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The Purpose of the Firm

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Introduction

Thank you Darrell. I appreciate the opportunity to share my thoughts on this important topic.

Purpose of the firm. It is so basic, and sounds so simple. Yet, I believe that the lack of attention to this topic is one of the fundamental causes of the problems society is having with business today. It is one of the leading contributors to why business is at or near the bottom of the 'trust' scale.

How we address this topic is fundamental to the kind of political and economic system on which our society is based, and the values by which we choose to bind us together. An open question is whether we can pull ourselves out of our self-absorbed, myopic tailspin long enough to realize that we all have a permanent interest in preserving the system that gives us the freedoms we now take for granted.

We need to remember history, and reread a page from 19th century England. The 'Tragedy of the Commons' occurred when individual farmers were permitted to graze their animals on the common lands. But, there were no regulations to protect the land from overuse. Certain individuals profited by turning out more animals onto the common land, but what resulted was overgrazing to the extent it eventually rendered the commons useless for the community. The pursuit of unchecked individual self-interest destroyed the system.

Today, corporate purpose is being held hostage by the myth of shareholder primacy. As a society, we must decide whether we are to embrace a *property*, or solely economic view of the corporation, or a *citizenship* view. If we choose the former view – that the purpose of the corporation is for its shareholders – we are on a path to replay the 'Tragedy of the Commons' and we all will lose. It becomes our own 'Faustian' bargain where we sacrifice our societal 'soul' for short-term, yet unsustainable gratification of the few. In the long run, we destroy our own motivations, beliefs and trust in each other and in our institutions.

If we embrace the latter view – the citizenship view – we can regain the path where business is a trusted and responsible member of society delivering for all its constituents, including its shareholders.

In the next few minutes, I will look at corporate purpose from four angles: a legal perspective, good business practice, human motivation, and societal requirements. I will then summarize around why this topic of corporate purpose is so important – why I see it as the forgotten brick in the foundation of good capitalism.

Legal Perspective

Why do companies exist? For whom do they exist?

I am keen to hear Lynn Stout's thoughts, as she is one of the foremost and most thoughtful thinkers on this topic in academic legal circles. So let me begin by quoting Lynn, the Paul Hastings Distinguished Professor of Corporate and Security Law at UCLA. She has written that:

"United States corporate law does not, and never has, required directors of public corporations to maximize shareholder wealth. To the contrary, as long as boards do not use their powers to enrich themselves, the law gives them a wide range of discretion to run public corporations with other goals in mind, including growing the firm, creating quality products, protecting employees, and serving the public interest. Chasing shareholder value is a managerial choice – not a legal requirement."

The corporate charter is granted by society, and grants limited liability protection to the managers and owners of the corporation. The expectation is that in return for liability protection and other rights, the corporation will make a positive contribution to society. As clearly stated by Edwin Gay, the founding Dean of the Harvard Business School, the role of the company is to do well for itself by doing well for society... to do *'both well and good'*, and for business leaders to *'make a decent profit, decently'*.

Today, the question of corporate purpose plays out in the legal context in the debate between shareholder and multi-stakeholder primacy. There are many who will vehemently argue that the driving – even sole – purpose of the corporation is to maximize profit for its shareholders. But let's be clear on this point: It was Milton Friedman – not corporate law – who wrote more than 40 years ago in *'The Social Responsibility of Business is to Increase its Profits'* that the sole purpose of the corporation is to maximize profit for its shareholders.

The cases cited by supporters of the shareholder primacy theory include the ninety year old *Dodge v. Ford*, and the more recent *eBay v. craigslist*. Yet, if you read these cases, they actually don't make the point shareholder primacists want. Yes, a corporation should make a profit for its shareholders, but the courts recognize and respect the business judgment of directors. This 'business judgment' standard opens the door for more balanced and reasoned considerations and actions. Practically speaking, in our litigious society today it may be your safest of safe harbors to act to maximize profit for shareholders, but it is not your legal obligation.

The debate will continue, and I expect some of these points will be addressed by the panelists that follow. But, allow me to be so presumptuous as to say that it really doesn't matter how it lands. Although certainly important from a legal perspective, it is less so from the standpoint of how one responsibly operates a business.

Good Business

The reason I believe the legality of shareholder primacy isn't the argument we should be having is because, over time, these two perspectives converge. Stated another way, I would argue that pursuing a multi-stakeholder approach to running a business will, in fact, deliver the best returns to shareholders.... *over time*.

The issue, of course, is time. This notion of time, and over 'what time' merits far more attention than it has received, and I believe is at the root of the problems – both real and perceived – that business faces today.

I will be the first to note that delivering the best results to shareholders over time means that it may not deliver the maximum return to current shareholders next quarter. But this point takes us to the question of what constitutes good and responsible business.

What are the metrics of 'good business'? Wall Street focuses on financial output metrics: profit; profit this quarter v. last quarter; profit this quarter v. same quarter last year; revenue growth; margins. Again, I won't argue that these metrics aren't important, but I will strenuously point out that these results are just that: results of doing other things very well. There is no business from which to derive a profit without customers. To deliver for shareholders, every company first should ensure that the business continues to offer something that somebody wants to buy, and then focus on delivering for customers. It is the focus on customers and on the inputs that drive performance that are more aligned with corporate purpose.

The link between a clear purpose and vision, and desirable operating results, is strategy.

Today, I serve as CEO of TASC. We are re-establishing ourselves as an independent company having existed for the last two decades as a division of a number of different companies, most recently Northrop Grumman. As a government contractor, we are taking these steps in a market environment that is facing gale-force head winds in the form of potentially trillion dollar budget reductions over the next decade. We have established our purpose and vision, and set a strategic intent that establishes TASC as the pre-eminent company at what we do: high level enterprise and systems engineering, mission architecture and design in the national security and public safety markets. Our purpose is to 'strengthen the security, safety, and basic values of society'; our vision is to be viewed as the most trusted, responsive and valuable long-term partner of our customers, particularly during these difficult times. Our strategy requires time to play out. It is a strategy designed to build sustainable long-term value for our constituents, beginning with serving our customers best. The performance metrics that matter to us are not the typical Wall Street trailing financial output indicators. Instead, they are the metrics that reflect industry thought leadership, high customer satisfaction, low employee turnover, increasing market share and traction in changing our business model to delivering more solutions-based offerings rather than cost-based services. These are the metrics that will tell us if we are making progress in achieving our longer-term goal of building the leading company in our industry.

I have two great advantages in running TASC. First, we are a private company; and second, I have a thoughtful and engaged board of directors. The first should not matter; the second is critical.

In today's business environment, there is a great advantage to being private. I have the time and space necessary to do what is right for the company. Public companies don't often enjoy such time and space. It would be easy to say that a private company, backed by sophisticated private equity, can take this long view, and that a public company cannot, but, having served as a CEO of both private and public companies, I reject that point of view. The key to the solution to this problem of excessive short-termism, and everyone pointing a finger at everyone else, is having a thoughtful and engaged board of directors.

A lot has been written, discussed and debated over the last decade as to the role of the board in business today. Many boards have fallen into the trap of believing their primary role is one of ensuring compliance. This role, while necessary, is insufficient. Boards must spend more time looking forward, not backward; they must spend more time on matters of strategy and direction. By doing so, they open up both time and space for responsible decision-making.

The role of the Board is to ensure that purpose, vision and core values are in place, and then to give the CEO and executive team the time and space to act responsibly. Boards must understand and support company strategies, confirm the metrics that will indicate both success and progress, and hold the CEOs accountable for performance. Boards also must help CEOs counter the short-term pressures of the market, and ensure that companies do not make short-term accommodating decisions that are not in its long-term interest as responsible contributors to society. To date, boards have become too compliance-oriented, are insufficiently grounded in company purpose, vision and strategy, and are too quick to buckle to the short-term market pressures, thereby denying CEOs and executive teams the time and space necessary to run the company in a responsible fashion. Said another way, boards of directors must step up to the whole job, not just the easy part.

The role of the CEO is to ensure that appropriate strategies are in place and aligned with the purpose and vision, and then to execute, balancing all the conflicts, tradeoffs and constituent needs in all time frames in a fair and appropriate way. Unfortunately, many CEOs do not show the necessary leadership, and instead have been co-opted by the short-term market forces and interests of its financial investors.

In the end, one cannot escape the need for judgment... at some point, orienting around long term value creation needs to show itself by delivering near-term benefits, and boards must have the wisdom to know when to hold the CEO who explains away poor short-term performance with claims of building for the long-term accountable for what is, in fact, inadequate performance. This is why progress metrics agreed to by the board and CEO, are so important. To use a baseball analogy, the CEO as batter shouldn't be benched for taking the first strike; the CEO shouldn't be benched for striking out from time to time. But, over time, the CEO needs to show she or he can bat, and deliver for the team. In this analogy, the board is the manager, and needs to know when and how to make the call. The crowd – or Wall Street – will react with every pitch and voice their collective opinion... but in the end, within any at-bat or game, its not their call.

Human Motivation

Let me now turn to the human side.

Have you ever considered how much time, money and focus is spent on improving corporate productivity by focusing on inventory management, supply chain streamlining, throughput and production analysis, quality programs and such....? What surprises me is not that these topics are the focus of business experts and consultants, but that there is so relatively little attention paid to the topic of human engagement, and improving human productivity.

What does it take to motivate human beings?

If you are the sole proprietor of a business, do you think that you can motivate your employees for maximum performance by encouraging them simply to make more money for you? That is

effectively what an enterprise is saying when it states that its purpose is to maximize profit for its investors.

Let me give three examples to illustrate the point...

First, think about leading a community-based volunteer organization. You don't have money, you don't have employment contracts and often you don't have titles, but you still need everyone to contribute. Further, in our day and age, no one has time for anything, and everyone can walk away. What holds people together is the fact that they are managed and led with respect, have a clear goal, and most fundamentally, a compelling purpose in which they believe. On this point, I think Aristotle was right when he said that the human being is, by nature, a social animal, and is most fulfilled by engaging with others. There are great leadership lessons for business in the realization of this simple point.

Early in my career, I joined a company called Space Industries where I had the good fortune to work with some of the leaders of the nascent U.S. space program – the people to whom President Kennedy turned to put a man on the moon: Bob Gilruth, Max Faget and Chris Kraft, to name a few. I was struck by how these accomplished people would speak about the Apollo program – how it represented the most satisfying time of their lives. The reason: they were contributing to something that mattered; they were part of a grand adventure that was bigger than any one of them; they had a sense of contribution, responsibility and purpose that went well beyond their paycheck. Something at the most human level was being addressed.

I expanded on these lessons in building Veridian, and I bring the same approach to TASC. It is clear for me that a meaningful purpose matters deeply. It is the key to unlocking employee commitment, building a positive operating culture, enhancing productivity, and ultimately, delivering exceptional performance. Most important, a clear purpose provides the foundation for institutional values. When your business depends upon attracting and retaining outstanding people, offering an environment where people are able to commit to a higher purpose than simply their job, and aligning institutional with personal values in such a way that neither is compromised – it's what the Apollo program did for those who worked on it in the 1960s. It addresses a basic human need. Frankly, it amazes me that more corporations today don't understand these connections, nor see the benefits.

It may be helpful here to distinguish between the *purpose* of the firm and the *nature* of the firm. Those who think the purpose of the firm is to maximize shareholder value also typically think the nature of the firm is as an economic entity in which people are rational, economically self-interested actors. The purpose-driven, multi-stakeholder perspective that I embrace views people as social animals, and views the firm as fundamentally a *social* institution as well as an *economic* institution. In these firms, the foundation of the firm is meaning, identity and trust, rather than simply economic self-interest. By creating a meaningful purpose, engaging employees, and attending in a reliable and responsible way to the relationships with all stakeholders, corporate leaders can unleash higher levels of personal energy and establish relationships of trust, which can enable their enterprises to outperform other firms over time. As work becomes more knowledge-based, and as corporations must build the capacity to collaborate across more complex boundaries, understanding the firm as a social institution becomes ever more important. This line of thinking reflects the research of TruePoint, as outlined in its recent book, *'Higher Ambition – How Great Leaders Create Economic and Social Value.'*

My point is this: Together, purpose and values give you something to stand for in your life. Without knowing what you stand for, you are like a ship without a navigation system. You will have no basis for your own ethical grounding, and therefore no basis for ethical decision-making. Institutions are no different..... Clarity of purpose and strong institutional values means you have the 'ends and means' covered, and you have created the context and foundation for a strong business that acts ethically, is a morally responsible member of society and delivers for its constituents... all its constituents.

Let me now look at the purpose of business from a societal perspective.....

Societal View

As a society, we must ask: What do we want from business? This question takes us back to the original compact that established the corporate charter.

We can answer this question. We want business to be a positive contributor to society, now and in the future, in a fair and responsible way. We want to trust business, and believe that there is some form of moral compass to enable it to 'do well and do good', as an ethical member of society.

There is an obvious and magnificent virtuous cycle: business is granted a charter, given protection from liabilities in order to encourage it to take risks, offer employment, develop and distribute new offerings, and contribute to an improved quality of life and standard of living in society, for all its members.

Today, this cycle is straining not to collapse.

In fact, the cycle is now taking a negative turn: business acts in the short-term interests of its financial investors, leading to what the public considers outrageous short-term decisions that favor the few over the many. We are selling our Faustian 'soul.' The public reacts, laws are passed, and the constraints on business increase. It now becomes harder for businesses to make decisions and deliver the good of business. The system has raced to its lowest common denominator point, with society obliged to set constraints for all in order to address the short-sightedness of the few. It becomes harder to do good business because trust has been lost.

We are seeing our modern day version of the 'Tragedy of the Commons' play out. Each party is acting in accordance with its own short-term self-interest, and no one is taking responsibility for the Commons. The collapse of time to the short-term is destroying the system. As the Honorable Leo Strine, Chancellor of the Delaware Courts has noted, *"we don't have time to relearn the lessons of the 19th Century!"*

Final Comments

What I have tried to do in these few minutes is to underscore the following rather straightforward points:

- First, we cannot forget the basic 'quid-pro-quo' relationship between business and society; that business exists to deliver value to society, and is granted certain rights and protections in order to do so. So ingrained is the notion of shareholder primacy that we have forgotten

that business was never intended to be solely for the purpose of enriching its financial shareholders.

- Second, from the perspective of basic human needs, purpose helps give one's life and work meaning. Having purpose addresses the basic human desire to be part of something important, something greater than oneself. Combined with strong values, purpose enables corporations to stand for something, thereby providing a foundation for ethical decision making and moral behavior.
- Third, an understanding of purpose introduces time as a variable in decision making. Over time, the goals of delivering a fair return to shareholders and delivering to the expectations of other constituents converge. The objection today is that business is acting in the short-term, for the benefit of one constituency, at the expense of the interests of others. A clearer focus on time as a variable provides a way to push back against the pressures of short-termism
- Finally, a greater emphasis on purpose creates the space for responsible leadership. Boards and CEOs have a shared responsibility to establish a clear vision and strategy for a company, and then to develop the metrics that will indicate whether the company is making progress. These metrics will be different from standard Wall Street trailing financial metrics; they will be based on a nuanced understanding of the business goals that boards must have. Since no vision can be achieved in a quarter, this kind of board engagement around strategy – not compliance – creates the space that allows a CEO to make the necessary and constant tradeoffs amongst constituents and across time to run the business responsibly. The board must hold the CEO accountable, but it also must push back on the near-term market pressures and give the CEO space to do his or her job well.

I am struck by how often the way forward to meet these difficult, messy challenges comes down to leadership. We might agree that one of the fundamental causes of the problems we face today around lack of business trust is self-interest being defined in the short-term, and actors making decisions that generate short-term returns for the financial constituent at the expense of the longer term benefit for all. The pressures for this short-term behavior are real and many, and in many ways simply reflect the current instant gratification values American society seems to have embraced today. In the end, however, absent laws that force changed behavior – laws that more often than not seem to lead to a new set of negative unintended consequences – we must look to stronger leadership in the executive offices of business, and from the boards of directors of companies.

Society needs business at the table contributing as part of the solution to the problems and challenges facing all of us – not just sitting in the corner counting its money. With some notable exceptions, the voice and presence of the business leader over the last decade have been strikingly absent. Business leaders need to step forth and be more actively engaged in finding the shared middle ground that we must find if we, together, are going to protect the Commons.

Understanding and recommitting to a shared understanding of the purpose of the corporation is a place to start.

Thank you.

