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Client Alert

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Corporate Governance Update: BlackRock's Sense of Purpose

On January 16, 2018, BlackRock CEO Larry Fink released his annual letter to CEOs.[1] Mr. Fink traditionally has used this letter to advocate for the governance practices he and BlackRock believe will maximize the long-term value of their clients' investments. In addition to discussing the key governance issues on which BlackRock will focus its attention in 2018, however, Mr. Fink's most recent letter argues that companies must "serve a social purpose" and show how they make a "positive contribution to society." This is a significant change from the traditional, shareholder-centric view of corporate purposes, but BlackRock, as the world's largest investment firm, is uniquely positioned to ensure companies consider its concerns.

BlackRock's Evolving View of Corporate Governance and Corporate Purposes

BlackRock—along with other prominent institutional investors like Vanguard and State Street—views good corporate governance practices as critical to protecting the perpetual investments it holds in its index funds. In addition, index fund investors often have long-term investment horizons, such as saving for retirement or their children's education. Active managers can sell the stock of poorly governed companies, but index funds generally must remain invested in all companies comprising the relevant index. For this reason, BlackRock and other institutional investors believe that effective corporate governance is a key component of maximizing long-term shareholder value and investor returns.

In his 2017 letter, Mr. Fink identified certain environmental, social, and governance factors that BlackRock views as important, such as "sustainability of the business model and its operations, attention to external and environmental factors that could impact the company, and recognition of the company's role as a member of the communities in which it operates." In this year's letter, however, Mr. Fink goes a small but significant step further. He now argues that:

> 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 of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

The *New York Times* recently wrote that Mr. Fink's letter may be "[a] watershed moment on Wall Street, one that raises all sorts of questions about the very nature of capitalism."[2] This is because Mr. Fink's focus on societal contributions departs from the traditional view that corporations exist to maximize

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[1] Mr. Fink's letter, "A Sense of Purpose," is available on BlackRock's website at https://www.blackrock.com/corporate/en-us/investor-relations/larry-fink-ceo-letter.

[2] Andrew Ross Sorkin, *BlackRock's Message: Contribute to Society, or Risk Losing Our Support*, N.Y. Times, Jan. 15, 2018, ***available at*** https://www.nytimes.com/2018/01/15/business/dealbook/blackrock-laurence-fink-letter.html.

shareholder value. Consider, for example, the following explanation of corporate purposes from one notable court decision:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[3]

As a result of this and many other decisions over the last century,[4] corporations and their directors typically focus on a single goal: to maximize shareholder value. Of course, they can take actions to benefit their employees, communities, or other constituencies, which are typically protected by the business judgment rule. But such actions are generally taken on the basis that they ultimately help increase shareholder value. Beyond providing the public with a valuable good or service, for-profit corporations generally do not try to serve a particular social purpose.[5]

Because BlackRock's view of corporate governance and corporate purposes—at least as set forth in Mr. Fink's recent letter—has diverged from the traditional view, companies and their boards will need to consider carefully how to address this important shareholder's demands.

Developing a Strategy to Achieve Long-Term, Sustainable Financial Performance

To be clear, BlackRock's goal remains to generate returns for its clients by investing in companies on their behalf. BlackRock therefore is not dismissing the importance of financial performance. Instead, BlackRock is asserting its belief that companies should focus on long-term, sustainable financial performance, which companies can achieve only when they understand the impact of their business on society and the effects that impact can have on their potential for growth. BlackRock expects companies to develop and disclose publicly their "strategic framework for long-term value creation and explicitly affirm that it has been reviewed by [their] board of directors." BlackRock presumably believes that any such framework should identify the positive impact on society resulting from a company's operations.

Like other prominent institutional investors,[6] BlackRock believes that companies are best served by having a diverse board of directors. The board should be diverse in terms of gender, ethnicity, career experience, and "ways of thinking," which, Mr. Fink argues, will result in a board less likely to "succumb to groupthink or miss new threats to a company's business model" and "better able to identify opportunities that promote long-term growth." Diverse boards will also help companies address environmental, social, and governance matters, which "demonstrates the leadership and good governance that is so essential to sustainable growth."

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[3] *Dodge v. Ford Motor Co.*, 204 Mich. 459, 507, 170 N.W. 668, 684 (1919).

[4] *E.g.*, *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010) ("Having chosen a for-profit corporate form, the [company's] directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders.").

[5] Benefit corporations, a recently developed twist on the traditional corporate form for companies that intended to produce a public benefit that is identified specifically in their articles of incorporation, are a notable exception to this general rule.

[6] *See, e.g.*, Press Release, New York City Comptroller, *Comptroller Stringer, NYC Pension Funds Launch National Boardroom Accountability Project Campaign — Version 2.0* (Sept. 8, 2017), ***available at*** https://comptroller.nyc.gov/newsroom/press-releases/comptroller-stringer-nyc-pension-funds-launch-national-boardroom-accountability-project-campaign-version-2-0/ (describing a new campaign to "ratchet up the pressure on some of the biggest companies in the world to make their boards more diverse, independent, and climate-competent, so that they are in a position to deliver better long-term returns for investors").

Developing a strategic framework to address environmental, social, and governance matters and to describe a company's social purpose and positive contribution to society will require careful deliberation by management and boards of directors. Open issues to consider include, among others:

- how BlackRock may apply its new view across different industries, particularly where companies have a naturally shorter (e.g., technology companies) or longer (e.g., utility companies) investment horizon;
- how much patience BlackRock will have if a company's short-term financial performance suffers while the company focuses on long-term value creation;
- whether BlackRock will, in practice, vote consistently in support of companies taking a long-term outlook;
- whether BlackRock will be able to monitor compliance with its new expectations; and
- what BlackRock will view as an acceptable social purpose or positive contribution to society.

Importance of BlackRock's New View

Mr. Fink's letter cannot be dismissed as mere rhetoric. With assets under management approaching $6.3 trillion at the end of 2017, BlackRock is the world's largest investment firm. A majority of its assets are invested in index funds and, as a result, BlackRock is one of the largest investors in most U.S. public companies. And importantly, it seems clear from Mr. Fink's letter that BlackRock intends to hold companies accountable if they fail to address its demands.

"Without a sense of purpose," Mr. Fink writes, companies "will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives." He goes on to argue that "companies who have not already developed and explained their plans will find it difficult to defend against [activist] campaigns." This is a not-so-subtle threat that companies without a clearly articulated strategy for long-term value creation—as publicly disclosed and affirmatively endorsed by the board—may find BlackRock supporting an activist investor who can explain its plan to generate returns for shareholders. Last year, for example, BlackRock reportedly voted in favor of 19% of all activist-led proposals in proxy fights, which included supporting activist hedge funds in proxy contests at Procter & Gamble and ADP, and also voted in favor of a proposal to enhance climate change disclosure after a company failed to provide sufficient information regarding its long-term strategy and risks related to that issue.[7]

Conclusion

Although BlackRock and other institutional investors have often emphasized the importance of a long-term outlook, Mr. Fink's most recent letter demands that companies also address how their business practices affect society. This is a small but significant change that will require management and boards to consider not just how to maximize shareholder value, but also how to demonstrate the contribution to society made by their company as it pursues long-term, sustainable financial performance. Companies and directors should be prepared to address these matters as they engage with BlackRock and other long-term institutional shareholders.

[7] Andrew Ross Sorkin, *BlackRock's Message: Contribute to Society, or Risk Losing Our Support*, N.Y. Times, Jan. 15, 2018, *available at* https://www.nytimes.com/2018/01/15/business/dealbook/blackrock-laurence-fink-letter.html.

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