared by multiple groups or constituencies, including employees, consumers, suppliers, and the general public.⁵⁶ But despite the public attention and support given to Dodd's society-oriented argument, we have seen that the Jensen-Meckling contractarian theory of the firm with its emphasis on shareholder primacy continued to gain standing in the economic and business communities. This theory argues strongly against the public corporation assuming societal or moral duties: If the corporation's essential nature is a "contractual nexus," then as a fictional device it lacks actual human consciousness that would enable it to assume such duties. Following from this observation, Jensen and Meckling argue that the sole fiduciary duty of corporate directors and officers—as "contractual agents" of shareholders—is to maximize shareholder wealth.⁵⁷

* * * * *

One indication of the broad acceptance of this revisionist theory of the firm in the United States and its implications for corporate purpose was the 180-degree turn that the Business Roundtable's "Statement on Corporate Responsibility" took between 1981 and 1997. In 1981, that statement read:

Balancing the shareholder's expectations of maximum return against other priorities is one of the fundamental problems confronting corporate management. The shareholders must receive a good return but the legitimate concerns of other constituencies must have appropriate attention . . . [In] striking the appropriate balance, some leading managers have come to believe that the primary role of corporations is to help meet society's legitimate needs for goods and services and to earn a reasonable return for the shareholders in the process . . . They believe that by giving enlightened consideration to balancing the legitimate claims of all constituencies, a corporation will best serve the interests of shareholders.

By 1997, the spirit and conditionality of this statement had changed substantially:

In the Business Roundtable's view, the paramount duty of management and boards of directors is to the corporation's shareholders; the interests of other stakeholders are relevant as a derivative of the duty to shareholders. The notion that the board must somehow balance the interests of stockholders against the interests of stakeholders fundamentally misconstrues the role of directors.⁵⁸

Another, more instrumental indication of this acceptance has been the wholesale conversion of executive compensation to stock-based pay for senior corporate officers. Heavy use of performance-

contingent stock option awards and stock grants was widely adopted and justified as a way of providing a direct link between pay and performance and mitigating agency problems between managers and shareholders. Indeed, starting in 1993, when Congress amended the tax code to encourage public companies to tie executive compensation to objective performance measures, this practice was supported by public policy.⁵⁹ Today, stock-based compensation in most large financial and industrial firms comprises about 70% of total annual compensation for senior executives in large public corporations.

The Embedding of Shareholder Value Maximization in Business Culture

It's difficult to explain fully why this new theory of corporate purpose and governance has become so solidly embedded in our business culture, but several explanations stand out. As a start, however, it is now obvious that much of the appeal of this new theory of the firm and its implications for corporate purpose and governance was created by the Jensen's widely read, practitioner-oriented articles, all of which were backed up by more than 100 scientific papers addressing, one way or another, what he referred to as "the struggle for organizational efficiency."⁶⁰ Along the way, Jensen anchored his theory in a series of conceptual building blocks that started, appropriately, with assumptions about the nature of man (including the role of self-interest) that led to analyses of the inefficiencies and learning disabilities of organizations (such as agency problems) and the disciplining power of a firm's capital structure (such as the heavy use of debt) and markets (as in the market for corporate control).⁶¹ This foundation was supplemented with a series of published case studies and provided Jensen with the platform he needed to address what he saw as capitalism's principal shortcomings—uncontrolled agency costs and unresponsive corporate governance practices—and a variety of proposals for reversing what he saw as the breakdown in the internal control systems of large firms. In addition to his writings, Jensen's public lectures and oversubscribed classes at the Harvard Business School, from which generations of students launched careers in investment banking, private equity, management consulting, and corporate management, brought him great popularity and, in some quarters, notoriety. For all these reasons, Jensen became one of the best-known and influential business economists spanning the millennium, even as his work was being challenged by academic colleagues and students who had entirely different conceptions of what role corporations served, and needed to serve, in contemporary society. To many audiences, however, Jensen's ideas about the coordination, control, and management of organizations made sense. And, in many respects, they did.^e

For example, many of Jensen's students and fans in industry were just as concerned as he was about failure of the internal control systems of large, public firms, which was the subject of his 1993 presidential address to the American Finance Association.⁶² After analyzing the performance of large public firms during 1980 to 1990 in preparation for this address and its accompanying paper, Jensen reported that a large proportion were unable to earn their cost of capital (due to major inefficiencies in their capital expenditures and R&D spending) on a sustained basis. From these findings of low investment returns and the widespread destruction of economic value in large firms (particularly those without monopoly power) during the 1980s, it seemed straightforward that Jensen's advocacy for aggressive pursuit of shareholder value maximization, coupled with compatible governance reforms, was the proper antidote for the number of underperformers. Many in academia and the business community agreed.

In addition, Jensen's concerns about underperforming firms coincided with the development of the market for corporate control that blossomed in the 1980s. His arguments in favor of hostile takeovers as a disciplining device for inefficient firms immediately found support from buyout firms, whose widely debated and oft-criticized takeover strategies suddenly found an elegant, academic validation. (In fact, starting in the 1980s, almost a quarter of public firms in the United States were the target of attempted

^e Full disclosure: In the early 2000s, I taught one section of Jensen's six-section CCMO elective course at HBS, developed with co-professors George Baker and Karen Wruck. Each section enrolled between 75 and 90 students, making it by far the most heavily enrolled elective course at the School.

hostile takeovers opposed by a firm's management and another quarter received takeover bids supported by management.⁶³) In this environment, Michael Jensen's rationale for shareholder value maximization and equity-based pay (as a way of reducing agency costs) was quickly embraced by buyout firms and takeover specialists seeking economic justification for supposedly value-creating strategies (one-third of which eventually turned out not to be, due to insolvencies stemming from an excess use of debt to finance takeovers⁶⁴).

Another source of popularity of this this new theory of the firm and expression of corporate purpose was that it offered corporate executives and financial analysts a simple, theoretically justifiable performance measure—stock price—that captured the present value of all future effects; namely, firm value. As Jensen famously wrote in 2002,

Any organization must have a single-valued objective as a precursor to purposeful or rational behavior . . . It is logically impossible to maximize in more than one dimension at the same time . . . Thus, telling a manager to maximize current profits, market share, future growth profits, and anything else one pleases will leave that manager with no way to make a reasoned decision. In effect, it leaves the manager with no objective.⁶⁵

From here, it was an easy step to place firm value at the center of corporate consciousness. In addition, profit maximization was widely seen as being compatible with notions of private property and ethical principles embedded in freedom theories of justice. The simplicity of this construct no doubt appealed to researchers, journalists, and students seeking an easy way to measure and monitor corporate performance; to buyout firms and takeover specialists seeking economic justification for their profitable work; and to CEOs and their boards who saw shareholder wealth maximization as a way of tying various pay-for-performance schemes to the interests of shareholders. In addition, the shareholder supremacy view of corporate purpose greatly simplified the ways that we think about valuing firms (discounted cash flow available to shareholders) and clarified the primary role of corporate governance (ensuring that managers make decisions consistent with shareholder value maximization).⁶⁶

Finally, the contractual theory of the firm, buttressed by agency theory, seemed to validate the argument of soon-to-be Nobel Laureate Milton Friedman. In his famous 1970 *New York Times* article, "The Social Responsibility of Business Is to Increase Profits," his voice rang loud and clear throughout the business community and continues to resonate today in many classrooms and boardrooms.⁶⁷ Friedman argued that a manager's primary duty is to maximize the value of shareholders' capital because it maximizes the chance of capitalism to allocate capital freely in the service of individual needs, promotes economic efficiency, preserves individual freedoms, and maintains the trust that shareholders place in managers to serve their interests. It was at base an ethical argument, resonating themes of fairness and freedom, as well as efficiency. In this sense, the concept of shareholder value maximization was co-branded by two of the leading lights of the Chicago school of economics (where Friedman was a professor and Jensen received his doctorate.) As US industries became increasingly deregulated during the 1990s, a new, less-constrained runway appeared for the exercise of the kind of value maximization espoused by Friedman and Jensen.

Conceptual and Practical Issues with the Revisionist Theory of the Firm and Corporate Purpose

Whatever the full explanation for its ascendancy, controversy and criticism surrounding this revisionist conception of the firm and corporate purpose persists. First of all, the theory is naive in several respects, despite its elaborate conceptual underpinnings. For example, the successful functioning of market economies and firms requires more than shareholder value maximization as a motivating principle. To operate functionally, firms need to work hard at building and retaining the mutual trust and confidence of constituencies beyond shareholders. In the absence of such trustworthiness, the social legitimacy of market-based institutions will be under relentless challenge—and the costs of coordination and commitment will skyrocket.

Second, the conception of the firm as a nexus of contracts with attendant principal-agent problems that only a focus on shareholder value maximization can mitigate is too simplistic. Corporations, in their everyday operation, are far more than a nexus of contracts through which business transactions are carried out—although associating with a corporate entity through contracts and law to pursue self-interest is certainly part of the creation story. But contracts and law, as Elizabeth Anderson points out, do not exhaust the reciprocal understanding on which the productivity of firms rests; supracontractual understandings or voluntary reciprocal exchanges with stakeholders are also required for corporations to be successful.⁶⁸ For example, relationships with internal stakeholders (directors, executives, employees and their unions) comprise the teamwork necessary for production and the mutual benefits flowing from that production, and in this production team, the contributions of each manager and worker are difficult to observe and ascribe to specific bits of the process. Since it is impossible to contractually specify all the ways team members need to cooperate for efficient production, and since excessive monitoring is likely to depress morale and breed reciprocal distrust, well-managed firms develop norms of trust and reciprocity among members in return for contractually unguaranteed rewards such as bonuses, promotions, better working conditions, family leaves, and so forth. In addition, relationships with external stakeholders (suppliers, customers, and communities in which the corporation does business) require similarly reciprocal understandings beyond contractual guarantees that, as just two examples, promote customer satisfaction and build creditor confidence that executives will not extract short-term gains at the risk of insolvency. For both classes of stakeholders, explicit contracts cannot ensure corporate success.

On this basis alone, it does not make much sense to view the firm simply as a nexus of contracts. Rather, it makes more sense to view the firm, in Anderson's words, as

a *joint enterprise* constituted by a nexus of cooperative relationships in which internal stakeholders commit firm-specific assets to relatively long-term team production arrangements, submit to common governance, and repeatedly interact on the basis of norms of trust and reciprocity, all for *mutual and reciprocal benefit*, the terms of which are *not* exhausted by law and contract. The firm also typically enters into protracted reciprocal relationships with external stakeholders . . . which are supported by normative expectations of trust, reciprocity, and mutual gain, not all of which are defined in explicit contracts.⁶⁹

The most important implication of this conception of the firm is that directors owe a fiduciary duty to the corporation itself, not to the shareholders exclusively, and shareholder value maximization as a singular definition of corporate purpose under market capitalism is inappropriate.

Anderson's vision of the firm, I should point out, is consistent with the view of Merrick Dodd, who had argued that corporations are major social institutions that play a key role in organizing economic and social life. For both Dodd and Anderson, shareholder value maximization in its pure form is an incomplete and corrupting guide for firms seeking affirmation in political regimes such as ours that espouse democratic capitalism.

Third, there are other problems with principal-agent and agency cost theories derived from the nexus of contracts conception of the firm. In considering the firm to be to be an instrument of its owners, who employ agents to operate on their behalf, agency cost theory assumes that these agents (managers) are, to a notable extent, shirkers or disloyal to the firm's principals (shareholders). It is by no means clear that this assumption holds up in real life. Jensen's 1993 study revealing the systematic inability of large public corporations to earn their cost of capital during the 1980s can only *imply* that agency costs are a driver of his computations of value destruction. There have been very few other attempts to measure agency costs directly, and it is probably impossible to do so because the definition of agency costs lacks the kind of specificity that can be converted into easily measurable, organizational, or behavioral characteristics. So the premise of agency costs, while conceptually plausible, remains to be proved.

Fourth, from a business point of view, any value-creation strategy based on a conception of corporate purpose that places shareholders in stark competition with other constituencies over the allocation of economic returns ignores many instances when reciprocity and cooperation and collaboration between a firm's stakeholders are critical to success.⁷⁰ Most commonly, entrepreneurship, which is the lifeblood of capitalism, involves the assembly of complementary resources and skills, and where that cooperation among enterprise members is absent, no new business can be launched, let alone developed. Apart from entrepreneurial startups, shareholders are rarely the sole group that provide specialized inputs to corporate production and make essential contributions to and have an interest in an enterprise's success. Executives, rank-and-file employees, creditors, even members of a local community also make essential contributions.⁷¹

Fifth, recent scholarship finds no systematic evidence strongly suggesting that an exclusive focus on share value and shareholder primacy actually enhances corporate performance or that firms with presumably non-value-maximizing employees on their boards of directors through codetermination arrangements have a negative effect on the performance of the firm's share price.⁷²

Sixth, the shareholder-primacy conception of the firm assumes that all shareholders are alike in their personal goals and values. But can we assume that all retail investors, family offices, mutual funds, pension funds, private equity funds, hedge funds, governments, foundations, and universities, have the same goals? What if some—but not all—institutional investors seek to maximize financial returns for their investors; what if families seek to maximize their “socio-emotional wealth”; what if governments seek to improve social welfare of their citizens? This assumption seems to be an oversimplification of shareholder and investor motives that both reduces the measurement of corporate performance to a single, amoral metric and promotes unbalanced devotion to achieving a goal that can be easily gamed or manipulated by management. Herein lies the degradation of corporate purpose. While simplifying the measurement of corporate performance by limiting consideration to a single metric (say, share price) may appeal to some minds, many corporate leaders would agree that corporate performance involves much more than current share price.

Seventh, in the shareholder-centric model of the firm, public company shareholders are not held accountable in any way for the effects of whatever policies they encourage corporations to take. As Joseph Bower and Lynn Paine argue, “shareholders have no legal duty to protect or serve the companies whose shares they own and are shielded by the doctrine of limited liability from legal responsibility for those companies' debts and misdeeds. Thus, by elevating the claims of shareholders over those of other important constituencies, “without establishing any corresponding responsibility or accountability on the part of shareholders who exercise those powers,” managers succumb to increasing pressure “to deliver ever faster and more predictable returns and to curtail riskier investments aimed at meeting future needs and finding creative solutions to the problems facing people around the world.”⁷³

Eighth, and finally, the economists' revisionist theory of the firm is detached from evolving ideas about the legal status of shareholder claims on the public corporation. It is axiomatic in the world of capitalism that those who have placed risk capital into an enterprise through their shareholdings deserve a satisfactory return on that capital (the minimum return determined by the riskiness of the investment). It is less axiomatic, but nevertheless supported by an array of legal scholars, organization theorists, and practitioners, that the interests of other constituencies comprising the firm need to be justly served as well (whatever *justly* means in case-specific situations) to ensure corporate stability and perpetuity.⁷⁴

* * * * *

For those sharing a broader vision of corporate purpose, capital remains the dominant constituency; why else would anyone want to become an investor/shareholder? Nevertheless, the assumption that capital is the only legitimate constituency that the purposes of the firm should serve seems unrealistic and impractical to an increasing number of institutional investors and asset managers who support a more

inclusive vision of corporate purpose. This group argues that managers have an affirmative, moral obligation not to subordinate public and other constituency interests to the sole interests of shareholders for the simple reason that the authority of managers and their boards of directors to pursue private profit is conveyed by corporate charters granted by the state—and because corporations receive many publicly funded benefits such as tax breaks and subsidies.

Over the years, a variety of legal opinions and legislation have supported the plural obligations and responsibilities of the corporation. As a result, corporate law does not today impose on management an exclusive profit-maximizing duty, but merely links directors' and managers' fiduciary responsibilities to the corporation's and stockholders' long-term interests. While Delaware's *corporate statute* (directly relevant to the 60% of publicly traded corporations that are incorporated in the state of Delaware) is not totally precise on the matter of corporate purpose, it does declare that directors owe fiduciary duties of care, loyalty, and good faith to both the corporation and its shareholders. The state's *case law* conveys a more precise opinion on the matter. For instance, after the court affirmed in *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, that corporate directors must put the interests of shareholders first in the case of takeovers and competitive takeover bids (by accepting the highest price offered once they have decided to put the company up for sale), it clearly left the door open for adopting a more pluralistic conception of corporate purpose if doing so serves the interests of non-shareholders in a way that is rationally related to shareholder interests.⁷⁵ This accommodation of plural interests is perfectly consistent with subsequent court opinions validating non-maximizing shareholder value in the short term in order to achieve corporate success in the long run (for example, *Virtus Capital LP v. Eastman Chemical Co.*).⁷⁶ Indeed, what Delaware case law has revealed is a definite preference for corporations focusing on longevity rather than current shareholder value maximization.

It is pretty clear that the Supreme Court is largely in agreement with the Delaware court. As Justice Samuel Alito noted recently, “While it is certainly true that a central objective of for-profit corporations is to make money, modern corporate law does not require for-profit corporations to pursue profit at the expense of everything else, and many do not do so.”⁷⁷ Consistent with Alito's views are OECD Guidelines for Multinational Enterprises and the OECD Corporate Governance Principles supporting the idea of corporations taking into account non-shareholder interests.

For all these pragmatic moral, economic, and legal reasons, one can argue that a more pluralistic vision of capitalism and corporate purpose has substantial merit—as long as managers and directors do not use “stakeholder” reasons to justify strategic decay due to underinvestment in the business and poor company performance. But can a more pluralistic vision of corporate purpose and governance be judged as being more just *and* efficient in some important ways than one rooted in shareholder value creation? Here is where the combined insights of Aristotle and Barnard come into play.

IV. Rehabilitating Corporate Purpose: Ethical Reciprocity as a Guiding Principle

In his book *Justice*, American political philosopher Michael Sandel observes that “Debates about justice and rights are often, unavoidably debates about the purpose of social institutions.” And complementing this observation, Sandel adds, more generally, that “it is hard to make sense of our moral lives without acknowledging the independent weight of reciprocity.”⁷⁸

Putting these two observations together helps frame the issue that I address in the remainder of this essay: namely, how reciprocity (and the theory of reciprocal justice) can serve as a sensible, guiding principal for definitions of corporate purpose that are more attuned to the emerging collective social values of civil society than shareholder value maximization. The place to start, as always, is with some relevant definitions.

Aristotle's Theory of Reciprocal Justice

According to Aristotle, *reciprocity* refers to an exemplary kind of social cooperation in a transactional setting. It is a practice by which transacting parties (or friends) “preserve parity in the distribution of benefits and burdens over time.”⁷⁹ In Book V of *Ethics*, Aristotle proposes a theory of exchange between transacting parties that defines the exchange as primarily an ethical problem: the exchange of goods is the material content of social relations between people that can only be sustained as long as it represents an “exchange of equivalents.”⁸⁰ At the societal level, Aristotle argues that in order for the economic basis of society to be secure—with that economic basis being defined by the division of labor and exchange of products of specialized labor—every exchange of goods also has to be an exchange of equivalents.⁸¹ In other words, market exchanges cannot take place on a sustained basis unless the partners to such exchanges are assured that what they give away and what they receive are of equivalent value to them. For this to happen, some form of justice is required that holds people together, and that form is *reciprocal justice*, which involves the notion of equivalent or proportional returns between contracting parties.

What Aristotle means by this is that if a shoemaker and a housebuilder, to use his example, were to enter into an exchange, what makes such an exchange reciprocal (and equivalent) is the value, or personal utility, of the work that is exchanged, not the specific cost of the individual units produced by the two parties. In other words, a reciprocal exchange considers the proportion of the parties' *wants* or personal *utility* for the traded goods. Economic goods have no value as such, but rather they may become valuable to people if put to use under specific conditions. According to this logic, goods cannot be separated from their relation to persons and therefore cannot be directly related to each other; it is the people who are related to each other that create the medium of exchange. The exchange ratio of goods is a ratio simultaneously set or negotiated between the people who put to use the goods exchanged and between the goods that belong to them.⁸² Thus, the more valuable a person's skill (say, the housebuilder) is to that of other persons (say, shoemakers), the greater will be the quantity of products that the first person can justly command from the second person.

Although Aristotle was preoccupied with exchanges between individuals and not with exchanges between many buyers and sellers competing with each other in markets of various degrees of price transparency, his theory of exchange addresses a universal paradox that exists in all markets: namely, that exchanges of goods take place between non-equivalent parties who desire goods or skills that they do not possess; yet in order for the exchange to take place, some sort of equivalency needs to be established. The objective of his theory was to find a *principle* that could equate what appears to be unequal or nonequivalent (by virtue of the different skills required to produce the desired goods).⁸³

This sounds simple enough, but of course it is not. The various forms of justice and just exchanges that Aristotle discusses are beyond the scope of this essay; still, it is possible to highlight his essential point that (a) justice refers to a principle that governs man's conduct in his dealings with his fellow men and (b) that the justness of the value of goods exchanged between parties is measured by the degree of the parties' “wants” or need for the traded good. In Aristotle's opinion, *wants* form the basis of exchange and serve as a measure of the value of the goods exchanged. (Money, of course, serves as a useful medium for expressing wants and thus the value of goods and services exchanged. And money facilitates exchange by transforming subjective, qualitative phenomena like *wants* and *want satisfactions* into objective, quantitative ones.) This notion of value—the basis of Aristotle's concept of reciprocal justice—is utility-based, not cost-based. In this sense, Aristotle was an originator of the utility theory of value as well as the principle of reciprocity.

As noted, to meet the standard of reciprocal justice, the utility value of the goods exchanged must be equal (actually, proportional) to each party's perceived needs and wants. If one party gets richer at the other's expense, there would not be reciprocal justice—because one party would receive a supernormal award and the other would suffer the injustice of having less.

The value of each party's needs and wants can be accurately and fairly established only if the relevant exchange negotiations are free from the domination of one party over another. In addition to this "absence of domination" condition, reciprocity demands that the resulting exchange be voluntary. Where there is no voluntary exchange, there is no reciprocity.

How can we apply Aristotle's standard of freely negotiated equivalent and proportional returns between contracting parties if one of the parties—let's say shareholders—is seeking supernormal returns? What Aristotle would answer is that if shareholders and their designated decision agents (corporate officers) were to seek above-average corporate returns at the expense of hourly workers whose needs and wants are either unmet or underserved, then there could be no reciprocity (as we now see in the current escalation of both share prices and executive pay in a bull market far beyond increases in the pay of non-supervisory workers). But if shareholders were to seek and achieve supernormal returns while at the same time being open to negotiate free of domination a new exchange of equivalent utilities based on any related changes in the wants and needs of employees, then it could be possible to meet Aristotle's standard of reciprocity. In this way, exchanges meeting the standard of reciprocal justice are not subject to any cap on the utilities exchanged.

The fact that voluntary markets are competitively structured in a capitalist economy and thus often adversarial in nature raises the question of whether any market transaction can be expected to be truly reciprocal or, for that matter, fair. If "fairness" connotes absolute equality in the exchange of benefits, then the answer is *no*—for the simple reason that it is impossible to precisely estimate and guarantee absolute equality or equivalency in value of benefits exchanged. But if fairness is based on subjective, self-interested definitions of needs, wants, and value-received from a transacting party, then the impossibility of fair, reciprocal transactions melts and the pursuit of individual self-interest can be consistent with just exchanges—except where the pursuit of rapacious self-interest ignores its direct, destructive effects on the exchange system as a whole (the market) or the industry in which the transacting parties participate.

It is not difficult to imagine the myriad of circumstances where reciprocal value exchanges persist in active markets today. As a contemporary example from the biotech sector, consider a startup drug development company (C4 Therapeutics) that signs a partnership agreement with a big pharma competitor under which it agrees to perform early drug research for that competitor and to cede potentially huge intellectual property rights in the future to its larger partner. In exchange, it receives a current payment of cash that will enable it to pursue its own proprietary cancer drug research. This transaction is difficult to define as equal: an upfront cash payment versus a downstream grant of potentially very high value IP rights. Yet the partnership agreement is testimony to the fact that self-defined reciprocal, proportional value apparently exists and changed hands for both parties. Many more examples of cooperative, mutually advantageous relationships in highly competitive markets exist, but cataloguing a larger list is beyond the scope of this essay; my central point is that recruiting Aristotelian notions of reciprocal justice into corporate governance is, at base, a rejection of the argument that efficiency is the only morality of the market.⁸⁴ Organizations, like individuals, have self-defined needs that may or may not relate to least cost considerations. And these needs or utilities are the basis for reciprocal market exchanges. This is Aristotle's moral and practical insight.

It should be clear by now that an important feature of Aristotle's conception of reciprocal exchange is that such an exchange is the result of a bargain struck between parties making their own terms of exchange. The parties make their own estimates of the want satisfactions that they will derive from the goods or skills they get in exchange for their own goods or skills. In subsequent bargaining or negotiation, parties arrive at an exchange ratio that is an intermediate or mutually determined ratio between the two (pre-bargaining) estimations of want satisfactions. And in the absence of domination of one party over another, this exchange ratio establishes each transacting party's "reserve price" for cooperation. Since utilities or want satisfactions are not directly measurable, their valuation is facilitated by the use of money, but not determined by money.⁸⁵

Aristotle’s concept of *reciprocal justice* is consistent with his larger conception of *commutative justice*, which refers to that which is owed between individuals, such as in business transactions where the rules of the price system are accepted. It contrasts, however, with other forms of justice, such as *contributive justice*, which refers to what individuals might owe to society for the common good; *legal justice*, which refers to rights and responsibilities of citizens to obey and respect the rights of all and the laws devised to protect peace and social order; and *distributive justice*, which refers to what society might owe to its individual members (i.e., the just allocation of resources). Reciprocal justice also does not assume that equality or egalitarianism is a transactional goal.

Aristotle’s model of exchange justice as it pertains to a purely business matter has many complexities, which is why it was probably underutilized by philosophers and the general public for so many centuries. But Aristotle’s connection of exchange to the notion of reciprocal justice is the reason why jurists and theologians in the Middle Ages first began to promote and employ his ideas about reciprocal justice in a big way. They needed some principle on which to make compensatory awards. In this way, early jurists began to codify the notion that exchanges of value involved exchanges of obligation and merited adjudication according to a principle of fairness.

In the millennia since Aristotle’s treatment of reciprocal justice in *Ethics*, many economic and organizational theorists have offered their own conceptions of efficiency in transactional settings. The two most widely known concepts have obvious philosophical implications: Pareto efficiency (a change or transaction that makes at least one person better off without making anyone worse off) and Marshall efficiency (a change or transaction that produces net gains—not some gain with no losses). I will comment below on the relevance of Pareto efficiency in a discussion of how Chester Barnard’s conception of efficient organizations provides a useful way of thinking about the economic benefits of Aristotle’s ethical principle of reciprocity; but suffice it to say here that reciprocal exchanges can be more or less efficient depending on the nature of the cooperative relationships comprising a stable organizational system.

It is also worth pointing out here that the simple bilateral contracting construct described by Aristotle becomes more complicated when agreements reached in negotiations with a single party affect the stakes and expected fair returns available to other contracting parties—or when one completed transaction affects the stakes and expected fair returns of contracting parties in subsequent transactions. Thus, the exercise of reciprocal justice in today’s world of business is continuously dynamic and, most importantly, transformational. In this context, reciprocity should be seen as a procedural conception based on dialogue, not an outcomes conception.

A common example of this dynamic can be seen in multi-union companies, where a labor negotiation with one union affects the expectations and negotiations of the other unions, which in turn affect the stakes of the original negotiating parties. In the same way, wage settlements in one region of a national company (like the Safeway grocery chain) inevitably change the expectations of fair returns in other regions, even though the “going wages” may be quite different. Similarly, transactions with one supplier can also affect agreements with other suppliers, and preferences awarded to investors in one round of external financing will affect all other financings, as well as relationships with existing investors. And so on.

Under such dynamic conditions, company-specific declarations of corporate purpose and modes of governance are best conceived of as reflecting a series of continuous interactions and exchanges of *quid pro quos* with strategic partners and other affected parties—that is, a mix of accommodated interests rather than a unilaterally imposed goal. Maintaining such “coalitions” (or equilibriums of fair returns), especially when interests shift as circumstances change, has always been a mark of administrative leadership and a force of long-term institutional stability.

* * * * *

Two millennia after *Ethics* was written, John Rawls, perhaps the leading moral and political philosopher of our time, picked up the subject of reciprocal justice where Aristotle left off. While Aristotle focuses on the personal utility of traded or exchanged goods, Rawls refined the concept of reciprocal justice to include the complementary principle or standard of mutual benefit. It is easy to imagine what this might mean for a contemporary corporation: that the standard by which business relationships should be measured is the degree to which mutual benefits for consumers, employees, suppliers, communities, and shareholders are created. A current example of such a commitment to mutual benefits can be seen in the statement of purpose of the privately held Mars Corporation, the global candy company.⁸⁶ The open question, to which I return below, is whether this is a standard that can be applied to a publicly listed corporation, which is much more exposed than Mars to the current preoccupation of the capital market with shareholder value maximization.

Rawls's standard of reciprocity is part of his more general theory of "justice as fairness" based on the principles of liberty (every individual has an equal right to basic liberties) and equality (equality of opportunity and the permissibility of inequality only if it works to the advantage of the worst off in society). Like Aristotle, Rawls does not address the matter of *efficiency* in either interpersonal or commercial exchanges. Neither does he pay attention to the role of the corporations as a major institutional feature of the modern state. In fact, it is quite remarkable that Rawls has nothing to say about the corporation, which limits the translation of his principles of justice to the market economy. Nevertheless, his refinements to Aristotle's theory of reciprocal justice are worth noting.

According to Rawls, the standard of reciprocity is met when parties to a transaction are prepared to offer one another fair terms, defined as (a) offering terms that proposers reasonably think would be acceptable to the persons to whom the terms are offered and (b) terms that proposers would think to be "reasonably acceptable" to *themselves*. An additional standard of Rawlsian reciprocal justice is that of autonomy, meaning that all parties to the transaction "must be able to do this as free and equal, and not dominated or manipulated . . ." ⁸⁷ This standard is a useful elaboration of Aristotle's position that reciprocity can exist only in voluntary exchanges.

One common form of domination that most concerned Rawls stems from a lack of shared understanding between contracting parties of each other's power and knowledge, strengths and weaknesses, and values and objectives. However, while this form of domination seems to be a common condition in many negotiations, Rawls does not address how negotiators can, in practice, discover the needs of counterparties at a reasonable cost and then be convinced to cede their greater insights or any other information advantage that they possess or have developed. Presumably, all this get arranged during negotiations leading to the formation of cooperative relationships or mutually advantageous transactions. But the point is an important one, because in the presence of unconstrained domination and the absence of interparty trust, it is highly unlikely that a culture of reciprocity can ever develop.

Another common form of domination in commercial affairs is bluffing and deception, a subject that Rawls also does not address, other than asserting that "threats of force and coercion, deception and fraud" by transacting parties are incompatible with "the idea of society as a fair system of cooperation between citizens as free and equal persons."⁸⁸ Although Rawls develops rigorously argued criteria for judging the fairness of transactions and other relationships in society, he does not apply them to the everyday conduct of firms where bluffing, puffery, and other forms of deception are common. He leaves this task to business-oriented ethicists, who are used to confronting such questions as, "What's wrong with making money through deception, as long as that deception does not violate accounting or SEC rules?"⁸⁹ While Rawls does not address this enduring business subject, his more general message is that deception is a form of domination that vitiates any claim to reciprocal justice.

Ethical Reciprocity

As I have described it so far, the principle of reciprocity can be an especially persuasive one in business situations where exchange relationships extend over prolonged or uncertain time periods, and where unanticipated contingencies cannot be planned for. This is the world in which most businesses live. In contrast to situations where a business exchange takes place over a specified time period (as in spot markets) and contracts can easily state in advance the terms of exchange with specified services and returns, exchanges taking place over multiple time periods and involving conditions and terms that cannot be easily specified in advance call for another kind of reciprocity. Aristotle refers to the latter situation as requiring *ethical* reciprocity, and the former requiring only *legal* reciprocity.

Under a regime of ethical reciprocity, exchanges are considered to be similar to a gift or service that is offered with the expectation that at some time in the future, the giver will receive an equivalent or greater return. In this way, ethical reciprocity moves beyond contracts and law and rigid *quid pro quo* terms. It is more deeply rooted in good will than codified obligation. And while consistent with ambiguities often associated with long-term exchange relationships, ethical reciprocity exposes participating parties to more vulnerabilities than exchanges made under a more legal, contract-based relationship. In marked contrast to legal reciprocity, ethical reciprocity is built on a diminished desire for transactional control by each party and heightened trust that others will not exploit one's vulnerabilities.⁹⁰ Aristotle's concept of ethical reciprocity finds contemporary expression in the economist's notion of relational contracts, which refers to "collaboration sustained by the shadow of the future as opposed to formal contracts enforced by courts."⁹¹

The practice of ethical reciprocity requires a different conception of self-interest than that which has become the bedrock of the economic theory of human behavior. The traditional economic conception of self-interest is "a commitment to one's interests without regard for how they affect others." This conception reflects a model of economic man (*homo economicus*) based on an assumption of infinite greed. Allen refers to this form of self-interest as *rivalrous self-interest*.⁹² (Others refer to it as psychopathic.⁹³) Rivalrous self-interest typically leads to conflicts of interest in the business world, as it does in the political world. In business life, the most common conflicts include those between shareholders (interested, say, in earnings-per-share growth, dividend payout, current stock price, and perhaps improving corporate and social responsibilities) and managers (interested, perhaps, in increasing the size of the company for personal reputation reasons and increasing their personal wealth by paying themselves higher remuneration), and those between equity holders who have operational control of the company and creditors who have a first claim on company assets in the case of bankruptcy but little or no operational control. Rivalrous self-interest also leads to conflicts of interest between a firm's various constituencies in the pursuit of winner-take-all strategies, such as scorched-earth takeovers, price gouging, exploiting suppliers by exerting maximum buyer power, labor lockouts, cornering commodity markets, and so on, all of which can seriously harm employment, the local community's economy, the industry's supplier base, or even the national interests. In contrast to rivalrous self-interest, there are other possible forms of self-interest, including treating "the good of others as part of our own interests" and remaining attuned to what others are giving up for the benefit of the community as a whole. Allen refers to this form of self-interest as *ethical self-interest*.⁹⁴

If ethical self-interest resonates mutuality, it also reflects practicality. We rarely serve our best interests by pursuing and promoting our own interests to the exclusion of others'. We typically need others to help us achieve our goals, and the longer we are indifferent to their interests, the greater the chance that others will act in ways that hinder achievement of our goals. Similarly, our self-interest is often furthered by restraining ourselves from maximizing our interests, knowing that taking into consideration the interests of others who are in a position to assist us in the future, they will be more willing to do so than they would otherwise.

Put in other words, ethical reciprocity *always* requires a certain amount of personal or institutional sacrifice. Sacrifice—namely, the surrender of something valued or desired for the sake of something regarded as having a higher or more pressing claim—is as central to the world of business as it is to the practice of democracy and democratic citizenship. With respect to democracy, sacrifice involves, for example, accepting defeat at the polls after a hard-fought election. In this way, sacrifice builds community and discourages violence and defections from the polity.⁹⁵ Sacrifice in the world of business involves not only completing economic transactions between self-interested parties, but also a willingness to give up or delay personal and corporate gains to maintain the health of the economic system. Sacrifice in this broader context reflects a sense of responsibility by self-interested economic actors for the economic system as a whole and an understanding of what self-restraints are required so that system can better preserve itself.

Consider, for example, a case of investment bankers being invited to join representatives of major audit firms to discuss the FASB accounting rules pertaining to M&A transactions—with no other party present representing the general public present.⁹⁶ The bankers face two choices: They can recommend rules that maximize their own economic interests, or they can also consider themselves to be stewards for the system as a whole, in the absence of any public participants. Performing both roles is sometimes referred to as *dual agency* (in contrast to single agency on behalf of a firm's owners), and dual agency is often required to manage competing responsibilities.⁹⁷ In this instance, ethical self-interest would require the adoption of dual agency and the possible surrender of something of value by the bankers in order to advance the cause of justice. Their failure to do so might well endanger the legitimacy of the financial system. Self-maximizing bankers can end up tomorrow's losers if, in this instance, the financial system becomes disabled.

A business culture rooted in ethical reciprocity enables transacting parties to make trade-offs of all kinds so that exchanges can be completed to the satisfaction of both parties. Since few transactions or exchanges can be a perfect bargain for all parties, this should appeal to practical businesspeople. But for ethical reciprocity to endure beyond a single transaction, those who initiate transactions—be they be individuals or organizations—must meet a minimum condition: namely, honoring promises and commitments made to counterparties. This is not only a moral condition (avoiding false promises) but a basic economic condition (efficient product- and service-markets can exist only in the presence of trust and cooperation based on credible expectations about what transacting parties owe each other).

Companies and their representatives that make credible promises, and then keep them, are in a position to reap the benefits that come with mutual trust: access, even privileged access, to valued customers, suppliers, and other counterparties; customer and supplier loyalty; low factor costs due to less contentious price negotiations and lower perceived risks of default; and so on. Where a company's promises to various constituencies and stakeholders are not trusted, the incentives to cease cooperating or withhold their resources will be high—as with investors and creditors withholding needed capital, or employees shirking their jobs, or customers shifting their purchases of a product or service to more trustworthy vendors, or society being unwilling to let businesses operate with a minimum of (costly) oversight.⁹⁸ In other words, the promise is, and always has been, the fundamental building block of business—and reciprocal justice.⁹⁹ Without the ability to make credible promises and commitments, corporations and other institutional players will face an ever-diminishing ability to attract resources and retain customers and talent.

Ethical Reciprocity and Corporate Efficiency

Pursuing corporate purpose based on the principle of ethical reciprocity not only meets an Aristotelian standard of justice, but also brings with it access to a major source of corporate efficiency. The foundational writings of Chester Barnard on cooperative systems provide the link between the practice of ethical reciprocity and organizational efficiency in market economies.

Barnard spent a forty-year career at AT&T starting in 1927, culminating in a long presidency of New Jersey Bell Telephone company and then the presidency of the Rockefeller Foundation. His book, *The Functions of the Executive*, which appeared in 1938, has become one of the intellectual cornerstones of modern organizational theory. For Barnard, organizational survival and efficiency depend in large part on the distributive process embedded in cooperative systems.

According to Barnard, organizations are best conceived as systems of “cooperative human activities” whose primary functions are the creation, transformation, and exchange of utilities. These functions transcend and embrace four different kinds of economies: (a) a *material* economy involving the control of physical assets useful to the organization; (b) a *social* economy consisting of the organization’s relationships with other organizations and individuals not connected with the organization, in ways that are both cooperative and have utility for the organization; (c) *individual* economies consisting of the continually changing balance between individual work and the material and social satisfactions received in exchange for this work; and (d) the *organization* economy involving the pool of utilities accruing to the organization by virtue of the physical material and social relations it controls and the personal activities it coordinates.

Readers should take note of the social economy, within which Barnard includes “relationships with other organizations and individuals not connected with the organization.” Presumably, these are parties who maintain exchange relationships with each other that can either be reciprocal or exploitive, efficient or inefficient. Such relationships are efficient, according to Barnard, when the distributive process creates “a surplus of satisfaction” for each participant in the cooperative system.¹⁰⁰ If each participant in this cooperative system gets back only what is put in, then there is of course no incentive or satisfaction in cooperation. What a participant in a cooperative system gets back must be an advantage in terms of satisfaction, but so, too, must that be true for the organization. In other words, efficiency for the individual and the system is that of satisfactory exchange.

The material and social satisfactions resulting from intra- and inter-organization exchanges in a defined cooperative system obviously appeal to different parties in different ways. And since the mix of required satisfaction varies by party, the process of distributing satisfactions is key to the efficiency of a cooperative system. This is where adopting the principle of reciprocity can help ensure that the distribution of satisfactions is efficient in Barnard’s sense of the word. Reciprocity provides the principle by which a fair and satisfying distribution of benefits can be achieved.

As I have already discussed, such exchanges require some degree of compromise or mutual sacrifice in order to achieve “the surplus of satisfactions” that can be *efficiently* distributed. Examples of such exchanges include employment contracts and all forms of deal structuring between an organization and collaborating parties where “dividing the pie” or sharing benefits and costs are paramount. In all such situations, some kind of surplus or slack has to be put on the table and traded so that the eventual returns to all contracting parties are mutually satisfying. According to Barnard, a cooperative system is *inefficient* when a balance of burdens and satisfactions does not exist. Under these conditions, there will be individual or group defections (including shirking of responsibilities) from the cooperative efforts, which in turn will threaten the continuance of that organization. This why Barnard strongly embraces the idea that, while there can be no precise measurement of organizational utility, the best indicator of the efficiency of an organization is in terms of its persistence or its decline and failure.¹⁰¹

Since cooperative systems need to be continually adaptive to changing conditions, a key executive function is to ensure that the bases of cooperation (exchanges) continually readjust as necessary to retain the structural integrity of the organization. This is very different perspective on the functions of administrative leadership than absolutist versions of shareholder value maximization.

Chester Barnard’s conception of efficient cooperative systems and administrative leadership echoes the thinking and writing of William James, one of the founders of pragmatist philosophy, who taught at Harvard from 1892 until 1907. Barnard was an undergraduate during the tail end of James’s academic

career, so it is possible that their paths crossed, physically or intellectually. Certainly, James's thoughts about why cooperation is an essential ingredient of social organizations are prominent in Barnard's thinking:

A social organization of any sort whatever, large or small, is what it is because each member proceeds to his own duty with a trust that the other members will simultaneously do theirs. Whenever a desired result is achieved by this cooperation of many independent persons, its existence as a fact is a pure consequence of the precursive faith in one another of those immediately concerned. A government, an army, a commercial system, a ship, a college, an athletic team, all exist on this condition, without which not only is nothing achieved, but nothing is even attempted."¹⁰²

Interestingly, Barnard's notion of firms as cooperative systems is also consistent with the origin of the word *company*. As Colin Mayer reminds us, both the the English word and its Italian counterpart, *compagnia*, come from the Latin *cum panis*, which means the "sharing of bread together."¹⁰³

Barnard's and James's conception of efficient cooperative systems gives practical relevance to the principle of Pareto efficiency in economics. According to Pareto's principle, whenever it is possible to make at least one person better off without making anyone worse off, then it is better to do so than not. Pareto's principle, in economic terms, can be seen as a general prohibition of waste, since if a manager can organize resources in such a way to improve one person's welfare without worsening anyone else's, it means that resources are being wasted under the status quo.¹⁰⁴ Pareto efficiency can be achieved in a number of ways that that illustrate the benefits of cooperation and reinforce the stability of cooperative systems.

As explained by Joseph Heath, the first form of cooperative benefit is *economies of scale*; the benefit arises from the fact that not all jobs can be done by one person and that people can be organized in such a way that working together leads to a better collective outcome than working separately. The second cooperative benefit comes from so-called *gains from trade*, a benefit that arises because individuals have different needs and tastes. A culture of cooperation and reciprocation facilitates the exchanges of satisfactions that Barnard sees as being the all-important glue of efficient organizational life. The third cooperative benefit is *risk-pooling*, which individuals cannot do efficiently (or at all) on their own. This benefit results from the organization serving as a kind of insurance mechanism that builds feelings of mutuality, reinforces acts of cooperation, and reduces the coordination costs of organizations. The fourth is sometimes referred to as *self-binding* (or self-control), where cooperative organizations can help individuals with very different short-term and long-term preferences achieve common premises for current decision making. The fifth cooperative benefit of cooperative systems is *information transmission*. A major efficiency advantage of social interaction is that it allows individuals to economize on learning costs. Heath's catalogue of cooperative benefits vividly suggests how—even in a world of organizational free-riders—the primary function of a corporation can be understood as a way of creating an environment that is insulated from certain noncooperative patterns of market behavior in order to foster "reciprocity, trust, and therefore more effective teamwork."¹⁰⁵

The various ways of meeting the standard of Pareto efficiency in organizations also reveal why reciprocity and cooperation in the governance of firms make economic sense. Adopting the principle of ethical reciprocity as a guideline for corporate purpose and governance is entirely compatible with the efficient management of organizations and, to boot, it does not require concessions to corporate economic performance, as long as the cooperative benefits summarized by Heath are seriously pursued. Further, if we can embrace Barnard's conception of what drives efficient and durable organizations—a view based on philosophical principles enhanced by extensive leadership experience—then we should be comfortable in embracing ethical reciprocity as a principle that governs exchange relationships both within and across organizational entities. Both Barnard's and Aristotle's conceptions of exchange relationships focus on cooperation as a core value. Barnard's stresses the efficiency benefits of cooperative personal relationships and organization systems; Aristotle stresses the ethicality of cooperation in transactional

settings; and both see both moral and economic value in truly reciprocal, cooperative relationships, which is not a priority in a shareholder value maximization regime.

The Promise of Reciprocity Theory: A Summary

The basic idea of reciprocity theory is that justice is achieved when the Aristotelian/Barnardian standards of fairness and efficiency govern relationships or transactions between various parties comprising an enterprise. As a principled tool for balancing constituency interests and ensuring that an organization's participants experience an exchange of benefits sufficient to guarantee continued cooperation, the principle of reciprocity can facilitate agreements between parties with non-identical goals and preferences. Such outcomes can, in turn, form the base of a "culture of reciprocity" where trade-offs are voluntarily made by transacting parties of all kinds—so that exchanges could be willingly and profitably concluded rather than imposed by winner-take-all strategies, which have the perverse effect of destroying a future willingness to cooperate in transactions and relationships with the potential for shared value gains. In this way, reciprocity can serve as an action-guiding principle for managers much like other maximizing principles, only what would be maximized is cooperation over discord.

According to the principle of reciprocity, expressions of corporate purpose and governance can be expected to reflect the interests of parties comprising and affected by the enterprise, recognizing that each of these parties have different minimum thresholds of fair returns and fair treatment that must be met to keep them as cooperative participants in the enterprise. As I have discussed, for employees, that minimum may be defined by the value of wages, benefits, and job security; for shareholders, that minimum may be defined by their required rate of return on investment considering the riskiness of that investment; for the community affected by the enterprise, the accounting may be less quantitative but no less critical. Adopting this way of thinking can lead businesses to define their mission or purpose in terms that encompass the mutual advantage of all participating parties and orient their actions toward this purpose.

Once liberated from the straitjacket of shareholder value maximization as the sole, legitimate expression of corporate purpose, public corporations are free to pursue a wide diversity of purposes of both an economic and social nature. These purposes are constrained only by the need to pay the reserve price required by parties participating in the life of the enterprise, including shareholders. Thus liberated, today's corporations can then refocus on what is, and always has been, the real purpose of business—satisfying the needs and the solving problems of society at large in a profitable manner. In a regime of ethical reciprocity, shareholder profits become a one of several qualifying conditions of durable relationships required to satisfy needs and solve problems, but not the corporation's sole purpose.

Finally, the promise of reciprocity theory—in both its simple and dynamic forms—is that it conveys a deeper sense of engagement, mutuality, good faith in business affairs than what a single-minded commitment to profit maximization and related strategies of intimidation and predation conveys. In everyday decision making, the principle of reciprocity offers an explicit guide to those struggling to *balance* corporate priorities: How much should management be focused on a company's ephemeral share price? What long-term public good would this accomplish? To what extent does focusing on shareholder value maximization as the holy grail lead to short-term, value-destroying practices and largely irreversible costs for customers, employees, the community, the country, and Planet Earth? In grappling with each of these questions, the principle of reciprocity suggests *fair value exchange* as a point of departure.

Still, unaddressed questions remain: Why should the leaders of public enterprises voluntarily adopt such a principle in shaping their corporate purpose and governance practices and abandon the maximization principle? What's the incentive to pursue justice principles in the rough and tumble of competitive life, where the game is all about achieving influence or dominance over competitors, suppliers, customers, and social institutions? How can we convince practical business leaders to accept to the concept of ethical reciprocity as guide to purposeful action?

Understandably, capitalist enterprises will pursue justice principles (such as reciprocity) in shaping their corporate purpose and governance practices only when it serves important business and shareholder interests. And one of the reasons that many firms have failed to avidly pursue justice principles is that they have simply seen few benefits of doing so. Part of that blindness has to do with lack of imagination and understanding of conditions where reciprocity serves important business interests. In addition, the expanding world of *social investing*—where criteria reflecting environmental, social, and governance (ESG) factors are integrated in the decision-making process of investors—is not commonly thought to be associated with superior investment performance,¹⁰⁶ although academic studies and reports from asset managers are beginning to report lower earnings volatility and higher returns on equity for ESG companies.¹⁰⁷ For this reason, the pressure on corporate executives and their boards from the investing public to adopt justice-based principles as guides to business policies and conduct has, until very recently, been weak.

In the absence of pressure from shareholders and institutional investors (a topic that I will return to below), reciprocity only “works,” or is most relevant to the shaping and implementation of corporate purpose, in two generic situations. The first is where there is high survival risk for economically distressed firms, industries, or economies. Under such conditions, there are strong incentives for various powerful parties and stakeholders to work together in a reciprocal fashion to survive a shock or otherwise preserve “life options” together. Post–World War II Germany and Japan provide good examples (beyond the scope of this paper) of intense reciprocity at work, involving the innovative exchanges of *quid pro quos* in the shared process of rebuilding shattered firms and economies. In bankruptcy proceedings, court-appointed (and, therefore, involuntary) reciprocal exchanges offer many other examples of reducing firms’ survival risk. More common and more voluntary examples include General Motors and the United Auto Workers union’s co-creation and co-management of the independent Saturn Corporation to survive the fast and vast inroads of Japanese automakers after the second oil shock in the 1980s.^f Another example is the reciprocal relationship forged between Bell South and the Communications Workers of America following the court-ordered breakup of the AT&T monopoly in 1984, when it became clear that the Bell South (and the other regional Baby Bells) could no longer compete with the low costs of non-union new entrants in the telecommunications business.¹⁰⁸ During the economic adjustments of the 1980s, the textile, clothing, semiconductor, telecommunications, and health-care industries also were required to forge more cooperative and less value-maximizing labor-management relationships.¹⁰⁹

The second situation, which poses more motivational challenges than the first, arises where a single-minded commitment to shareholder value maximization creates a long-term survival risk by diminishing the public’s perception of the legitimacy of contemporary capitalism. This *system survival* risk—which I have tried to characterize in my discussion of moral disengagement under shareholder value maximization—is the one that generally gets ignored in shareholder-focused boardrooms. Reversing this narrow focus under conditions of intense competition for market position and above-average returns is a big challenge. Convincing practical business leaders to accept to the notion of ethical reciprocity as guide to purposeful action will require several shared understandings.

Apart from the obvious need to preserve the well-being of an economic and political system that enables American capitalism to prosper for all citizens, the most important understanding relates to the possibilities of ethical reciprocity becoming a central feature of corporate purpose in the US legal setting.

^f A notable feature of this new, cooperative venture—aided by financial incentives from the State of Tennessee to locate in Spring Hill—was the elimination of the distinction between production and salaried employees, along with the elimination of the time clocks. In addition, Saturn’s facilities had only five job classifications, in contrast to as many as 100 in other GM plants, giving management more flexibility in the production process. In addition, about 20% of Saturn employees’ base salary was tied to corporate performance. If Saturn did well, employees would get their full base pay, and possibly more. This base pay was equivalent to 80% of standard industry wages. If Saturn floundered, they could end up with 20% less. In return, UAW employees received unheard-of employment guarantees. Four-fifths of them received a permanent job security guarantee based on a seniority formula. I should point out that Saturn eventually failed as a business venture in 1999, not because of its radical governance model but rather because of product decisions that turned out badly in a weakening new-vehicle market.

As I have already discussed, ethical reciprocity is perfectly consistent with the determinative Delaware statutes and case law, which give wide latitude to corporate managers to pursue whatever business policies that are deemed to be in the long-term interests of the corporation as a whole. In addition, the adoption of ethical reciprocity as a guiding principle of corporate purpose in no way changes the fiduciary duty of corporate directors. Practicing ethical reciprocity does not obligate corporations and their boards to owe fiduciary duty to any parties other than shareholders. Fiduciary duty to *non*-shareholders that may have transactions with the corporation can be established only by formal contract. But such a contract is not required to build cooperative organizations committed to accommodating the mutual interests of multiple parties involved in the life of the business enterprise. What *is* required is that sufficient satisfactions be distributed by the organization to maintain a willingness to cooperate on the part of these parties and to deter their slacking or defection. For example, it did not require any changes in corporate law or GM's corporate charter or directors' fiduciary duty to co-create and co-manage the Saturn Corporation subsidiary with the UAW. I have been clear from the beginning of this essay that integrating principles of ethical reciprocity into the governance of the corporation is not a matter of corporate law but rather a matter of conducting business sensibly and morally, whether the motivating conditions be to reverse a distressed financial state or to enable financially successful firms achieve stability and profitable continuity through creative collaboration rather than trust-destroying antagonism.

A second important understanding involves the practical, business reasons for embracing ethical reciprocity and its underpinning ideas—cooperation, ethical self-interest, and voluntary sacrifice—as an action-guiding principle of management. Ethical reciprocity offers the philosophical basis for a form of capitalism that embraces engagement, mutuality, and good faith (*fairness*) alongside profit making in business affairs. By avoiding the exploitation of other parties to the enterprise, it reinforces system stability and legitimacy by drawing people (and firms) into networks of mutual obligation whereby those who sacrifice today reap reciprocal benefits in the future.¹¹⁰ Surely, preserving such system stability and saving democratic capitalism from the fate that Arnold Toynbee has identified for all great civilizations contributes to the economic value of shareholders' investments. This is a matter of common sense.

Objections

The promise of reciprocity theory as a guide to corporate purpose also depends on effective rebuttals of inevitable intellectual objections. One of the most challenging objections will come from those who see shareholder value maximization as being consistent with another, well-established, competing theory of justice—namely, the *freedom theory of justice*. According to this theory, preserving freedom of choice in matters of personal and institutional preference should be the primary standard for judging capitalism (a view rooted in the writings of John Locke, Friedrich A. Hayek, Milton Friedman, and Robert Nozick, which emphasize freedom of choice as the ultimate social goal and economic freedom as the “indispensable means toward the achievement of political freedom”¹¹¹). While this theory offers important insights about what “justice” can stand for and what kind of social contract between individuals and between individual and political authority is the most just, serious questions remain unanswered about to how it can help guide corporation purpose and contain social injustices currently associated with strict shareholder value maximization.

As an example, many freedom theorists show minimal concern for income inequality, a position not uniformly accepted by American citizens. For “pure” freedom theorists (and libertarians), the just distribution of income or wealth arises from the free exchange of goods and services in an unfettered marketplace. In arguing that the goal of income equality can only be achieved by a government with totalitarian powers—which would certainly represent a morally unjustifiable violation of personal liberty—many followers of this school of justice ignore the ways in which markets and firms can create socially unjust or oppressive conditions. Their core ethical belief is that voluntary exchanges between self-maximizing economic actors make society better off. But this cannot be true in any practical sense. We all know that under this model of capitalism there are large numbers of citizens who get left behind. And herein lies a practical problem that cannot be ignored.

Frank Knight, an early Chicago-school economist who championed a classical (pre-1930s) liberal theory of social justice, observed long ago that the ethics of markets is both competitive and adversarial, meaning that the system is designed to create winners and losers. But markets are only sustainable, Knight added, if they reward everyone decently.¹¹² In Knight's words, ". . . economic freedom is freedom to use economic power." But when this power creates losers in a competitive market who cannot effectively exercise their economic freedom, then "competition may undermine freedom." Freedom needs to guarantee that individuals have some degree of satisfaction, and when the distribution of economic power is so unequal that some people cannot afford the simplest necessities, then market capitalism is "fundamentally objectionable."¹¹³ For Knight, economic desperation is as unsustainable on political grounds as it is on socio-ethical grounds—a view shared by many so-called libertarian economists such as Milton Friedman (who studied with Knight at the University of Chicago) who have argued for some sort of government-sponsored safety net as the most efficient way (in contrast to private charity) of alleviating poverty and bringing stability to market capitalism. But the most relevant point for the present discussion is that applying strict freedom theories of justice to the selection of corporate purpose has encouraged the kind of social and moral disengagement and created troublesome social conditions that are left for others to fix. The question for those justifying shareholder value maximization in terms of freedom theories of justice is, quite simply, "Is this the future we want or can survive?" We have seen that an increasing proportion of the body politic thinks not.

Another objection will come from those who argue that unrelenting economic pressures to deliver continual improvements in operating efficiency (whether through automation and reduced employment, outsourcing, or reduced prices from suppliers) make concessions related to reciprocity economically impossible in today's hypercompetitive markets. Doubters will further argue that this economic pressure is currently intensifying in the United States with the increased presence of "active investors" threatening to ouster incumbent management teams that appear inattentive to their firms' competitive cost position and opportunities to maximize profitability. In brief, the argument of these doubters will be that making concessions to reciprocity detracts from competitiveness and profits: Why would General Motors, for example, commit to \$30 per hour labor costs in Columbus, Ohio, when the option of shifting work to Chihuahua, Mexico, could reduce per hour labor costs to \$4? (GM didn't, and it moved the assembly of electrical harnesses to Chihuahua.) Or why would a company facing a deteriorating competitive cost position or obsolete capacity in its domestic operations hesitate to restructure through immediate layoffs? (Nokia didn't hesitate to close its Bochum plant in Germany in 2008.) After all, not doing so invites activist investors and takeover sponsors to do the dirty work for them and asset managers to trim their holdings, thereby depressing share prices and portfolio values for shareholding institutions and individuals. How can the principle of ethical reciprocity be relevant guide to corporate purpose in such a situation?

Staying with the outsourcing and plant obsolescence issue, we would need to concede that in a hypercompetitive world where the bases of product cost and differentiation advantages are shifting from one locale or technology to another, the economic incentives to adopt of ethical reciprocity as a guide to corporate purpose and governance are very weak—except where there are formal bargaining arrangements in place between firms and their employees, as certainly was the case with GM. Today, most companies are in continual conversations and negotiations with their employees, whether they are unionized or not—especially in the tight labor markets that we see today in many industries. In this context, many companies have come to understand that how they deal with their employees in one time period has enormous effects on employee relations, productivity, and policy options in subsequent time periods. This practical consideration has forced public companies like GM and AT&T to experiment with employment philosophies that are perfectly consistent with principles of reciprocal justice—because it makes business sense to do so.¹¹⁴

AT&T executives concluded in 2013 that 100,000 of the company's 240,000 employees were working in jobs that that would no longer be relevant in a decade. Instead of letting these employees go

(and replacing some of them with new talent), AT&T decided to retrain all of them by 2020. Within 18 months of the program's inception, the company's chief strategy officer reported that the company had decreased its product development cycle time by 40% and accelerated its time to revenue by 32%. In 2017, AT&T even made *Fortune's* 100 Best Companies to Work For list for the first time.¹¹⁵ Similar efforts have been pioneered by Nokia (after its disastrous experience in closing its Bochum plant), Michelin, and Honeywell, to mention just a few.

Yet another objection will come from skeptical business executives who will ask, "Do firms intent on pursuing a pluralist, reciprocity-based mode of corporate governance realistically stand a chance of competing against value maximizers?" This is a question that deserves special attention.

V. Can Ethical Reciprocity Survive Under Value-Maximizing Capitalism?

Can firms adopting governance principles rooted in reciprocity and reciprocal justice avoid being destroyed by competitors who choose not to be so ethically or civic minded and are therefore free to reinvest as much of their cash flow as they want into their business rather than making side payments or concessions to various constituencies? Won't shareholder value maximizers who keep their cash flows "intact" and ready to be deployed be able to reinvest financial resources in their business more generously and rapidly than reciprocity practitioners?

The Free-Rider Problem

These risks form the basis of the *free-rider problem*, where, in this instance, value maximizers would be free to take advantage of more resource-constrained competitors choosing to invest in public goods as well as future private gains. But this is not the only economic issue posed by the practice of ethical reciprocity. If a majority of competing firms decide to adopt the principle of ethical reciprocity in their pursuit of corporate purpose, a *single* shareholder value maximizer will not do much damage to the perceived legitimacy of the market (and the single shareholder value maximizer will most likely get away scot-free with minimal social damage). However, if *multiple* free riders (where defectors from ethical reciprocity avoid the cost of compliance with the reciprocity principle) are given "free passes" from reciprocity, practitioners who fail to respond competitively to extreme shareholder value maximizers, then the result could be a major transfer of financial value from the less competitive but responsible firms to the more competitive but less responsible value maximizers. Under these conditions, the value maximizers win, and the reciprocity practitioners and society lose.

This outcome is inevitable unless (a) a culture of reciprocity is somehow able to freeze out the value maximizer by some form of collective action or (b) the firm practicing reciprocity manages to sustain sufficient returns to attract and reinvest resources in the business at a rate comparable to that of the less socially committed free rider. The first condition is likely to take hold only where a culture of reciprocity is able to develop and spread. I will return to this challenge in part VI below. The second, far more accessible, condition can be satisfied only when reciprocity practitioners continue to work for the creation of real long-term economic value while *at the same time* integrating the principles of ethical reciprocity into their business. This dual effort is a core commitment required to successfully rehabilitate corporate purpose and governance.

Nowhere is it written on a tablet that yielding some short-term economic returns to accommodate priorities with little short-term economic benefit for shareholders with short-term investment horizons means abandoning longer-term value creation. The version of corporate purpose accepted by "practical" reciprocity practitioners is that while shareholders may remain a dominant constituency of the public corporation, they are not the only ones possessing legitimate claims of fair exchange and mutuality with the corporation. As enlightened value creators, practical reciprocity practitioners fully recognize the importance of shared value as a critical determinant of long-term firm value, but also understand that the long-term market value of a firm cannot be maximized if important constituencies are either ignored or

mistreated.¹¹⁶ This is the only way to mitigate the risk of being disadvantaged by competitors with greater financial resources at their command and a less plural view of corporate interests and objectives (and perhaps, being taken over buyout sponsors seeing opportunities for squeezing more returns for their investors from companies practicing ethical reciprocity).

Overcoming the Free-Rider Risk

So, more specifically, what does it take to overcome this risk? The answer is that it takes what it has always taken to achieve competitive advantage under conditions of unevenly distributed resources across industry players: an ability to work smarter, faster, harder, and more economically than one's competitors. As long as firms can earn their cost of capital and grow at or above the average growth rate of their competitors, they will be able to retain and attract sufficient capital to reinvest in the competitiveness of the business, while generating a sufficient surplus of satisfactions to a firm's participants to cement their willingness to cooperate in the life of the enterprise. There is of course more to this task (especially where heavily lobbied government regulations, exemptions, and subsidies affect the cost structures and competitiveness of different classes of players, such as in the power generation and financial services industries), but there is nothing in this formula suggesting that shareholders should accept uneconomic returns or cede competitive advantage in the market place. And there is nothing in Larry Fink's warning to the CEOs of potential portfolio companies in BlackRock's investment funds suggesting that concessions should be made to long-term financial performance. What Fink and like-minded asset managers recognize is that as long as the current norms and expectations regarding capital asset valuation and pricing remain a part of the capitalist system and the more a firm seeks to satisfy the interests and utilities of all parties participating in the life of an enterprise, the higher the standards of corporate performance need to be. What Larry Fink and the principle of ethical reciprocity require is for public corporations to up their game on multiple dimensions. Short-term concessions to value maximization are fine, but only if long-term prospects for financial and social sustainability are maintained (and effectively communicated to a firm's relevant publics).

Conceptually, this performance requirement is no different from the standard tasks facing any firm that wants to up its competitive game or maintain its flow of attractive returns, such as ensuring sufficient product or service differentiation to build demand at appealing price levels, and driving costs at each stage of the value-added chain as low as possible to build gross margin and profit growth that is equal to or greater than for all other competitors. As every successful businessperson knows, meeting these requirements involves clear goals, rigorous performance measurement, aligned incentives, and disciplined spending—all aimed at strengthening the drivers of revenue growth and finding new ways of building a competitive cost advantage vis-à-vis competitors. No exploitation of the firm's constituencies is necessarily required—and no rejection of ethical reciprocity is required—where the sources of long-term competitiveness are in place and paid attention to.¹¹⁷

Similarly, meeting the standards of ethical reciprocity is conceptually no different from meeting and exceeding the standards of new environmental regulations set by political authority. For example, since the 1990s, a growing body of literature has questioned the conventional wisdom that environmental regulation inevitably increases costs for regulated businesses and penalizes American industries in the face of fierce global competition. In a paper published in 1995, Michael Porter and Claas van der Linde set out a theory that “properly designed environmental regulation can trigger innovation that may be partially or more than fully offset by the costs of complying with them.”¹¹⁸ What is now known as the “Porter hypothesis” claimed that there are many circumstances in which “innovation offsets” resulting from well-designed environmental regulation (where regulation is flexible, stringent, and conveys minimal uncertainty about how its application will spur firms to innovate) at least partially offset the regulated industry's private costs of compliance. These offsets include the benefits accruing from increased innovation and competitive advantage through corporate improvements in efficiency by firms committed to the challenge of upping their game.

There has been serious testing of the Porter hypothesis since its publication. Most recently in 2015, the Institute for Sustainable Prosperity (SP) conducted a meta-analysis of a body of research covering seven industry studies that included manufacturing, construction, and oil and gas in the United States, Europe, and selected Asian countries.¹¹⁹ The SP study tested three versions of the Porter hypothesis: a “strong” form where regulation induces innovation whose benefits to the firm exceed its costs; a “weak” form where innovation and lower operating costs occur, but where it is unclear whether the innovations are socially beneficial; and a “narrow” form where innovation effects are achieved only under special conditions that do not concern us here. The essential finding of this study was that the weak form of the Porter hypothesis is “largely uncontested,” suggesting that at least innovators responding to mandated environmental regulations need not pay an economic penalty for their compliance efforts.¹²⁰

A 2019 published study by Ioannis Ioannou and George Serafeim helps shift attention from upping one’s game in response to environmental regulation to the performance effects of companies *voluntarily* integrating sustainability practices into their strategy, business models, and organizational processes. These two researchers asked whether such self-initiated moves could be a differentiating move with the potential of creating competitive advantages and superior returns. It was a timely question, since sustainability has now become a central issue for many companies, indicated by the fact 93% of the largest 250 companies in the world issue a corporate sustainability report and 78% of them integrate sustainability information in the audited annual financial reports (according to the audit firm KPMG).

After studying a sample of 3,802 companies across multiple industries for the period 2012–2017, Ioannou and Serafeim found that while companies adopting *common sustainability practices* (or *converging industry practices*) were positively associated with market valuation multiples, those firms adopting differentiated *strategic sustainability practices* (or *leading practices*) were significantly and positively associated with return and capital as well as market valuation multiples. More concretely, upping one’s game and achieving a two-point increase in the researchers’ index of strategic sustainability practices was associated with a 1.1% higher return on capital (where the average sample ROC was 8.3%). In other words, the adoption of strategic sustainability practices was found to be associated with superior financial performance.¹²¹ These findings are consistent with the returns of a large population of Sustainable/ESG Investment funds noted above.

The implications of the Porter hypothesis and the Ioannou and Serafeim study are directly applicable to any contest between value maximizers and reciprocity practitioners. Companies can and do up their game when striving, one way or another, to manage themselves according to the principle of ethical reciprocity. The organizational inertia of committed value maximizers presents an opening for more civic-minded firms (such as sustainability leaders) to steal a march on their less responsive competitors and become beneficiaries in garnering support from both the general public and the financial community. According to Sustainalytics, which tracks the total returns of companies in its Global Sustainability Leaders Index (GSLI) that meet their proprietary standards related to human rights, labor, the environment, and anticorruption, GSLI has outperformed its benchmark (Global Large-midcap Equities) by over 70 basis points from September 2012 through June 2018. What this means is that sustainability leaders in a variety of industry sectors such as Intel, Citigroup, Cisco, Novo Nordisk, Bristol-Myers-Squibb, and Starbucks have consistently received higher market valuations than nonconforming companies.¹²²

Apparently, many institutional investors and asset management firms have taken notice of these results en route to arriving at the same conclusion as Larry Fink at BlackRock—namely, that investing in companies with definitions of corporate purpose broader than singular shareholder value maximization can be a way of minimizing the risks and enhancing the returns of their investments in corporate equities and bonds. The number of institutional investors and asset managers that include environmental, social, and governance (ESG) factors in the investment decision-making process of their more traditional investment fund offerings has been on the rise.¹²³

According to a 2017 survey of US-based institutional investors with more than \$20 billion in assets by Callan LLC, a leading institutional investor consulting firm, 37% currently incorporate ESG issues (defined in a myriad of ways) into investment decision making.¹²⁴ A 2018 survey of 1,731 companies and institutional investors sponsored by HSBC Holdings showed that 58.1% of US institutional investors had an ESG strategy in place. (The percentages were 84%, 82.5%, and 40% for European, Canadian, and Asian investors, respectively.)¹²⁵ What these asset owners believe is that high performance on ESG issues can enhance their portfolio companies' performance by increasing demand for their products and services, reducing price sensitivity, obtaining better resources (including skilled employees), enhancing corporate reputation, and mitigating the likelihood of negative regulatory action.¹²⁶ Some fund managers are actually pressing actively for specific, ESG-related changes in corporate governance.¹²⁷ Although it is still to be determined how much *alpha* (or returns in excess of overall market return or some other benchmark return) has been broadly achieved by the cohort of companies pursuing ESG strategies under the calculating eyes of asset managers, these managers may turn out to be the ones who will add impetus to the embrace and practice of ethical reciprocity along the lines discussed in this essay. In this role, investment fund managers—responding to the interests and concerns of their clients—may also turn out to be the ones who play a decisive role in saving present-day capitalism from its self-destructive tendencies by leading the way in the rehabilitation corporate purpose.

VI. Fostering Change in Corporate Purpose and Governance

Henry Kissinger once noted that “in the world of diplomacy, execution dominates conception.” Making it happen—making *something* happen—is more important than designing the perfect diplomatic outcome. The same can be said for the world of corporate governance. It would great if CEOs and their boards of directors instantaneously saw the benefit of integrating ethical reciprocity into their expressions of corporate purpose and corporate governance practices. But it took decades for shareholder value maximization to become the default purpose of most public corporations, and it will take years for a major course correction by public companies, one that embraces some version of ethical reciprocity as a principled guide to corporate purpose. Shifting management mindsets away from emphasizing domination of markets, competitors, and suppliers in the quest for competitive advantage and above-average returns toward the mutual interests of all constituencies comprising the firm (including those of shareholders, of course) is a huge challenge. The required change is greater than a simple change of mind. It requires a *conversion* to a very different management ideology, and under our current version of market capitalism, it is highly unlikely that public companies will adopt a new conception of institutional purpose unless there are good business reasons for doing so. And even when there are good business reasons to change governance practices, firms will do so according to an assessment of their own idiosyncratic situations.

For distressed firms like General Motors in the 1980s, adopting principles of reciprocity helped the company and its employees regain competitive viability at that point in its history. Similarly, in the cases of bankruptcy, where a form of reciprocity and exchange of quid pro quos is mandated and led by the courts, the business reasons (perpetuating the enterprise) are clear. For less economically troubled enterprises, however, the incentives and pressures to change will need to come from other sources: from the capital market or, more precisely, asset holders and their asset managers who can have enormous influence over the governance of listed firms; from corporate leaders and their boards of directors; and from educators who instruct and train many of our nation's business leaders and influence a larger public through their research and writings.

What Asset Holders and Asset Managers Can Do

Institutions holding large amounts of investible assets (such as insurance companies, public and private pension funds, endowments, banks, and mutual funds) and investment managers investing these assets alongside those of individuals (such as BlackRock, UBS, Vanguard, Fidelity, and many others) comprise the most powerful force in fostering change in the purposes and governance corporate

governance of public corporations. By virtue of their ability to affect the demand and market value of public company securities, large asset holders and asset managers are in a position to wield enormous power over the governance of public companies, if they chose to do so. The percentage of corporate equity owned by institutional investors in 2017 was about 78% of the market value of the US broad-market Russell 3000 index, and 80% of the large-cap S&P 500 index. In Europe, institutions held about 58% of the companies in the S&P Euro index. And for the largest US companies, between 70% and 85% of their equity was held by institutional investors.¹²⁸ If encouraged and unleashed by their beneficiaries, the legitimacy and power of these financial institutions to engage with their portfolio companies over their corporate purposes and governance is incontestable.

As we have seen, the interest in, and demand for, “sustainable investing” by the investing public and clients of large asset owners and asset managers is growing. Correspondingly, the adoption of ESG standards as a cornerstone of investment decision making by asset holders and asset managers is on the rise. So, too, is there an increasing willingness and capability of some asset managers to engage knowledgably with current and potential portfolio companies over their treatment of non-shareholding, corporate participants in ways protect employee health and safety, limit environmental degradation, and more generally ensure public trust in our system of economic governance.

To the extent that the interest of shareholders and beneficiaries of institutional investors continue to push back against the adverse consequences of shareholder value maximization, the role that these financial institutions can play in encouraging reforms in corporate purpose and governance will only increase. And if these institutional investors were to reward reciprocity practitioners through share purchases for their dual achievements—financial performance *and* moral and social engagement—then the market values of *non*-practicing firms would lag those of more inclusive firms (at least in the absence of unpredictable windfalls). In this way, the influence of large institutional investors and asset managers can be determinative.

In addition, adopting suggestions like George Serafeim’s—that large institutional investors with long time horizons and significant common ownership across different companies be legally sanctioned to collaborate in urging publicly listed firms to focus on integrating positive social impact into the core mission and purposes of the organization—would only turbocharge the growing influence of the investment community.¹²⁹ Alternatively, investors and large asset holders could select as their preferred asset managers firms (like Fidelity International) that have perfected rigorous “engagement” protocols with portfolio companies around material ESG matters as a way of both modifying corporate behavior *and* ensuring sustainable profitability for all their fund offerings. Whatever the specific mechanisms of influence, large asset holders and asset managers hold the key to a successful rehabilitation of corporate purpose. This is not a widely recognized or accepted role by institutional investors and investment managers. It needs to be. A few institutional asset holders and asset managers recognize this and have perfected this role as a source of competitive advantage. When acting on behalf of shareholders and their fund investors, they can be highly effects agents of change.

What Corporate Directors Can Do

With tailwinds gathering behind the idea that corporations have some kind of direct obligation for their non-shareholding stakeholders, corporate boards will be increasingly called upon to accelerate the integration of the reciprocal justice principle into expressions of corporate purpose and corporate governance priorities. Three self-reinforcing and facilitating actions are key to making this happen.

Voicing Unequivocal Commitment to Fairness and Reciprocity as Governing Principles. Taking the lead in explaining how the pursuit of fairness and reciprocity in matters of corporate governance is critical in minimizing social injustices linked to single-minded shareholder value maximization and, equally important, ensuring sustainable, corporate profitability for current shareholders is *the* critical task for prospective reciprocity practitioners. This essay may be helpful in laying out the case for firms adopting the principle of reciprocity as a substitute guideline for corporate purpose. This case rests on efficiency

benefits of ethical reciprocity, which flow from the willingness of a firm's participants to cooperate and make commitments that are beneficial to the corporation and themselves; ethical and social benefits, which flow from the increased moral and public-spirited engagement of firms and their top leaders in matters related to the public good; and restored public trust in our capitalist system and a reduction in systemic risks associated with a weakening social contract.

Monitoring Conformance with Espoused Principles of Fairness and Reciprocity. A second, critical task is establishing ways to monitor firms' corporate conformance with their espoused purpose and commitment to the principles of fairness and ethical reciprocity. Here there are several options. A CEO may choose to convene the kind of annual, top management get-togethers that former Johnson & Johnson CEO James Burke used year after year to restate and clarify company core values and principles and discuss the challenges of living up to these principles in everyday business life. Or a company may see fit to empanel special management committees—similar to Morgan Stanley's "franchise committee"—to review all major transactions and relationships with constituencies with the purpose of assessing potential violations of the its espoused values and risks to its reputation in advance of any major transaction or business decision. A board committee could serve a comparable function.

Eliminating Perverse Incentives Blocking Consideration of Ethical Reciprocity. A third critical task is fixing the perverse incentive problem that currently inhibits serious consideration of the mutual economic benefits accruing from the management of the enterprise according to the principles of fairness and ethical reciprocity. The incentive structure for senior executives under the shareholder value maximization regime rivets management attention on the short-term wealth benefits for shareholders and themselves and crowds out many considerations—including ethical reciprocity. Fixing this incentive structure includes such corporate governance reforms as (a) deemphasizing short-term capital productivity metrics as ROI, RONA, and ROCE as a basis for executive bonuses; (b) lengthening the duration of all performance metrics to conform to the time horizon appropriate for judging a business initiative's success or failure, most often closer to five years than the twelve-month calendar; (c) extending the payout of executive bonus awards via pay deferrals, such as four payments spread out over four years; (d) extending the period for unwinding stock-based incentives by mandating holding periods for stock grants and stock options beyond their vesting dates to better match the time horizon required for sustaining a culture of ethical reciprocity and efficient cooperation with a firm's various constituencies; and (e) requiring senior executives to have skin in the game or substantial wealth invested and at risk in their companies, so that holders of stock grants and options are not only directly exposed to the costs of risky outcomes stemming from poor investment decisions, but also to breakdowns in the many reciprocal relationships required to sustain the enterprise. For board members, I suggest the following threshold commitment: \$250,000 to \$500,000 for companies with \$1 billion to \$3 billion in revenues, and \$500,000 to \$1 million for directors of companies with more than \$3 billion in revenues. For executives, this investment should be equivalent to at least one year's salary and bonus.¹³⁰

In short, the perverse financial incentives embedded in the shareholder value maximization paradigm crowd out many forms of moral consideration—including ethical reciprocity. Only corporate boards have the ability to keep this from happening.

What Educators Can Do

A third, important source of influence are the business schools and economic departments of our leading universities. Long before the "takeover" of corporate purpose by financial and organizational economists during the late-1970s and 1980s, most business school faculties were struggling with their students to define the moral responsibilities of business. Since that takeover, that interest has persisted, albeit with very strong intellectual headwinds. At Harvard Business School (where I have been a faculty member for 50 years), the faculty has remained committed to investing in new courses and new teaching materials highlighting the importance of ethical leadership and recognition and balancing of stakeholder interests. Current examples of this long-standing commitment include the well-regarded, *required* MBA

course on Leadership and Corporate Accountability (the first required, full-length ethics course in the School's history, focusing on the complex moral and social responsibilities facing business leaders¹³¹) and a similarly successful *elective* course, Re-Imagining Capitalism (which explores the moral roots of capitalism and the challenges that value maximizing firms face when engaging in such "big problems" of contemporary life as environmental degradation and inequality¹³²). Many other leading business schools have invested heavily in this space as well. For example, at the University of Pennsylvania's Wharton School, all MBA students must take either the Responsibility in Business or Responsibility in Global Management courses, where students explore their personal perceptions of what it means to be a responsible leader. At Stanford University, first-year MBAs are required to take the Ethics in Management course that explores a wide range of ethical issues faced by managers and organizations. Like Harvard and Wharton, Stanford has been confronting issues of corporations' moral responsibilities since before the 1960s.

But to be as effective as possible in confronting the problem of corporate purpose elaborated in this essay, these pedagogical innovations and commitments need to include a formal assessment of the current state of contemporary capitalism as viewed through the normative perspective of justice principles. For such an effort to have impact, faculty members need to acknowledge the possibility of decreasing compatibility between contemporary capitalism and justice and then help frame robust discussions of how best to narrow the breach between them. When this discussion inevitably leads to considerations of constituency conflict and resolution, exhortations to balance shareholder interests against other parties' interests in expressions of corporate purpose are insufficient. In the absence of a specific guiding principle, such as the principle of reciprocal justice and ethical reciprocity, this balance is likely to reflect personal preference, partiality, and improvisation untethered to any guiding principle at all. This essay can be seen as a first defense against this possibility and an effort to suggest an explicit, principled alternative to the dominant shareholder value maximization expression of corporate purpose.

In addition, we need to further explore how the application of moral philosophy principles, and especially those pertaining to ethical reciprocity, can help us better understand the current incompatibility between capitalism and justice. Again, this paper is a first knock on that door. Business schools also could prepare new industry studies and case histories that (a) demonstrate how and under what conditions the adoption of reciprocity principles (and other justice principles) has served important business interests in the past and (b) enable prospective managers and current executives to explore the application of justice principles to matters of corporate strategy and governance today.

One example is the aforementioned Saturn Corporation study. A promising source of more contemporary studies could be the long list of corporations that have adopted (and perfected) the reporting of corporate social responsibility (CSR) performance in double bottom line and triple bottom line constructs. Such firms include IBM, Weyerhaeuser, Johnson Controls, Procter & Gamble, Microsoft, Ecolab, and 3M. A similar list can be drawn from adopters of ESG standards. Another source of informative case histories could be companies with unique ownership structures that allow for more plural definitions of corporate purpose—such as companies controlled by family-derived industrial foundations as in Denmark and other northern European countries (e.g., Novo Nordisk, Ikea, Robert Bosch, Heineken, Bertelsmann) whose charters include a more inclusive set of purposes than simple shareholder value maximization.¹³³ The experiences of large benefit corporations, or B Corps, might also offer some relevant insights, although very few have made a successful conversion from private to public ownership.^g

^g A benefit corporation (B Corp) is a voluntary certification for businesses that attests to higher standards of social and environmental performance, accountability, and transparency. Certified through the nonprofit B Lab, B Corps are united in their goal of redefining success in business in terms beyond shareholder value maximization. Today, there are more than 1,000 certified B Corps from 33 countries and over 60 industries—mostly sole proprietorships and microbusinesses. Notably, there are few B Corps that have survived as public corporations. Patagonia is one. Ben & Jerry's was another, until it sold out to Unilever (with some fairly stringent governance provisions). Etsy is a case of a B Corp that was forced to renounce its governance

Finally, business schools need to think seriously about reintegrating the humanities and humanity into the study of economics and business. As Colin Mayer, a long-time professor at Oxford's Saïd Business School and well-informed advocate of inclusive capitalism, recently reminded an audience at the British Academy, "The importance of markets in the *Wealth of Nations* was balanced by morality in a *Theory of Moral Sentiment*. But that balance has been lost in the subsequent 250 years and ethics has been surpassed by economics."¹³⁴ Redressing this imbalance is a matter of utmost urgency.

structure when it went public. As far I know, Laureate Education, Inc., which converted itself into a B Corporation in 2015, is the only public B Corp to be traded on any stock exchange in the world.

ENDNOTES

¹ There are many reasons for this, the most important of which will be discussed below. See Lynn A. Stout, *The Shareholder Value Myth* (San Francisco: Berrett-Koehler, 2012); Jay B. Barney, “Shareholders, Stakeholders, and Strategic Factor Markets,” in *Performance and Progress: Essays on Capitalism, Business, and Society*, ed. Subramanian Rangan (Oxford: Oxford University Press, 2015); and Colin Mayer, *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It* (Oxford: Oxford University Press, 2013) for recent analyses of shareholder value maximization as corporate purpose.

² A 1995 survey of 50–150 middle managers in France, Germany, Japan, the United Kingdom, and the United States regarding their views about the purpose and policies of their companies found that 71% and 76% of respondents in the United Kingdom and the United States, respectively, saw their companies being run for its shareholders rather than its stakeholders—in contrast to just 22% in France, 17% in Germany, and just 2% in Japan (Masaru Yoshimori, “Whose Company Is It? The Concept of the Corporation in Japan and the West,” *Long Range Planning* 28 [1995]: 33–44).

³ Philip Selznick, *Leadership in Administration* (New York: Harper & Row, 1957), pp. 148 and 167.

⁴ Arnold J. Toynbee, *The Study of History*, (Oxford: Oxford University Press, 1934–1961).

⁵ Gabriel Almond, “Capitalism and Democracy,” *Political Science and Politics* 24, no. 3 (September 1991): 467–474.

⁶ In a winner-take-all society, if you come in second, you get nothing or not very much. In the world of business (as opposed to, say, the world of sports, where games are programmed to yield clear-cut winners and losers), winner-take-all strategies are a bit of a dream because in competitive (oligopolistic) markets, there is rarely a dominant player. But a winner-take-all attitude can and does exist in most capitalist economies, since firm strategies are typically designed to dominate competitors in some way in their search for supernormal returns. In markets for corporate control, where hostile takeovers and competitive LBO battles are the norm (for example, during the 1980s, almost one-quarter of all major US firms were the subject of hostile takeover attempts), competition between firms most resembles the winner-take-all culture of athletics. As I suggest, the social effects of a winner-take-all culture not good: Not only can economic resources be terribly misallocated in striving to win at all costs, but grave inequalities in the distribution of income can result. See Robert H. Frank and Philip J. Cook, *The Winner-Take-All Society: Why the Few at the Top Get So Much More Than the Rest of Us* (New York, The Free Press, 1995) and John Kenneth Galbraith, “The Winner Takes All . . . Sometimes,” *Harvard Business Review*, November–December 1995. See also Jacob S. Hacker and Paul Pierson, *Winner-Take-All Politics: How Washington Made the Rich Richer—and Turned Its Back on the Middle Class* (New York: Simon & Schuster, 2010).

⁷ For an extensive discussion of moral disengagement, see Lisa Shu, Francesca Gino, and Max H. Bazerman, “Dishonest Deed, Clear Conscience: Self-Preservation Through Moral Disengagement and Motivated Forgetting,” *Personality and Social Psychology Bulletin* 31, no.3 (2011): 330–349. Also see Samuel Bowles, *The Moral Economy: Why Good Incentives Are No Substitute for Good Citizens* (New Haven: Yale University Press, 2016), chapter 4.

⁸ Bruce R. Scott, *The Concept of Capitalism* (Berlin/Heidelberg: Springer, 2009), p. 37.

⁹ David Ciepley, “Beyond Public and Private: Toward a Political Theory of the Corporation,” *American Political Science Review* 107, no. 1 (February 2013): 141.

¹⁰ Bruce R. Scott, *Capitalism: Its Origins and Evolution as a System of Governance* (Berlin/Heidelberg: Springer, 2011).

¹¹ *Ibid.*, p. 38 and chapters 3 and 4.

¹² *Ibid.*, pp. 21, 42–43.

¹³ Many companies that once secured financing through public offerings now raise capital through private offerings. Indeed, private offerings in the United States in 2016 raised nearly five times the equity in IPOs, largely in response to increasing listing costs and the expensive, time-consuming reporting requirements that provide little information to investors. See F. William McNabb III and Ronald P. O’Hanley, “The SEC Has Ways to Stop the Slide in Public Offerings,” *Wall Street Journal*, September 13, 2018, p. A19.

¹⁴ René M. Stulz, “The Shrinking Universe of Public Firms: Facts, Causes, and Consequences,” *NBER Reporter* 2018, no. 2, <http://www.nber.org/reporter/2018number2/stulz.html>; and Craig Doidge, G. Andrew Karolyi, René M. Stulz, “The U.S. Listing Gap,” *Journal of Financial Economics* 123, no. 3 (2017): 464–487. See also Lee Brorsen et al., “Looking Behind the Declining Number of Public Companies,” Ernst & Young report posted on Harvard Law School Forum on Corporate Governance and Financial Regulation, May 18, 2017, <https://corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies/>. Although precise calculations are difficult, I am guessing (based on Federal Reserve Economic data) that the earnings of these 4,300 companies account for roughly 10–12% of the nation’s GDP. But considering their supplier base, their large population of employees, and the number of communities in which they reside, their economic, political, social, and environmental impact this sector is far greater, for better or worse, than this ratio suggests.

¹⁵ Milton and Rose Friedman, *Free to Choose* (New York: Harcourt Brace Jovanovich, 1980), pp. 136–137.]

¹⁶ According to Equilar (a leading provider of executive compensation data), nearly two-thirds of total CEO compensation was delivered in the form of stock or options in 2008. Stock and stock options currently comprise over 50 percent of average CEO pay in S&P 500 companies.

¹⁷ Some scholars might reject my approach to assigning purpose to public corporations by relying on “revealed purpose” (as revealed by the firm’s performance measurement and reward system and other governance mechanisms) rather than on “espoused purpose” (as expressed in mission or vision statements unconnected to an explicit scorecard for performance measurement). For example, economist Michael Jensen claims that value maximization is merely “a metric for measuring success in whatever activity or passion the firm chooses to pursue” and definitely not “a vision or a strategy or even a purpose” (Michael C. Jensen, “Value Maximization, Stakeholder Theory, and the Corporate Objective Function,” *Journal of Applied Corporate Finance* 14, no. 1 [Fall 2001]: 16). Yet when value maximization is accepted by firms as the only legitimate way of keeping score and telling an organization’s members how successful they have been in implementing some competitive strategy (as Jensen argues), and when executive compensation is tightly bound to such a metric (for which Jensen has strongly argued), it is difficult in a practical sense to separate institutionalized performance metrics from some wider espoused purpose. As the time-worn aphorism suggests, one gets what one measures, and for this reason it is easy for value maximization to overshadow other possible interpretations of corporate purpose in the conduct of corporate affairs.

¹⁸ Andrew Haldane, “Patience and Finance,” paper delivered at Oxford China Business Forum, Beijing, September 2, 2010, <http://www.bankofengland.co.uk/publications/speeches/2010/speech445.pdf>.

¹⁹ See <http://data.worldbank.org/indicator/CM.MKT.TRNR>. This turnover ratio, in turn, is largely driven by hedge funds, which now account for as much as half of all stock trades and for whom the annual rate of equity turnover reaches as high as 1,200 percent. In addition, so-called “hyperspeed” traders, who can account for as much as 70 percent of daily trading volume in U.S. equities, often only hold stock for only a few seconds. See D. Barton, “Capitalism for the Long Term,” *Harvard Business Review*, March 2011.

²⁰ P. M. Healy, “The Effect of Bonus Schemes on Accounting Decisions,” *Journal of Accounting and Economics* 7 (1985): 85–107 and D. I Bergstresse and T. Philippon, “CEO Incentives and Earnings Management,” *Journal of Financial Economics* 80 (2006): 511–529. For related research, see E. Goldman and S. L. Slezak, “An Equilibrium Model of Incentive Contracts in the Presence of Information Manipulation,” *Journal of Financial Economics* 80 (2006): 603–662; and L. Peng and A. Röell, “Managerial Incentives and Stock Price Manipulation” (Baruch College/City University of New York, 2009). Leading researchers at Harvard Business School who have focused on this problem include William S. Abernathy, Robert H. Hayes, Michael C. Jensen, Robert S. Kaplan, Kenneth A. Merchant, Michael E. Porter, Robert Simons, and William W. George. See, for example, R. H. Hayes and W. J. Abernathy, “Managing Our Way to Economic Decline” *Harvard Business Review* July–August 1980, p. 71; M. E. Porter, “Capital Choices: Changing the Way America Invests in Industry” *Journal of Applied Corporate Finance* 5 (1992): 2; K. A. Merchant and W. A. Van der Stede, *Management Control Systems: Performance Measurement, Evaluation and Incentives* (New York: Financial Times/Prentice-Hall, 2003); W. W. George, “Another View: Can Biotech Survive Icahn?,” <http://www.billgeorge.org/page/nyt-dealbook-another-view-can-biotech-survive-icahn>; and N. P. Reppenning and R. M. Henderson, “Making the Numbers? ‘Short Termism’ and the Puzzle of Only Occasional Disaster,” HBS Working Paper No. 11-033 (2010). Other contemporary studies include those by D. Krehmeyer, M. Orsagh, and K. N. Schacht, “Breaking the Short-Term Cycle,” Business Roundtable Institute for Corporate Ethics, July 24, 2006, http://www.corporate-ethics.org/pdf/Short-termism_Report.pdf; P. David, M. A. Hitt, and J. Gimeno, “The Influence of Activism by Institutional Investors on R&D,” *Academy of Management Journal* 44, no. 1 (2001): 144; and K. Laverty, “Economic Short-Termism: The Debate, the Unresolved Issues, and

the Implications for Management Practice and Research,” *Academy of Management Review* 21, no. 3 (1996): 835–860. For a more recent summary of research and an analysis of short-termism, see D. Marginson and L. McCauley, “Exploring the Debate on Short-Termism: A Theoretical and Empirical Analysis,” *Strategic Management Journal* 28 (2008): 273–292; and L. Dallas, “Short-Termism, the Financial Crisis, and Corporate Governance,” San Diego Legal Studies Paper No. 12-078, *Journal of Corporation Law* 37 (2011): 264, <http://ssrn.com/abstract=2006556>. Finally, see A. Haldane, “Patience and Finance” (presentation at the Oxford China Business Forum, Beijing, September 2, 2010), which explores behavioral drivers of short-termism in the financial markets; available at <http://www.bankofengland.co.uk/publications/speeches/2010/speech445.pdf>.

²¹ Reported by John Authers, “Profits Likely to Stay Buoyant Despite Shift Against Capitalism,” *FT Weekend*, May 12–13, 2018, p.22.

²² Trust of “general population” in U.S. business fell to 48%, https://www.edelman.com/sites/g/files/aatuss191/files/2018-10/2018_Edelman_Trust_Barometer_Global_Report_FEB.pdf

²³ See <https://blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

²⁴ See “Report on U.S. Sustained, Responsible and Impact Investors Trends,” 11th ed. (2016), <http://www.cii.org/files/events/2016/CI%20and%20US%20SIF%20Trends%202016%20presentation.pdf>.

²⁵ For an excellent description of the development of Generation Investment Management and the details of its sustainable investing, see Joseph L. Bower, Herman B. Leonard, and Lynn S. Paine, *Capitalism at Risk: Rethinking the Role of Business* (Boston: Harvard Business Review Press, 2011), pp.140–144.

²⁶ Based on performance data for 10,228 open-end mutual funds, on a risk-adjusted basis, across asset classes, and over time. See Morgan Stanley Institute for Sustainable Investing, *Sustainable Signals: The Individual Investor Perspective*, February 2015.

²⁷ Chester I. Barnard, *The Functions of the Executive* (1938; repr. Cambridge, MA: Harvard University Press, 1964), pp. 92–93, 240. Barnard’s notion of organizational efficiency is the intrafirm equivalent of the view that markets (as opposed to organizations) are sustainable only if they reward everyone decently, an argument eloquently championed by Frank Knight, an early Chicago School economist; see Frank H. Knight, “The Role of Principles in Economics and Politics,” *American Economic Review* 41, no.1 (1951) and “The Ethics of Competition,” *Quarterly Journal of Economic* 37, no. 4 (1923).

²⁸ Shu, Gino, and Bazerman, “Dishonest Deed, Clear Conscience.”

²⁹ Congressional Budget Office, “Trends in the Distribution of Household Income,” November 16, 2017.]

³⁰ Facundo Alvaredo et al., *World Inequality Report 2018*, World Inequality Lab, 2018, <https://wir2018.wid.world/>.

³¹ Michael C. Jensen and Kevin J. Murphy, “CEO Incentives: It’s Not How Much You Pay, But How,” *Harvard Business Review*, May–June 1990. Throughout the 1980s, Jensen and Murphy were the leading proponents of increased CEO pay, claiming that while there might be serious problems in CEO compensation, excessive pay was not the problem. Rather, the problem was that they were paid like bureaucrats, with their compensation unlinked to corporate performance.

³² CEO pay level data from Theo Francis and Joann S. Lublin, “Should Bar Be Lifted on CEO Bonuses?” *Wall Street Journal*, June 2, 2017, p. B3. Pay ratio data from GMI ratings. The 354× has been variously calculated downward by the Economic Policy Institute to 200×, and calculated upward by Lucien Bebchuck and Jess Fried to 500×; see Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2006). Some companies have reported ratios of CEO pay to median employee pay far above this average: such as 4,987/1 for Margaret Georgiadis at Mattel; 2,028/1 for Frank Bisgnamo at First Data; 1,188/1 for Doug McMillan at Walmart; and 651/1 for Jeff Bewkes at Time Warner.

³³ The value-extraction claim is that the large proportion of stock-based pay for senior executives has led them to make resource allocation decisions designed to drive up current stock price and shareholders’ wealth position rather than invest in the kind of innovation required to sustain long-term corporate prosperity for all members of the enterprise. (For a detailed discussion of this claim, see William Lazonick, “The Value-Extracting CEO: How Executive Stock-Based Pay Undermines Investment in Productive Capabilities,” Institute for New Economic Thinking Working Paper Series No. 54, December 3, 2016, <https://ssrn.com/abstract=2993933>.) As one would

expect, most senior executives (and their boards) reject the value-extraction claim, arguing that their stock-based compensation appropriately reflects the value they have created for shareholders.

³⁴ Reported by Paul Kiernan in “Workers Claim a Shrinking Slice of the Pie,” *Wall Street Journal*, February 25, 2019, p. A2.

³⁵ Hedrick Smith, *Who Stole the American Dream?* (New York: Random House, 2012), pp. xvii–xix.

³⁶ For a full discussion, see Malcolm S. Salter, “Lawful but Corrupt: Gaming and the Problem of Institutional Corruption in the Private Sector” Harvard Business School Research Paper No. 11-060, December 4, 2010. <https://ssrn.com/abstract=1726004> or <http://dx.doi.org/10.2139/ssrn.1726004>.

³⁷ What’s more, for executives of S&P 500 companies who were criminally prosecuted between 2001 and 2015, and then resolved their criminal charges through a guilty plea or a deferred or non-prosecution agreement, there is little evidence of a CEO pay cut in the year of legal resolution. In fact, there were many spikes in CEO bonuses in the year of prosecution. See Brandon L. Garrett, Nan Li, and Shivaram Rajgopal, “Do Heads Roll? An Empirical Analysis of CEO Turnover and Pay When the Corporation Is Federally Prosecuted,” Virginia Law and Economics Research Paper No. 2017-11/Columbia Business School Research Paper No. 17-54, May 11, 2017.

³⁸ Joseph Schumpeter, *Capitalism, Socialism and Democracy* (1942; London: George Allen & Unwin, 1976).

³⁹ See Steven J. Davis et al., “Private Equity, Jobs, and Productivity,” *American Economic Review* 104, no. 12 (2014): 3956–3990.

⁴⁰ Donald J. Boudreaux, “Trade Is Not the Real Job Killer,” *New York Times*, March 29, 2018, p. A23.

⁴¹ For a detailed history of the corporation since Roman times, see Colin Mayer, *Prosperity: Better Business Makes the Greater Good* (New York: Oxford University Press, 2018), chapter 3.

⁴² Peter F. Drucker, *The Practice of Management* (New York: Harper and Row, 1955).]

⁴³ Theo Vermaelen, “Maximizing Shareholder value: An Ethical Responsibility,” in Craig Smith and Gilbert Lenssen, *Mainstreaming Corporate Responsibility* (Hoboken, NJ: Wiley, 2009), cited in Mayer, *Prosperity*. op. cit.

⁴⁴ See, for example, H. T. Koplín, “The Profit Maximization Assumption,” *Oxford Economic Papers* 15, no. 2 (July 1963), pp. 130–139.

⁴⁵ See Oliver E. Williamson, “Managerial Discretion and Business Behavior,” *American Economic Review* 53, no. 5 (December 1963): 1032–1057.

⁴⁶ David Wooten, *Power, Pleasure, and Profit* (Cambridge, MA: Belknap Press of Harvard University Press, 2018), pp. 3–5.

⁴⁷ Stephen A. Ross, “The Economic Theory of Agency: The Principal’s Problem,” *American Economic Review* 63, no. 2 (1973): 134–139.

⁴⁸ Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,” *Journal of Financial Economics* 3, no. 4 (1976): 305–360.

⁴⁹ R. H. Coase, “The Nature of the Firm,” *Economica* 4, no. 16 (1937): 386–405.

⁵⁰ Jensen and Meckling, “Theory of the Firm.”

⁵¹ For a detailed legal discussion of the historical role of political authority in the creation of the US corporation (the delineation its various rights and privileges), see Leo E. Strine and Nicholas Walter, “Originalist or Original: The Difficulties of Reconciling *Citizens United* with Corporate Law History,” The Harvard John M. Olin Discussion Paper No. 812, February 13, 2015, <https://ssrn.com/abstract=2564708> or <http://dx.doi.org/10.2139/ssrn.2564708>. (Strine is the Chief Justice of the Delaware Supreme Court, and Walter is an attorney at Wachtell, Lipton, Rosen & Katz.)

⁵² These papers have been collected into Michael C. Jensen, *Foundations of Organizational Strategy* (Cambridge, MA: Harvard University Press, 1998).

⁵³ J. B. Heaton, “Corporate Governance and the Cult of Agency,” July 16, 2018, <https://ssrn.com/abstract=3201934> or <http://dx.doi.org/10.2139/ssrn.3201934>. Heaton’s source on citations was E.

Han Kim, Adair Morse, and Luigi Zingales, "What Has Mattered to Economics Since 1970," *Journal of Economic Perspectives* 20, no. 4 (2006): 189–202.

⁵⁴ Michael C. Jensen (2001), *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms* (Cambridge, MA: Harvard University Press, 2001) and Michael C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function," *Business Ethics Quarterly*, Vol. 12, No. 2 (January 2002).

⁵⁵ Adolph A. Means and G. C. Means, *The Modern Corporation and Private Property* (New York: Harcourt, Brace, and World, 1932).

⁵⁶ E. Merrick Dodd, "For Whom Are Corporate Managers Trustees?" *Harvard Law Review* 45, no. 7 (1932): 1145–1163.

⁵⁷ Jensen and Meckling, "Theory of the Firm."

⁵⁸ I should note that corporate governance in the United Kingdom has repeatedly and recently supported this principle in law and code via the Companies Act (2006), Listing Rules, Takeover Code, and the Stewardship Code. See Barnali Choudhury and Martin Petrin, "Corporate Governance that 'Works for Everyone': Promoting Public Policies Through Corporate Governance Mechanisms," January 2018, p.8, <https://ssrn.com/abstract=3095249>.

⁵⁹ Under new rules, Internal Revenue Code section 162(m) capped the deductibility of executive compensation at \$1 million for non-performance pay, but firms could continue to deduct compensation expenses for executives when and if the board's compensation committee certified that preexisting goals had been met and such performance-based compensation was disclosed to shareholders.

⁶⁰ Some of the most widely read and influential practitioner-oriented articles were published in the *Harvard Business Review*: Michael C. Jensen, "Eclipse of the Public Corporation" *Harvard Business Review*, September–October 1989; Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's Not How Much You Pay, but How," *Harvard Business Review*, May–June 1990; and Michael C. Jensen, "Corporate Budgeting Is Broken—Let's Fix It," *Harvard Business Review*, November 2001.

⁶¹ Selections of these foundation papers were eventually integrated into two books published by the Harvard University Press: Michael C. Jensen, *Foundations of Organizational Strategy* (Cambridge, MA: Harvard University Press, 1998) and *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms* (Cambridge, MA: Harvard University Press, 2001).

⁶² Michael C. Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *Journal of Finance* 48, no. 3 (July 1993): 831–880.

⁶³ Mark Mitchell and J. Harold Mulherin, "The Impact of Industry Shocks on Takeover and Restructuring Activity," *Journal of Financial Economics* 41, no. 2 (June 1996): 193–229.

⁶⁴ Bengt Holmstrom and Steven N. Kaplan, "Corporate Governance and Merger Activity in the U.S.: Making Sense of the 1980s and 1990s," NBER Working Paper No. 8220, April 2001.

⁶⁵ Michael C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function," *Business Ethics Quarterly* 12, no. 2 (April 2002): 235–256.

⁶⁶ For a discussion of this issue, see Barney, "Shareholders, Stakeholders, and Strategic Factor Markets," p. 204.

⁶⁷ Milton Friedman, "The Social Responsibility of Business Is to Increase Profits," *New York Times Magazine*, September 13, 1970.

⁶⁸ Elizabeth Anderson, "The Business Enterprise as an Ethical Agent," in *Performance and Progress*, p. 188.

⁶⁹ *Ibid.*, pp. 191 and 189–190.

⁷⁰ R. E. Freeman, K. Martin, and B. Parmar, "Stakeholder Capitalism," *Journal of Business Ethics* 74, no. 4 (2007): 303–314.

⁷¹ For further discussion of firm-specific investment by other stakeholders, see Margaret M. Blair and Lynn A. Stout, "A Team Production Theory of Corporate Law," *Virginia Law Review* 85, no. 2 (March 1999): 248–328.

⁷² Margaret M. Blair, "Corporate Law and the Team Production Problem" Vanderbilt Law and Economics Research Paper No. 12-12 (April 9, 2012), p. 13, <https://ssrn.com/abstract=2037240>

⁷³ Joseph L. Bower and Lynn S. Paine, “The Error at the Heart of the Corporation,” *Harvard Business Review*, May–June 2017, pp. 50–60.

⁷⁴ See, for example, Blair and Stout, “A Team Production Theory of Corporate Law”; Stout, *The Shareholder Value Myth*; Barney, “Shareholders, Stakeholders, and Strategic Factor Markets”; Freeman, Martin, and Parmar, *op. cit.* and Lynn Paine, *Value Shift: Why Companies Must Merge Social and Financial Imperatives to Achieve Superior Performance* (New York: McGraw-Hill, 2003), among many others.

⁷⁵ *Revlon, v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. (1985)). See also *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010). For a legal review of these two cases see David G. Yosifon, “The Law of Corporate Purpose,” 10 *Business Law Journal* 181 (2013), <http://scholarship.law.berkeley.edu/bblj/vol10/iss2/1>.

⁷⁶ According to Vice Chancellor Travis Laster, “The fiduciary obligation to maximize the value of the corporation for the benefit of its stockholders does not mean that directors must sacrifice greater value that can be achieved over the long term in pursuit of short-term strategies, and it certainly does not mean that directors must attempt to maximize the public company’s stock price on a daily or quarterly basis. The fiduciary relationship requires that directors act prudently, loyally, and in good faith to maximize the corporation’s value over the long-term for its stockholders’ benefit.” 18 *Virtus Capital L.P. v. Eastman Chem. Co.*, Civ. A. No. 9808-VCL, 2015 WL 580553, at *16 n.5 (Del. Ch. Feb. 11, 2015). See discussion of this directive in Heaton, “Corporate Governance and the Cult of Agency.”

⁷⁷ *Burwell v. Hobby Lobby Stores, Inc.*, 2014 WL 2921709 - Supreme Court 2014. Also see Stout, *The Shareholder Value Myth*; and Karthik Ramanna, “Thin Political Markets: The Soft Underbelly of Capitalism,” *California Management Review* 57, no. 2 (Winter 2015): 5–19.

⁷⁸ Michael J. Sandel, *Justice: What’s the Right Thing to Do?* (New York: Farrar, Straus and Giroux, 2009).

⁷⁹ Danielle S. Allen, *Talking to Strangers: Anxieties of Citizenship Since Brown v. Board of Education* (Chicago: University of Chicago Press, 2004), p. 131.

⁸⁰ Josef Soudek, “Aristotle’s Theory of Exchange: An Inquiry into the Origin of Economic Analysis,” *Proceedings of the American Philosophical Society* 96, no. 1 (February, 1952): 45–75. Soudek’s analysis of Aristotle’s theory of exchange and relevance of reciprocal justice principles is the most complete and authoritative one that I came across in my research. Soudek was trained as an economist and was a widely respected student of Aristotle’s contribution to economic thought.

⁸¹ *Ibid.*, p. 45.

⁸² *Ibid.*

⁸³ *Ibid.*, p. 47.

⁸⁴ Joseph Heath, *Morality, Competition, and the Firm* (Oxford: Oxford University Press, 2014), chapter 7, 173 ff.

⁸⁵ Soudek, “Aristotle’s Theory of Exchange,” p. 64.

⁸⁶ See <https://www.mars.com/global/about-us/five-principles/mutuality>.

⁸⁷ John Rawls, *Political Liberalism* (1993; New York: Columbia University Press, 2005), p. xlii.

⁸⁸ John Rawls, “Justice as Fairness: Political not Metaphysical,” *Philosophy and Public Affairs* 14, no. 3 (Summer 1985): 223–251.

⁸⁹ The most famous affirmative response to this question was by Albert Z. Carr in “Is Business Bluffing Ethical?” *Harvard Business Review*, January 1968. To make his point, Carr quotes an executive who had “given a good deal of thought to this question.” According to this person, “If the law as written gives a man a wide-open chance to make a killing, he’d be a fool not to take advantage of it. If he doesn’t someone else will. There is no obligation on him to stop and consider who is going to get hurt. If the law says he can do it, that’s all the justification he needs” (p. 146). While Carr himself believes such behavior to be unethical, he argues that one’s personal morality does not apply to business—a view that places the world of business in a moral domain completely separate from that of human beings who make decision to deceive others. Most business ethicists today would reject such an argument, along with inappropriate references to chess and poker. Nevertheless, the practice endures.

⁹⁰ This is clearly explained by Allen, *Talking to Strangers*, pp. 131–132. I should point out that the theory of reciprocal justice elucidated here is quite different from social exchange theory pioneered by George C. Homans in

the 1950s, which claims that the relationships we choose to pursue are the ones that maximize our rewards and minimize our costs. See “Social Behavior as Exchange,” *American Journal of Sociology* 63 (1958): 597–606. This theory assumes that we are all self-serving, cost-benefit rationalists—and not concerned with equality in either the here-and-now or over time. Homans’s social theory exchange has influenced research and thinking about business-to-business exchanges, much of it concluding that firms evaluate the economic outcomes of each transaction in terms of what they feel they deserve rather than according to some standard of justice. In this sense, social exchange theory is consistent with economists’ assumptions about “economic man” and individual self-interest as the primary driver of all economic activity.

⁹¹ Robert Gibbons and Rebecca Henderson, “Relational Contracts and Organizational Capabilities,” *Organization Science* 23 (2012): 1350–1364.

⁹² Ibid.

⁹³ Paul Collier, *The Future of Capitalism* (New York: Harper-Collins, 2018), p. 11.

⁹⁴ Ibid.

⁹⁵ Allen, *Talking to Strangers*, chapters 3 and 4.

⁹⁶ Ramanna, “Thin Political Markets.”

⁹⁷ Ibid.

⁹⁸ Elizabeth Doty and Maryam Kouchaki, “Commitments, Disrupted: Understanding and Addressing Commitment Drift in For-Profit Enterprises,” Edmond J. Safra Working Papers, No. 64, May 21, 2015, p. 12. Available at <https://ssrn.com/abstract=2608931> or <http://dx.doi.org/10.2139/ssrn.26093>.

⁹⁹ Donald N. Sull and Charles Spinosa, “Promise-Based Management: The Essence of Execution,” *Harvard Business Review* April 2007, pp. 78–86.

¹⁰⁰ Barnard, *The Functions of the Executive*

¹⁰¹ Ibid., pp. 240–244.

¹⁰² William James, cited in Collier, *The Future of Capitalism*, p. 29.

¹⁰³ Mayer, *Prosperity*, p.82.

¹⁰⁴ Heath, *Morality, Competition, and the Firm*, p. 10.

¹⁰⁵ Ibid., pp. 234–243.

¹⁰⁶ According to a recent (2016) J.P. Morgan report, “A Quantitative Perspective of How ESG Can Enhance Your Portfolio,” ESG investing has grown to include about 350 equity funds with a combined AUM (assets under management) of \$111 billion. According to the report, “It may still take much convincing before ESG factors are considered as standalone alpha sources. (*Alpha* refers to returns in excess of overall market return or some other benchmark return.) Full report available at <https://yoursri.com/media-new/download/jpm-esg-how-esg-can-enhance-your-portfolio.pdf>.

¹⁰⁷ See, for example, Mozaffar N. Khan, George Serafeim, and Aaron Yoon, “Corporate Sustainability: First Evidence on Materiality,” Harvard Business School Working Paper No. 15-073, March 2015. Bank of America Merrill Lynch, “ESG: Good Companies Can Make Good Stocks,” <https://paxworld.com/esg-good-companies-can-make-good-stocks>.

¹⁰⁸ See Kirsten S. Wever, Rosemary Batt, and Saul Rubinstein, “Innovation in Isolation: Labor-Management Partnerships in the United States” (Ithaca, NY: Cornell University ILR School, 1996), <http://digitalcommons.ilr.cornell.edu/articles>.

¹⁰⁹ See Malcolm S. Salter and John T. Dunlop, *Industrial Governance and Corporate Performance*, HBS Note 9-390-032 (Boston: Harvard Business School Publishing, 1990).

¹¹⁰ Allen, *Talking to Strangers*, p. 11.

¹¹¹ Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962, 1982), p. 15.

¹¹² See Frank H. Knight, “The Role of Principles in Economics and Politics,” *American Economic Review* 41, no.1 (1951) and “The Ethics of Competition,” *Quarterly Journal of Economics* 37, no.4 (1923).

¹¹³ Knight, “The Ethics of Competition.”

¹¹⁴ Sandra J. Sucher and Shalene Gupta, “Layoffs That Don’t Break Your Company,” *Harvard Business Review*, May–June 2018.

¹¹⁵ John Donovan and Cathy Benko, “AT&T’s Talent Overhaul,” *Harvard Business Review*, October 2016.

¹¹⁶ Practical reciprocity practitioners also understand that all participants in an enterprise who make essential contributions or investments in the enterprise need not receive equal compensation for their participation. Rather, according to the standard theories of organizations, they need to receive returns that represent at least a modest premium over their opportunity costs so as to provide sufficient incentive to remain engaged with the coalition or team comprising the corporate enterprise. See Barnard, *The Functions of the Executive*, p. 58 and Blair and Stout, “A Team Production Theory of Corporate Law,” p. 282. Of course, this is as true for the suppliers of capital as it is for other contributing parties, except in the case of equity capital modest premiums over the opportunity costs of other investments is, as a practical matter, rarely sufficient.

¹¹⁷ This is not to equate *upping one’s game* with the Porter-Kramer concept of *shared value creation*, which is rooted in the belief that corporations can meet social needs within a shareholder value maximization regime by simply improving on their competitive advantages through better serving existing markets or lowering costs or improving product quality through innovation (Michael E. Porter and Mark R. Kramer, “Creating Shared Value,” *Harvard Business Review*, January–February 2011, pp. 62–77.) Economic value can certainly be shared after it has been created if approved by shareholders, and concessions to shareholder value can be avoided by highly competitive firms harvesting supernormal returns. But this is very different process than that of practicing ethical reciprocity, which recognizes (a) that the interests of a firm’s constituencies are not always mutual and, indeed, rarely presented as such and (b) that these different interests can be reconciled only by value exchanges honoring the reserve price of continued participation in the life of the firm from the very moments that corporate purpose and strategy are developed and publicly espoused. The practice of ethical reciprocity is a front-end bargain with constituencies; shared value creation is an after-the-fact distribution of benefits at the discretion of shareholders and their agents.

¹¹⁸ Michael Porter and Claas van der Linde, “Toward a New Conception of the Environment-Competitiveness Relationship,” *Journal of Economic Perspectives* 9, no. 4 (Autumn 1995): 97–118.

¹¹⁹ Sustainable Policy Institute, “Environmental Regulation and Innovation: Select Case Study Evidence of the Porter Hypothesis,” policy brief, November 2015, https://institute.smartprosperity.ca/sites/default/files/publications/files/Porter_1.pdf

¹²⁰ The SP study is generally consistent with the findings of more controversial and less granular research by Jim Collins and Jerry I. Porras (*Built to Last: Successful Habits of Visionary Companies* [New York: HarperBusiness, 2002]), which argued on the basis of a study of sample of paired companies (such as Merck and Pfizer, HP and Texas Instruments, Procter & Gamble and Colgate, Marriot and Howard Johnson) drawn from a list of *Fortune* 500 industrial companies, *Fortune* 500 service companies, *Inc.* 500 private companies, and *Inc.* 100 public companies that companies that put more emphasis on profit in their statements of corporate purpose were the less profitable in their financial statements. This book, once celebrated as one of the most influential business books of our era, has been criticized in recent years as a “delusion” rooted in the illusion of rigor embodied by data-based research that can neither convey cause and effect or predict outcomes any better than pure chance. The statement and tests of the Porter hypothesis have been more circumspect and contingent.

¹²¹ Ioannis Ioannou and George Serafeim, “Corporate Sustainability: A Strategy?” Harvard Business School Accounting & Management Unit Working Paper No. 19-065, January 1, 2019, <https://ssrn.com/abstract=3312191>.

¹²² Sustainalytics, Global Sustainability Leaders Index at <https://www.sustainalytics.com/global-sustainability-leaders-index/>.

¹²³ Environmental issues include climate change, carbon emissions, water stress, renewable energy, and green building, just to name a few. Social issues typically include such matters as community engagement, human rights, labor standards, product liability, and stakeholder opposition. Governance issues include board structure and processes, executive pay, accounting, corruption, business ethics, and so on.

¹²⁴ See Callan 2017 ESG Survey, <https://www.callan.com/wp-content/uploads/2017/11/Callan-2017-ESG-Survey.pdf>.

¹²⁵ Paulina Pielichata, “Two-Thirds of Institutional Investors Utilize ESG Policy—Report,” *Pension & Investments*, September 12, 2018, <https://www.pionline.com/article/20180912/ONLINE/180919934/two-thirds-of-institutional-investors-utilize-esg-policy-8211-report>.

¹²⁶ Khan, Serafeim, and Yoon, “Corporate Sustainability.” See also R. Eccles, I. Ioannou, and G. Serafeim, “The Impact of Corporate Sustainability on Organizational Processes and Performance,” *Management Science* 60, no. 11(2014): 2835–2857.

¹²⁷ See Ned Salter, “Why Engagement Is the ESG ‘X Factor’?” Reprinted in *Investor Daily*, July 3, 2018, <https://www.investordaily.com.au/analysis/43231-engagement-the-esg-x-factor>. Ned Salter is the head of research for Europe at Fidelity International.

¹²⁸ Charles McGrath, “80% of Equity Market Cap Held by Institutions,” *Pensions & Investments*, April 25, 2017, <http://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions>.

¹²⁹ George Serafeim, “Investors as Stewards of the Commons?” *Journal of Applied Corporate Finance* 30, no. 2 (2018): 8–17.

¹³⁰ Another approach for directors might be a rule of thumb that directors’ ownership stakes should be at least roughly equal to their level of compensation—at the higher level I have suggested. For comparison, boards are requiring a growing number of senior executives to hold several times their salaries in company stock. As just one example, in 2005 the General Motors board required CEO Richard Wagoner to hold seven times his 2004 salary of \$2.2 million in GM stock. To ensure a supply of independent directors and encourage their purchase of meaningful equity stakes, public companies could facilitate borrowing for this purpose. Leveraged ownership of company shares could also help minimize the potential adverse effects of simply expanding costless equity grants to directors. One such impact is directors’ inclination to focus (perhaps subconsciously) on remaining on the board and enjoying the stream of risk-free compensation, rather than on the difficult task of overseeing the drivers of long-term revenue and profit growth.

¹³¹ Based largely on the work of Thomas Piper, Joseph Badaracco, and Lynn Paine.

¹³² Pioneered by Rebecca Henderson.

¹³³ Several writers and scholars have already laid the foundations for such an exploration. See, for example, and Mayer, *Firm Commitment*, for a deep discussion of the darker sides of shareholder-controlled corporations stemming from the ways they are owned and governed; Marjorie Kelly, *Owning Our Future: The Emerging Ownership Revolution* (San Francisco: Berrett-Koehler, 2012), for an exploration of a variety of experiments with new forms of ownership and what appears to make these new ownership models work; and a paper discussing the impact of corporate ownership forms on building sustainable and responsible businesses written by Belén Villalonga, “The Impact of Ownership on Building Sustainable and Responsible Businesses,” *Journal of the British Academy* 6, supplementary issue 1 (December 2018): 375–403.

¹³⁴ Colin Mayer, “Reinventing the Corporation,” Sir John Cass’s Foundation Lecture at the British Academy, March 3, 2015, Mayer_Reinventing_the_Corporation-Revised_2015.pdf.