

Paper Series on Corporate Design

NOVEMBER 2007

New Principles for Corporate Design

- 1. The purpose of the corporation is to harness private interests to serve the public interest.
- 2. Corporations shall accrue fair returns for shareholders, but not at the expense of the legitimate interests of other stakeholders.
- 3. Corporations shall operate sustainably, meeting the needs of the present generation without compromising the ability of future generations to meet their needs.
- 4. Corporations shall distribute their wealth equitably among those who contribute to wealth creation.
- 5. Corporations shall be governed in a manner that is participatory, transparent, ethical, and accountable.
- 6. Corporations shall not infringe on the right of natural persons to govern themselves, nor infringe on other universal human rights.

For information on the development and context of these principles, www.corporation2020.org



NOVEMBER 13, 2007

Dear Colleague,

It is with great pleasure we share with you this copy of the Paper Series for the Summit on the Future of the Corporation. Many of the ideas presented here have emerged from the three-year process of Corporation 20/20, a multi-stakeholder initiative – involving leaders from business, labor, finance, law, and civil society - seeking to answer this question: What would corporations look like that were designed to seamlessly integrate social purpose into the core of the organization?

Most debates about corporate responsibility narrowly define a stark choice between government regulation and free markets. Corporation 20/20 posits a third path: system design. Corporate design is about the fundamentals of the corporation, its essential structure, as opposed to its interior design only, e.g., culture and management practices. Design is about matters such as purpose, ownership and control, internal rewards and incentives, capitalization, and fiduciary duties in law. In approaching the topic of corporate design, our objective has been to scrutinize conventional wisdoms, to think out of the box, and to foster dialogue and action among an ever-growing circle of participants who believe that the corporation can and must play a pivotal role in achieving a sustainable future.

The goals of the paper series are threefold:

- To make available to a broad audience cutting-edge thinking on key aspects of corporate design;
- To set the stage for the Summit on the Future of the Corporation, November 13-14, 2007, at historic Faneuil Hall in Boston;
- To begin positioning corporate design as a prominent issue in contemporary public discourse on the role of business in society.

We wish to offer our deepest appreciation to all the authors of the papers for their outstanding contributions in bringing to life exciting new ideas in corporate design. We also thank Anna Fleder and David Wood for their expert review of various papers, Faye Camardo and Emily Volkert for their editorial and production assistance, and Christina Williams for design.

We hope participants in the Summit, as well as other readers worldwide, will find the papers both informative and provocative.

Cordially,

Allen White and Marjorie Kelly



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Table of Contents

Part I: Setting the Stage
1. Specific Investment and Corporate Law: Explaining anomalies in corporate law
Margaret M. Blair and Lynn A. Stout1
After decades of intellectual hegemony in legal scholarship, conventional shareholder primacy seems poised for decline. The old principal-agent model is vulnerable because it fails to explain important anomalies. For example: contrary to the notion that corporate directors have an enforceable duty to maximize shareholder value, liability is only very rarely imposed on directors for anything other than breach of the duty of loyalty (using their positions to line their own pockets). A new paradigm is appearing in corporate law scholarship, emphasizing the problem of protecting "specific" investments—specialized resources of highest value when used in a particular project. Under this new team production model, directors are not agents of shareholders but "mediating hierarchs" who protect specific investments by many stakeholders and distribute returns from that investment. 2. A New Era for Corporate Law: Using corporate governance law to benefit all stakeholders
Kent Greenfield
Law is essential to make the corporation successful. Yet under present law, a corporation meets its obligations if it creates wealth only for its shareholders. This is a narrow view of corporate purpose. Responsible corporate leadership is about creating value not only for shareholders but for employees, customers, and communities as well. In this view, management could be required to owe fiduciary duties to the firm as a whole, and corporate boards could be reconstituted to include representatives of various stakeholders. Approaches like these – using corporate law reform to address social issues – could be more efficient than existing regulatory options.
3. More Than Corporations: A new economy for a new era
David Korten
The day of reckoning for our reckless human ways has arrived. Reversing the present downward spiral

ral of social and environmental disintegration will require a deep transformation of our economy. Curbing the abuse of corporate power is central, but is only one piece of a larger agenda—a work best understood as a large historical movement from an ethos of empire to one of community. For 5,000 years, we humans have organized relationships by a dominator hierarchy, denying the humanity of the many to privilege the few. Change begins with a new Earth Community prosperity story that looks to life, rather than money, as the true measure of wealth. Our challenge is to transform our economic system from the bottom up by bringing forth living economies that root power in community, balance individual and community interests, and support a cooperative sharing of resources.

Part II: Internal Drivers

4. Internal Transformation of Corporations: The road to conscious capitalism

The root cause of our widespread environmental, economic, and social issues is organizational design. Few of our complex organizations have been designed to be learning organizations or conscious, empathetic, self-evolving social systems. This design deficiency is at the heart of our global problems. Corporate metamorphosis to conscious capitalism – where corporations function for the world – needs to be an inside job. It will be initiated by corporate leaders because it is a superior business model and better serves the needs of all stakeholders. It can be catalyzed by well-designed external initiatives, and it can be confounded by poorly designed external initiatives. The coming just-in-time evolutionary shift will be driven by leaders who see that they can strengthen their organization's financial sustainability by addressing rather than avoiding the major social, economic, and environmental challenges of the 21st century.

Part III: External Drivers

5. Long-term Investing: A proposal for how to define and implement long-term investing

Steven Lydenberg47

Many voices have extolled the virtues of long-term investing and condemned short-termism. But little real change is taking place. Financial professionals are forced to act in the short term because of the Short-Term Measurement Dilemma. When the market is valued according to a short-term measurement—that is, stock prices—and when performance is measured against these prices, long-term investing is impossible. This paper proposes a simple definition of long-term investing: Long-term investors speculate on the value of corporations to society and the environment, while seeking to enhance that value at the company and societal level. The wealth corporations create is more than stock price. Thus investors can function not only as price takers, but as value makers. To do so, they must engage management on social and environmental issues and set clear standards—beyond relative price—for allocating investments.

6. The Next Generation of Stock Exchanges: Creating local stock exchanges as hubs to support local living economies

Local, small- to medium-sized companies constitute the lion's share of the U.S. economy yet lack opportunities to be traded on national stock exchanges. These companies are directly connected to our well-being since their assets are by definition locally sited and owned. They hire neighbors, and their success benefits residents. Capital access for such enterprises must be established. We must explore what a new kind of local exchange might look like, which could create an easy way for community residents to invest in local businesses. A local exchange could include small companies in various stages of their lifecycle—some in a moderate growth phase. And business owners could sell minority stakes to local residents (primarily non-accredited investors) who are devoted customers, who share their vision, or who want to support local businesses. A local exchange might also develop responsible social reporting standards, and encourage listed companies to amend articles of incorporation to take stakeholder interests into account.

7. Revisiting Corporate Charters: Reviving chartering as an instrument for corporate accountability and public policy

Charles Cray......67

Though little used since the 19th century, corporate chartering has the potential to be one of the best ways to hold corporations accountable to the public interest. Three approaches are possible, focused on single companies, all companies, or specific industries. Examples of federal chartering of individual companies are Fannie Mae and Amtrak – the mortgage giant and passenger rail companies – which suggest a strategy that could be taken further. More broadly, a uniform higher standard of chartering might be established to reinforce the public purpose of every corporation, or to provide a framework of accountability that current regulatory systems can't provide. This might include a process of "sunset and review," with public input. More immediately, policy-makers might first use chartering to address problems in specific industries where the case for public intervention is obvious, such as public health, natural security, energy, or transportation.

8. Transforming Corporate Reporting: Envisioning a new reporting framework that serves multiple stakeholders

Alan Willis.......77

When we understand the anatomy and physiology of the current corporate reporting regime, it becomes readily apparent that this model is inadequate for disclosures to a broader group of stakeholders beyond shareholders. There is an urgent need for transformation of this system. Any new reporting model should satisfactorily address issues raised by Corporation 20/20's Principles – that corporations have a duty to serve the public good, to consider the interests of many stakeholders, to distribute wealth equitably, to operate sustainably, and to respect human rights. This paper imagines what a new reporting regime might look like and how steps could be taken in that direction.

Part IV: Pathways

9. The Emergence of New Corporate Forms: The need for alternative corporate designs integrating financial and social missions

Corporate social responsibility initiatives lull us into thinking that somehow our disparate actions add up to a cohesive whole. In fact, no current movement has the transformative power engendered by civil rights, anti-apartheid, or women's suffrage movements. How do we move from Corporation 20/20's articulation of a vision to achieving measurable change? This will require action on many fronts. Large companies can support stakeholder-based governance, while smaller companies can demonstrate alternative corporate designs. Investors should tackle short-termism, while civil society organizations campaign for policy reform. The role of government may be to explore charter reform, while media creates new reporting tools such as indices and scorecards that redefine success. This paper sketches a possible action agenda to build a cohesive social movement.

Part V: Biographies of Authors and Editors

Specific Investment and Corporate Law

Explaining anomalies in corporate law

BY MARGARET M. BLAIR AND LYNN A. STOUT*

What is a business corporation? What purposes does and should it serve? These questions have been raised repeatedly by legal scholars, practitioners, and policy-makers for at least the last 150 years. Each generation has struggled to find acceptable answers.

In the last decades of the twentieth century, corporate theory has been dominated by an approach to these questions that can be called the principal-agent model. According to this model, shareholders are the principals or ultimate "owners" of corporations. Directors are agents for the shareholders and, as such, should be subject to shareholder control. Corporations are run well when directors run them according to a "shareholder primacy" norm that requires directors to maximize shareholder wealth. When directors fail to do this, inefficient "agency costs" result.

Interestingly, corporate law does not impose any obligation on directors to maximize shareholder wealth.

It is difficult to overstate the influence the principal-agent model has had on modern business thinking. This is especially true in the United States, where shareholder primacy has for years largely crowded out other notions of corporate purpose. Yet a new generation of legal and economic scholars has begun to question the principalagent model as the best way to understand corporate law and to propose alternatives. After decades of intellectual hegemony, conventional shareholder primacy seems poised for decline.

In this essay we explore why. In particular, we explain that the principal-agent model is vulnerable for the simple reason that it fails to explain many important aspects of corporate law. During the heyday of shareholder primacy, academics tended to react to these legal "anomalies" either by glossing over them, or by arguing that corporate law needed "reform" to bring it closer to the shareholder primacy ideal. Today many scholars are trying a different approach. Rather than trying to make corporate law fit the principal-agent model, they are searching for new models that better fit corporate law.

In the process, they are providing an object lesson in the nature of intellectual progress described in Thomas Kuhn's classic and much-cited The Structure of Scientific Revolutions.² As Kuhn observed, the world bombards us with information that is often puzzling, ambiguous, incomplete, even apparently contradictory. Somehow we must do our best to find meaning in the barrage of data. Kuhn argued that we make sense of the world by developing mental models about the way it works, theories about how certain causes lead to certain effects. At different times, for example, people have believed that infectious diseases were caused by witches, by night air, and by microbes.

Kuhn labeled these mental models "paradigms." According to Kuhn, once a society or culture embraces a particular paradigm as a way to explain a particular phenomenon, most of the individuals in that society will cling to the paradigm with remarkable tenacity. They will believe the paradigm to be a true and accurate description of the world even in the face of significant anomalies—empirical phenomena that cannot be explained by, or that even seem inconsistent with, the paradigm. Rather than reconsidering the paradigm, they overlook, dismiss as unimportant, or attempt to explain away the anomalies. Yet at some point, the anomalies may become so obvious and so troubling that a few individuals begin studying them. These individuals may develop a new theory that explains the anomalies, an alternate paradigm that does a better job of predicting what we see in the world. Often their ideas will be resisted by those who follow the original paradigm.

Yet if the new paradigm does a better job than the old one of predicting what we actually observe, it will eventually win hearts and minds, and be accepted as correct. The old paradigm will come to be viewed as incomplete and outdated, a partial explanation at best.

During the 16th century, for example, many Europeans believed the sun revolved around the earth. This theory did a nice job of explaining why the sun appeared to rise in the east each morning and set over the western horizon each evening, but it could not explain the movements of the planets in the night sky. The Italian astronomer Galileo advanced an alternative model of a heliocentric universe that predicted not only the sun's movements but those of the planets as well. Not everyone appreciated Galileo's ideas at the time (he was investigated by the Inquisition and placed under house arrest for heresy), but today most educated people believe the earth does indeed circle around the sun.³

For most of the last three decades, corporate scholarship has been dominated by the powerful paradigm called the principal-agent model. This paradigm teaches that the concept of a corporate personality is not something to be taken seriously. Rather, a corporation is best understood as a nexus of private contracts. Chief among these contracts is the contract between the shareholders of the firm (often described as the "principals" or "owners" of the firm) and the directors and executive officers (usually described as the shareholders' "agents"). The principal-agent model envisions this contract as an agreement that the directors and executives will run the firm in a fashion that maximizes the shareholders' wealth.

The principal-agent model maintained a firm grip on the corporate law literature throughout the 1980s and 1990s, and many influential academics still employ the model today. Yet even as a generation of experts embraced the principal-agent model, they could not help but observe, often with frustration, how many fundamental aspects of corporate law seemed inconsistent with the approach. Part I of this Essay explores four of these fundamental corporate law anomalies: (1) corporate law does not grant shareholders the legal rights of principals nor burden directors with the legal obligations of agents; (2) corporate law does not treat shareholders of solvent firms as sole residual claimants; (3) far from being an empty fiction, legal personality is a key feature of the corporate form; and (4) corporate law does not impose any obligation on directors to maximize shareholder wealth.

Despite these obvious inconsistencies between theory and practice, until recently most corporate experts continued to accept the principal-agent model and to assume. consistent with this approach, that shareholder wealth maximization should be the corporate goal. This sometimes-uneasy embrace of the shareholder primacy norm illustrates another of Kuhn's observations: intellectual progress often must await the arrival of new tools and technologies. The hypothesis that infectious diseases are caused by microbes rather than witches or night air, for example, could not gain widespread acceptance until the invention of the microscope, a technology that confirmed the existence of microbes by allowing scientists to observe them directly.

Similarly, corporate law scholars until recently lacked the theoretical tools necessary to explain the anomalies that are so obvious to informed observers. The principal-agent literature was the primary intellectual tool available to business scholars in the 1980s and 1990s, and they naturally tended to apply it liberally to many aspects of the corporate form. As the saying goes, "when your only tool is a hammer, every problem tends to look like a nail."

More recently, however, theorists have begun to study and to write on a second economic problem that may be even more important to understanding the corporate form. This is the problem of protecting and encouraging "specific" investments—specialized resources that achieve their highest value only when used in a particular process or project. The developing literature on the difficulties associated with fostering specific investment has created new theoretical tools that offer fresh insights into old puzzles in corporate law.

Part II of this essay explores how, in particular, two new ideas being developed on specific investment—work on team production and the emerging concept of capital lock-in (work we have contributed to elsewhere, both individually and together)—shed light on important features of corporate law that contradict the principal-agent model. With these new intellectual tools, modern corporate scholars are poised to take up where a previous generation, of necessity, left off. In the

process, they will need to revisit the question of the proper social and economic role of business corporations.

Part I: The Principal-Agent Model and the Structure of Corporate Law

To understand the origins of the principal-agent paradigm of the corporation, we need to go back to a famous article published in 1976 by finance theorists Michael Jensen and William Meckling. In *Theory of the Firm*, Jensen and Meckling argued that a firm should not be characterized as an entity that has its

Easterbrook and Fischel argued that shareholders play a role similar to that of individual proprietorship, thus it is reasonable for them to be treated as "owners" of a corporation. own goals and intentions (e.g., "maximize profits"). Instead, a firm should be regarded as a nexus of contracts through which human actors—who do have goals and intentions—interact with each other. In particular, Jensen and Meckling said the most important contractual relationship in the firm was that between the primary investors or "owners" of the business, and the professional "managers" whom the owners hire to carry on the business on their behalf. (As this brief description suggests, Jensen and Meckling's analysis from its inception failed to reflect at least one reality

of the modern corporation. As students who take corporate law quickly learn, corporations are not run by generic "managers." Rather, the law divides the task of running corporations among three categories of corporate participants—directors, officers, and shareholders—with each of these groups facing a different set of legal rights and responsibilities.)

The Jensen and Meckling article built on an important literature in economics dealing with problems that arise when firms are run not by their owners, but by professionals whom the owners hire.⁶ In particular, Jensen and Meckling suggested that whenever one person (a "principal") hires another (an "agent") to act on the principal's behalf, there will inevitably be "agency costs" that arise because: (1) the agent might not always make the same choices

the principal would; and (2) it is costly for the principal to try to monitor and control the agent to prevent this. The Jensen and Meckling approach highlighted the slippage between the principal's desires and the agent's actual choices, and the trade-off principals face between suffering the slippage or trying to control it through costly monitoring or incentive arrangements.

The agency cost model described the structure of certain types of contracts, but not the structure of firms in general, nor the structure of the unique type of firm called a public corporation. Nevertheless, many corporate scholars embraced their approach and, in applying it to corporations, concluded that the shareholders must be the "principals," and directors and officers must be the shareholders' "agents." This idea had enormous appeal for a generation of business scholars who were confronted during the 1970s and early 1980s with the pressing question of what corporate law should require of executives and directors confronted with the newly-popular practice of unsolicited tender offers.

Economist Robin Marris had argued in the early 1960s that, even though in theory corporate "managers" might be tempted to let their personal concerns interfere with shareholder wealth maximization, if managers failed to maximize the value of a firm's shares in practice, an outside investor could make money by buying up the corporation's shares at a discount and replacing the managers or compelling them to maximize value. Very soon after, legal scholar Henry Manne proposed a similar idea, arguing that corporate managers would be driven to maximize share value by what he called "the market for corporate control."

This argument, combined with the Jensen and Meckling theoretical framework, was seized upon by other corporate scholars as a rationale for arguing that corporate law ought to respond to the development of the hostile tender offer with rules that prohibited directors from resisting such offers. A substantial literature soon appeared arguing that directors, as "agents" for the corporation's shareholders, ought to have a legal duty to manage the corporation to maximize share value, including acquiescing to any takeover that offered an immediate premium over the current market price of the shares. 9

This example illustrates how enormously appealing the principal-agent model was to corporate scholars during the 1970s and early 1980s, when they were eager to find an approach that would allow them to make definitive policy judgments and recommendations about hostile tender offers. Nevertheless, there remained at least one glaring problem with simultaneously arguing that a corporation should be regarded as a nexus of contracts, and arguing that corporate law should require corporate managers to act on behalf of the shareholders who "owned" the firm. The problem was that the nexus metaphor did not support the notion that the corporation was something that could be "owned."

Legal scholars Easterbrook and Fischel, two leading advocates of the "law and economics" movement, soon fixed that problem. In a series of articles in the early 1980s, they argued that while it did not make sense to speak of a nexus as having an owner, it was still conceptually useful and normatively correct to treat corporate directors and officers as shareholders' agents. 10 Easterbrook and Fischel asserted that when the various groups that participate in corporate production come together (groups that include, among others, creditors, suppliers, executives, employees, and shareholders) to interact through the nexus of contracts called "the corporation," only one of these groups—the shareholders—contracts to be the firm's residual claimant. 11 All other participants enter contracts that require them to be paid first, before the common stockholders can be paid. Since shareholders only get paid if the corporation produces a surplus over and above all its contractual obligations (according to the theory), shareholders have a strong incentive to see that this surplus, the "profit" from the enterprise, is maximized. Thus, as holders of both residual claim rights and residual control rights, shareholders play a role similar to that played by the owner of an individual proprietorship, and it remains reasonable to refer to shareholders as "owners" even though technically no one can own a nexus. 12

The end result was the paradigm we call the principal-agent model of the corporation, an elegant theoretical framework for thinking about what corporate law should look like and what purposes it should serve. This framework was quickly adopted by mainstream scholars

in the corporate law community, and it was in the context of this framework that a generation of theorists examined the corporate issues of the day, including the development of antitakeover defenses like the staggered board and "poison pill," the structure and enforcement of directors' fiduciary duties, the best way to compensate directors and executives, and the nature and extent of shareholders' voting rights. Nevertheless, despite the conceptual beauty of the principalagent framework, these attempts to apply the principal-agent model to the practice of corporate law highlighted how the model did not fit quite right. Despite decades of repeated calls for "reform," the rules of corporate law and the realities of business practice stubbornly remained at odds with the principal-agent framework.

Directors Are Not "Agents"

One of the most important ways in which corporate law departs from the predictions of the principal-agent model is that, unlike traditional principals, shareholders in publicly-traded corporations have little control over who the directors are and no direct control over what the directors do. The rules of agency law provide that an agent owes her principal a "duty of obedience." Yet U.S. corporate law does not require directors to follow shareholder mandates in any way. To the extent shareholders exercise any influence at all, it is only through two indirect and very dilute sources of power.

The first source of power is shareholders' very limited voting rights. Corporate law gives shareholders a right to vote on a slate of directors that has normally been selected by the existing directors (in extraordinary circumstances and at great personal cost, a disgruntled shareholder can propose an alternative slate). Once elected, it is the directors and not the shareholders who control the corporation and select and control the executive officers who run the firm on a dayto-day basis. Neither directors nor executives are required to do what the shareholders request. As a result it is directors, and not shareholders, who enjoy the legal right to set general business strategy and to control such key matters as the selection of executives and other employees, ¹³ the declaration and distribution of dividends, ¹⁴ the setting of directors' fees and employees' salaries, 15 and the decision to use corporate assets or earnings to benefit nonshareholder constituencies like creditors, employees, the local community, or even general philanthropic causes. ¹⁶ Nor do

In reality, corporate law only gives shareholders two indirect and dilute sources of power: voting rights and the right to sell their shares.

the rules of fiduciary duty constrain directors in such matters. Although the duty of loyalty precludes directors from expropriating corporate assets for themselves, ¹⁷ as long as directors refrain from using their corporate powers to line their own pockets their decisions are protected from shareholder challenge by the doctrine known as the business judgment rule. ¹⁸

The second weak and indirect source of power available to shareholders in a public corporation is their power to sell their shares. Normally the power to sell shares does not offer individual

shareholders much protection from director incompetence for the same reason that the power to use emergency exits does not offer much protection to partygoers in a burning nightclub; neither strategy works well when everyone tries to employ it simultaneously. However, as both Marris and Manne pointed out in the 1960s, when shareholders sell en masse to a single buyer, whether an individual or another corporation, that single buyer can overcome the obstacles to collective action that plague dispersed shareholders in public firms and use voting rights to oust a recalcitrant board. The result (to use Manne's hopeful phrase) is an active "market for corporate control."

The principal-agent model gained much of its traction in the early 1980s, the peak years of the hostile takeover wars. In the decades since it has become clear that, like shareholders' voting rights, the "market for corporate control" (at least in the United States) gives shareholders only a very weak and indirect source of influence over corporate boards. In particular, the widespread adoption of poison pills, staggered boards, and other antitakeover defenses has made it possible for today's directors to fend off all but the most determined, wealthy, and patient bidders. ¹⁹ Moreover, by the late 1980s, case law and

"other constituency" statutes had affirmed directors' discretion to adopt these and similar devices in response to hostile takeovers, including their authority to use defenses to protect nonshareholder interests²⁰ and to protect "long run" corporate strategies (with the directors, of course, in charge of selecting the time frame for carrying out those strategies).²¹

Thus, U.S. corporate law today retains the same structure it had evolved before the rise of the principal-agent model: directors' legal powers and responsibilities do not resemble those of agents, but rather those of trustees. As corporate law guru and former Dean of the Harvard law school Robert Clark has succinctly articulated, the actual authority structure of the corporation is as follows:

"(1) corporate officers like the president and treasurer are agents of the corporation itself; (2) the board of directors is the ultimate decision-making body of the corporation (and in a sense is the group most appropriately identified with 'the corporation'); (3) directors are not agents of the corporation but are *sui generis*; (4) neither officers nor directors are agents of the stockholders; but (5) both officers and directors are 'fiduciaries' with respect to the corporation and its stockholders."

This description forthrightly acknowledges what many corporate scholars writing during the last part of the twentieth century tended to gloss over, dismiss as unimportant, or simply refuse to see. The claim that shareholders are "principals" and directors are "agents" contradicts the realities of corporate law.²³

Shareholders Cannot Demand Dividends (And So Cannot Be Sole Residual Claimants)

A second important anomaly of corporate law, closely related to the legal fact that corporate law does not give shareholders the control over corporations associated with the idea of "ownership," is the fact that corporate law also does not grant the shareholders of a corporation that is not in bankruptcy the rights

of sole residual claimants.²⁴ This economic reality is reflected in the corporate law rules surrounding dividends.

One of the most basic rules of corporate law is that only directors may cause the corporation to declare and pay dividends.²⁵ Moreover, they must do this acting as a body-no individual director has the authority to declare dividends by herself. This rule seems to strike a fatal blow to the notion that corporate law treats shareholders as sole residual claimants entitled to every penny of profit left over after the firm's contractual obligations to other groups have been met. To address this obvious

Only directors may cause the corporation to declare and pay dividends, striking a fatal blow to the notion that corporate law treats shareholders as sole residual claimants.

point, corporate scholars defending the principalagent paradigm typically argue that it still makes sense to view shareholders as the firm's sole residual claimants because, even if a corporation's profits are not paid out in dividends. they are preserved as retained earnings. Thus (the argument goes) retained profits increase the value of the firm and. with it, the market value of the shareholders' equity interest.26

The power of the principalagent paradigm is such that it has led even sophisticated commentators²⁷ to overlook the rest of the

anomaly—the retaining earnings argument doesn't work for the simple reason that earnings are an accounting concept that directors, and not shareholders, control. Even if a corporation is drowning in a flood of money, it remains up to the directors to decide whether and to what extent shareholders will share in that wealth through either dividends or share price appreciation. This is because directors control dividends under the dividend rules, and also control earnings under the accounting rules. Earnings are nothing more than revenues minus expenses—and it is the directors, and not the shareholders, who determine the corporation's expenses.

The board of a firm that is making a surplus can choose to pass that surplus on to the corporation's shareholders. But it can choose

instead to use the corporation's increasing wealth to raise employee salaries, buy the CEO an executive jet, build an on-site childcare center, improve customer service, or make donations to charity and the local community. Economic and legal reality simply does not track the principal-agent model. Many different groups are potential "residual claimants" in corporations in the sense that they can share in the surplus created by the activities of the enterprise, including not only shareholders, but also creditors, customers, employees, and the community as well.

"Legal Personality" is a Key Feature of Corporations

The nexus of contracts approach to the corporation implies that the notion that the corporation is a legal entity is not only a useless idea, but a misleading one—a corporation is only a web of explicit and implicit agreements among the various groups that participate in "the firm." This view has led economists and corporate scholars to downplay the importance of corporate personality and even to scoff at the notion that the corporation is an entity in its own right.²⁸ Nevertheless, legal personality remains an essential corporate characteristic. Indeed, it may be the most important characteristic to distinguish the corporate form from proprietorships and traditional partnerships.²⁹

This is because entity status allows corporations to do something neither proprietorships nor traditional partnerships can easily do: shield the property used in the enterprise from the claims of equity investors, their successors and heirs, and their creditors.³⁰ At law, the corporation itself "owns" all assets held in the corporate name. This is more than a mere convenience. It means that an equity investor who needs money cannot raise it by forcing the corporation to return her investment.

As Part II will discuss in greater detail, this ability to "lock in" corporate capital may be vital to understanding the evolution and success of the corporate form. In particular, it allowed public corporations to invest safely in what economists call "specific" assetsinfrastructure, machinery, processes, or relationships that are specialized to the enterprise, and that would be worth far less if sold on the market for cash than they are worth when used in the firm.³¹ Specific investments are often essential to long-term, uncertain, and complex economic projects (building railroads, developing new technologies, creating trusted brand names). Unfortunately, specific investment is easily discouraged when individual investors have a legal right to prematurely withdraw their contributions and, with it, the ability to threaten to withdraw in order to opportunistically "hold up" their fellow investors and extract a larger share of the surplus generated by corporate activity. After investors have pooled their money to build a railroad, for example, it would cause enormous trouble if any of the investors were entitled to demand his or her money back. The corporation's legal personality helps solve this problem by saying, in effect, that the railroad's assets belong not to the investors but to the railroad itself, and that only the railroad's directors—not its shareholders—may decide when to pull capital out of the enterprise to pay dividends, repurchase shares, or for any other purpose.

Incorporation accordingly means that individual equity investors in a public corporation can only get their money back by finding someone else willing to purchase their shares and their interest in the enterprise. Especially before the development of business forms like the limited partnership or limited liability company (LLC), this consequence of legal personality provided a key difference between partnerships and corporations. In traditional partnerships, each partner has the right at any time to withdraw her share of the assets from the firm.³² Part II will discuss in greater detail how the corporation's ability to "lock-in" capital through its status as a legal personality may be important to explaining the rise of the corporation in the nineteenth century, and the peculiar advantages corporations enjoy in encouraging long-term, complex economic projects.

Corporate Law Does Not Require Shareholder Wealth Maximization

Finally, let us consider one of the most significant anomalies in corporate law to trouble scholars who follow the principalagent model: the rules of corporate purpose. According to the principal-agent model, the purpose of the corporation is clear. Corporations exist only to maximize profits and, with them, the wealth of the shareholders who are said to be the firm's sole residual

claimants. There is one obvious and dramatic problem with this claim, however. There is very little in U.S. corporate law that supports it, and much that cuts against it. Partnership law defines a partnership as an association for the purpose of earning business profits.³³ But corporate law does not define the purpose of the corporation beyond restricting it to "lawful" activities.34 This means that corporate purpose remains, as a matter of law, an "extremely varied, inclusive, and openended" concept. 35 Nevertheless, having only the principal-agent paradigm to work with, most corporate scholars writing in the waning years of the twentieth century tried to accommodate that perspective. While often recognizing how corporate law did not fit principal-agent analysis, many nevertheless ultimately accepted the idea that corporate directors should, as a normative matter, focus on maximizing value for shareholders. A classic example can be found in Robert Clark's leading treatise on U.S. corporate law, which states that "[a]lthough corporation statutes do not answer this question explicitly, lawyers, judges, and economists usually assume that the more ultimate purpose of a business corporation is to make profits for its shareholders."36

The main case Clark relied on in making this claim was, of course, the old chestnut *Dodge* v. Ford—a case nearly a century old, from a state unimportant to corporate law (Michigan), dealing with shareholder fiduciary duties in a closely-held (not public) company to boot.³⁷ Virtually every corporate scholar who has ever tried to argue that U.S. corporate law follows shareholder primacy has been forced, like Clark, to base his or her argument on the dictum of the antiquated *Dodge v. Ford.* Yet ample modern case law confirms directors' legal freedom to divert corporate assets and earnings to creditors, employees, customers, the community, and even general charities.³⁸ Corporate law also clearly permits directors to require the corporation to obey laws and regulations even when violating the law would be more profitable for shareholders.³⁹

This anomaly can be readily dismissed by those who want to dismiss it, because it is easy for corporate directors (as Clark's treatise puts it) to "make the right noises" and claim that actions taken on behalf of nonshareholder constituencies also benefit shareholders "in the long run." And if the directors themselves fail to advance this claim, it also is easy for a

court, or a scholar, simply to advance the claim for them. Nevertheless, the outcome is clear. U.S. corporate law does not follow the principal-agent paradigm on the question of corporate purpose.

Part II: Explaining Anomalies: On Specific Investment, Capital Lock-In, and Team Production

Contrary to the notion that corporate officers and directors have an enforceable duty to maximize value for shareholders, liability is only very rarely imposed on directors for anything other than breach of the duty of loyalty (that is, using their corporate positions to line their own pockets, a practice which

Modern case law confirms directors' legal freedom to divert corporate assets and earnings to creditors, employees, customers, the community, and even general charities.

harms not just shareholders but all the groups that participate in firms.) Very few cases impose liability on directors for breach of the duty of care and, curiously, most of those cases were brought on behalf of banks or other financial institutions in situations where directors' supposed lack of care harmed not shareholders but depositors or other creditors. Thompson & O'Kelley, Corporations and Other Business Associations: Cases and Materials 233-234 (2003). Apparently it is usually the bankruptcy trustee who pursues these cases.

As Part I has detailed, there are many important ways

in which the structure of U.S corporate law departs from the predictions of the principalagent model. Although the misfit is obvious and in some cases dramatic, the reasons for the divergence remained unclear to a generation of theorists forced to work in a paradigm that treated common shareholders as the sole residual claimants in corporations. This paradigm, in turn, in turn reflected legal scholars' enthusiasm for adapting the economic literature on the principal-agent problem to the institution of the public corporation.

In this section we suggest that a new paradigm is appearing in corporate law scholarship,

one that offers to resolve many of the anomalies discussed in Part II. The new paradigm is emerging because corporate scholars have an intellectual tool to work with that they did not have a generation ago: a developing literature on the economic problem of encouraging and protecting specific investment. In several recent papers, economic and legal scholars (including ourselves, working both alone and together) have investigated how specific investment offers insights into a number of peculiar features of corporations that don't fit the principal-agent model, including

their entity status and their director-dominated governance structure. 41 This growing literature suggests that the principal-agent model fails to predict many fundamental aspects of corporate law because it assumes that the only economic problem to be solved is the problem of getting directors and executives to do what shareholders want them to do.⁴² Yet corporate law may to a very great extent be driven by the need to solve a different problem: the problem of encouraging essential specific investments in projects where contracting is incomplete because the project is complex, long-lived, and uncertain.

Corporations tend to be formed to pursue businesses that require large amounts of enterprise-specific assets, meaning assets that cannot be withdrawn from the enterprise without destroying much of their value. Specific assets can take a large variety of forms. For example, "sunk-cost" investments in research, development, and business processes and relationships—money or time that has already been spent in the hope of earning future profits and is now "water over the dam"—are specific. So are specialized machines and equipment that cannot be easily converted for other uses. Executives' and employees' acquisition of knowledge, skills, and relationships uniquely useful to their present firm, and of little value to other potential employers, are investments in firmspecific "human capital." Developing customer loyalty, a trusted brand name, or a unique business process are all examples of specific investment.

Specific investment poses unique contracting problems. To understand why, consider the case of a group of investors who pool their money and intellectual talents to develop a cancer treatment. Once the money is spent and the research begun, the investors' time and

money has been transformed into an intellectual asset that, at least until it is patented and gets Food and Drug Administration approval, is largely specific to the enterprise. Neither the bottles and petrie dishes in the lab, nor the lab notes, nor the

Forming a corporation requires the participants to yield decision-making power over the ability to earn a return on their specific investments to a board of directors.

records of the biologists and physicians who tested the treatment would have much value if not used by the company to get the patent and the FDA approval, and to manufacture and sell the drug. The investors get the greatest value from their investment by keeping their resources together until they can bring the whole project to fruition.

As a result, each of the investors must worry that if the business is formed as a traditional partnership—if there is no entity status and no capital-lock in—all of the investors are vulnerable to the possibility that the group might not hold together long enough to see the project through to its finish. Alternatively, and just as threatening, any one investor who provides a critical

resource would be in a position to opportunistically threaten to withdraw his or her interest in order to coerce the others into giving up a larger share of any gains that flow from the joint project. Co-investors who contribute to projects requiring large amounts of specific investment accordingly can find themselves at risk from each other and from each others' successors and creditors. Unless the risks are controlled, the project may not be pursued in the first place.

This is where the new scholarship suggests that the creation of an incorporated legal entity with board governance can be useful. If the investors form a corporation and take shares of stock in exchange for their contributions, the money that financial investors have put up, along with the scientists' work-in-progress and any patents obtained, belong to the corporate entity. The financiers cannot unilaterally withdraw their funding, nor can the entrepreneurs and employees unilaterally extract the value of their time and effort (much less their lab notes and intellectual contributions) unless such a break-up and liquidation of the firm is agreeable to the

corporation's board of directors. The board, in turn, cannot be controlled by any one of the participants alone. All of the participants in the venture have to some degree "tied their own hands" and made it harder to withdraw. ⁴⁴ This seemingly self-defeating arrangement can in fact be self-serving if it encourages profitable joint investment in projects that require specific investments that could not otherwise be protected.

The problem of encouraging specific investment when corporate production requires different individuals to contribute different types of resources, such as a project that requires an executive's time, an entrepreneur's idea, and an investor's money, is often described as one of "team production." Building on the work of economists Armen Alchian and Harold Demsetz, 45 we define "team production" as "production in which 1) several types of resources are used . . .2) the product is not a sum of separable outputs of each cooperating resource . . . [and] 3) not all resources used in team production belong to one person."46 Team production presents obvious problems of coordination and shirking, problems addressed by Alchian and Demsetz⁴⁷ and by Holmstrom⁴⁸ in early work proposing solutions that echo typical solutions to the principal-agent problem.

Then Oliver Hart and some coauthors began to look at the issue. 49 Although they did not use the language of team production, they considered a similar problem, and added an important additional confounding conditionthe team members must make investments specific to the enterprise, putting them at risk if the enterprise failed or one team member attempted to hold up the others. Hart et al.'s addition may be vital to understanding corporations, because corporate production often requires a variety of "stakeholder" groups to make specific investments that cannot be protected by formal contracts, and that put them at risk if the business fails or they are forced to sever their relationship with the firm. Consider the executive who works long hours at a start-up company for belowmarket wages, or the customer who becomes adept at using a particular corporation's products, or the community that builds roads and schools to serve a company's factory employees.

Once again, however, the solution proposed by Hart et al. echoed the principal-agent model: at

least one team member must have "ownership" or "property rights" over the team's joint output, meaning a residual right of control. This proposed solution was admittedly flawed: while such a property right would protect the team member who owned it, assigning the right to only one member of the team left the other members vulnerable. Hart et al. suggested this might be an inevitable difficulty with specific investment in team production, and that the best that could be done would be to assign the property right to the team member whose enterprise-specific investment was most "important" in some sense. ⁵⁰

Board autonomy worsens the agency cost problem in corporations, because it means shareholders have less leverage to pressure boards to maximize corporate returns.

Rajan and Zingales then proposed an alternative solution. They noted that under Hart's solution, not only would team members who do not "own" a right to the team's output have reduced incentives to make specific investments, but the owner might sometimes have a stronger incentive to opportunistically sell his control over the other team members (thereby capturing the value of any specific investments they had made), instead of completing the team and making specific investments himself. Their

proposed solution to this problem was that all team members might be better off if they yielded control rights to an outsider. In a detailed discussion elsewhere, we have expanded upon the Rajan and Zingales solution and suggested it provides a rationale for why people might choose to organize production through a corporation with entity status governed by a board of directors. 2

In brief, forming a corporation requires the participants in that corporation to yield decision-making power over their ability to earn a return on their specific investments to a board of directors that is not, itself, a residual claimant in the firm. ⁵³ Corporate participants yield power over their specific investments in the sense that, if they choose to withdraw from the firm, they must leave those investments behind or see their value destroyed. And as long as they stay with the firm, they cannot directly control how their (or other team

members') specific assets are used, nor can they demand that the corporation pay for the value of those specific investments.

As a result, the only way corporate participants can profit from specific investment in the company is by continuing their relationship with the corporate "team" and hoping the board allocates to them some portion of the surplus generated by team production. Since the board is not itself a residual claimant and its members are precluded by fiduciary duties from expropriating the surplus for themselves (at least in their roles as directors), the board has no incentive to opportunistically threaten the value of team members' specific investment. And since the board, at a minimum, wants the team to stay together and to stay productive (thus assuring the continuation of the members' board positions), the board has some incentive to do this.

Space constraints preclude a full discussion here of how focusing on capital lock-in and specific investment in team production can explain a wide range of important phenomena in the business world, including the development of the corporate form, ⁵⁴ the nature of directors' fiduciary duties, ⁵⁵ the proper role of corporate counsel, 56 the rules of derivative suit procedure, ⁵⁷ the regulation of takeover bids and antitakeover defenses,⁵⁸ and even bankruptcy reorganization⁵⁹ and the necessity of a corporate-level income tax. 60 Interested readers are invited to explore the large and growing literature on such topics. Below we simply note how these new intellectual tools promise to help us build a paradigm of corporate law that both explains and predicts the important anomalies discussed in Part I.

Directors Are Not Agents But "Mediating Hierarchs" Who Protect Specific Investment in Corporations and Distribute the Returns from That Investment

Viewing corporations through the lens of capital lock-in and team production offers a variety of insights into the basic nature and structure of corporate law. One of the most important of these insights is an answer to the question of why, as discussed earlier, corporate law does not treat corporate directors as agents who must do the shareholders' bidding, but instead grants boards a remarkably wide range of autonomy and control over corporate assets. Board autonomy

worsens the agency cost problem in corporations, because it means shareholders (and other stakeholders for that matter) have less leverage to pressure boards to maximize corporate returns. At the same time, both the capital lock-in approach and the team production model suggest that director authority in public corporations remains a "second-best" solution that provides offsetting economic benefits by encouraging and protecting specific investment in corporate production.

For example, capital lock-in theory explains that corporate law does not allow any individual shareholder or subgroup of shareholders to exercise direct control over the board for the simple reason that, if this were allowed, a shareholder with liquidity concerns (for example) could use that control to force the firm to sell essential specific assets at a loss in order to raise the funds necessary to buy out the shareholder's interest. Alternatively, and perhaps even more likely, the shareholder might opportunistically threaten to do this to try to force the other investors to agree to give the opportunist a larger share of corporate earnings. 61 The need to protect the company's specific assets thus explains why corporate law limits individual shareholders' power to control directors and to demand dividends, share repurchases, or other transactions that would threaten locked-in capital.

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Relatedly, team production analysis emphasizes how shareholders' capital must be locked in and controlled by boards not only to protect shareholders' interests, but also to protect the interests of other team members who have made specific investments (e.g., employees, creditors, and customers who may have made past contributions of time and effort, invested in specialized relationships, skills, and loyalties, or acquired knowledge of particular firm processes and products). Shareholders cannot be allowed to control corporations directly because they are only one

among the many groups that must yield control rights over the firm's assets and outputs, in order to make credible commitments to other team members that they will not hold up the whole team to extract a larger share of the surplus.

Team production analysis, accordingly, can explain why, under the rules of corporate law, directors are not "agents" of either subgroups of shareholders or shareholders as a class, nor of any other class of investors. Rather, as we have argued in some detail elsewhere, 6 directors are better described as "mediating hierarchs" who must balance the competing needs and demands of shareholders, creditors, customers, suppliers, executives, rank-and-file, and even the local community, in a fashion that protects specific investments in the corporation and keeps the corporation alive, healthy, and growing. In other words, boards of directors, who alone are empowered to decide how to distribute the corporate surplus, should use this power to ensure that every vital team member gets at least enough of the surplus to keep that member motivated to stay with the team.

Many Different Groups Make Specific Investments in Corporations and Are Potential Residual Claimants

Once one acknowledges the legal reality that directors are not shareholders' agents, one must also accept that a second key component of the principal-agent model—the idea that shareholders are the sole residual claimants in firms—lacks a solid foundation. When corporate directors enjoy any significant discretion to decide how the corporation uses its assets, it becomes grossly inaccurate as a descriptive matter to assert that shareholders of a public corporation are the sole residual claimants of that firm. 63 To the contrary, shareholders are only one of many groups that may act as residual claimants or residual risk bearers in the sense that directors have authority to provide those groups with benefits (and sometimes to saddle them with burdens) above and beyond the benefits and burdens described in their formal contracts with the firm. For example, when a corporation is doing spectacularly well, it is common to see employees receive dental benefits and greater job security, executives get nicer offices and access to a company jet, bondholders get increased protection from insolvency, and the local elementary school get charitable

donations of money and equipment. Conversely, these groups suffer along with shareholders when times are bad, as employees get stingier benefits, executives fly coach, debtholders face increased risk, pension funds fail, and the elementary school does without.

Directors, in reality, simply do not behave the way the principal-agent model predicts they should. They reward many groups with larger slices of the corporate pie when the pie is growing, and spread the loss among many when the pie is shrinking. Far from providing evidence that directors are doing something wrong by imposing "agency costs" on shareholders, this observation suggests directors may be doing exactly what team production analysis says they should be doing—acting as mediating hierarchs who balance the conflicting interests of the many members who make up a healthy, productive corporate team.

The Concept of "Legal Personality" Plays An Important Economic Role in Protecting Specific Investment

One of the greatest weaknesses of the principal-agent model is its characterization of the firm as a nexus of contracts. As noted earlier, this idea is in tension with the claim that shareholders "own" corporations, since it is difficult to envision how one might own a nexus. A second problem, however, is that the nexus metaphor does not give any guidance on where, exactly, the "firm" begins and ends. If an executive who signs an employment agreement with Microsoft is "in" the firm, what about the closely-held corporation that signs an agreement to supply certain software programs? Are Microsoft and the closely-held supplier one single company? What about the buyer who signs a contract to purchase a Microsoft product? Is the buyer part of Microsoft? Under the nexus approach, it is difficult to see where Microsoft ends and the rest of the world begins.

The capital lock-in approach may not, by itself, tell us what "a firm" is, but it at least provides a way to define what "a corporation" is. In brief, a corporation is a legal entity that can own property in its own name. This concept has economic as well as legal importance. As noted in the previous section, entity status allows a corporation to lock in resources so they can be converted safely to

specific assets. Although one might imagine other legal mechanisms for achieving capital lock-in—say, a trust arrangement⁶⁴—incorporation accomplishes the same result, cleanly and simply.

Indeed, team production analysis suggests incorporation does more. By placing ownership of the firm's assets in the hands of the firm itself rather than in the hands of the firm's shareholders, incorporation encourages specific investments from other important groups that often participate in corporate production, including creditors, executives, customers, and rank-and-file employees. These constituencies become more willing to invest because they know that control over the corporation—and with it, control over their specific investments—now rests in the hands of a board, and not in the hands of shareholders who might opportunistically threaten to destroy their investment or exclude them from the firm in order to demand a larger share of any surplus. The result is a mutual "hand's tying" arrangement among the various groups that make specific investments in corporations, an arrangement that ultimately works to benefit all. This arrangement would be undermined by allowing any one of the team members to exercise direct control over the firm's assets.

Focusing on the problem of specific investment rather than the problem of agency costs accordingly allows us to see why corporate "personhood" matters so much. Legal personality worsens agency costs. As Clark's treatise puts it, from a shareholder's perspective "a major problem with legal personality as it has been developed for public corporations has been presented by the 'hardto-kill' character of the corporation."65 At the same time, this Frankenstein's monster aspect of incorporation may perform a vital economic function by protecting the value of shareholders' and other team members' specific interests in corporate production. To quote again from Clark's treatise, legal personality can "safeguard going concern values."66

Corporate Law Leaves Corporate Purpose Open To Protect Directors' Role As Mediating Hierarchs

What does all this imply for the fourth anomaly noted in this essay—the open-ended nature of the legal rules regarding corporate

purpose? Interestingly, here capital lock-in and team production analysis give somewhat different, although in some respects complementary, answers.

The capital lock-in function of corporate law helps protect what Clark's treatise calls "going concern" value for all corporate participants, not just shareholders. But capital lock-in theory, by itself, it doesn't necessarily preclude a legal stance that emphasizes shareholder value maximization as the appropriate corporate goal. The team

The appropriate normative goal of directors is to build and protect the wealth-creating potential of the entire corporate team, where wealth is broadly defined.

production approach, however, offers another and in many ways more intriguing explanation for the anomaly of open-ended corporate purpose. In brief, it suggests that the appropriate normative goal for a board of directors is to build and protect the wealth-creating potential of the entire corporate team—"wealth" that is reflected not only in dividends and share appreciation for shareholders, but also in reduced risk for creditors. better health benefits for employees, promotional opportunities and perks for

executives, better product support for customers, and good "corporate citizenship" in the community. ⁶⁷ To accomplish this, directors must have a wide range of discretion to balance competing interests in a way that keeps the team together and keeps it productive.

Team production analysis consequently warns against defining corporate purpose in a narrow fashion that would allow one or more members of the corporate team to challenge the boards' authority and argue either that the board is pursuing the wrong goal, or that it is pursuing the right goal the wrong way. Once we leave behind the narrow objective of maximizing share value, it is impossible for an outsider like a court to design an algorithm to measure whether a board is maximizing returns to the corporate team, and dangerous to invite courts to try. Allowing either shareholders or other stakeholders to claim in court that directors who are not violating their loyalty duties by using their corporate powers

to enrich themselves are nevertheless acting with an "improper purpose" simply invites corporate participants to try to extract wealth from other team members by waving the stick of personal liability over the directors' heads.

A corollary is that the corporate desideratum associated with the principal-agent model— "increase share value whether this helps or harms other team members"—is a recipe for inefficiency. The team production approach undermines the principal-agent model's claim that corporations are governed well when they are governed in a fashion that maximizes share value. Rather, good governance means making sure the corporation survives and thrives as a productive, value-creating team—even though this is an objective that is difficult to measure, much less maximize

It is important to note that the idea that corporate law does not require directors to maximize share value in no way implies that shareholders are worse off under corporate law rules that give directors such open-ended discretion. Team production analysis teaches that equity investors as a class are better off when corporate participants, including equity investors, lenders, employees, and entrepreneurs, have an organizational form available to them that allows them to cede power over corporate assets to the kind of director governance system provided by corporate law. Without director governance, these groups might not be able to overcome the risks of mutual rent-seeking created by complex, uncertain, and long-lived projects, and so might not pursue profitable projects in the first place.

Past and present business experience supports this hypothesis. Nineteenth century American business history is a story of entrepreneurs going to state legislatures in increasing numbers to seek permission to form corporations—corporations that outside investors purchased shares in and outside creditors loaned money to. The increasing popularity of this practice, even when it was much simpler and less costly to use partnership law to organize businesses, suggests that both the entrepreneurs, and the creditors and equity investors who financed their projects, found the arrangement valuable.⁶⁸

Today we have even better evidence that incorporation and board governance serves the

interests of shareholders and other corporate participants—evidence that was not available to scholars writing in the 1980s and even early 1990s. In brief, U.S. corporate law is mostly "default rules," meaning that incorporators can modify the basic rules of corporate law by putting customized provisions in the corporate charter before the company "goes public" and sells shares to outside investors. 69 If investors really wanted more power over boards, there is no reason why an enterprising entrepreneur who wanted to appeal to this desire could not add a charter provision that, for example, prohibited the board from adopting a "poison pill" that would allow them to reject a premium takeover bid the shareholders favored. Similarly, if outside investors really believed that requiring boards to pursue share value would make them better off, incorporators could put "shareholder wealth maximization" in the charter as the corporate purpose.

Public corporation charters virtually never contain such provisions. 70 Even more telling, recent empirical studies demonstrate that when promoters do tinker with charter provisions in the pre-IPO stage—exactly the stage in which they most need to appeal to outside investors—they almost always move in the opposite direction, adding provisions like a staggered board structure that insulates directors from shareholder influence even more than the default rules of corporate law already do. 71 Outside investors happily buy shares in these firms. This pattern strongly suggests that director discretion, including the discretion that comes from open-ended rules of corporate purpose, serves the long-run interests of "the investor class" even if it works against the interests of particular shareholders in particular firms at particular times. Capital lock-in and team production help explain why.

Conclusion

For most of the past three decades, U.S. corporate law scholarship has been dominated by a single, widely accepted paradigm: the principal-agent paradigm. Yet U.S. corporate law itself refuses, in many puzzling ways, to follow the precepts of the principal-agent model. These puzzling departures include such important anomalies as director governance; shareholder powerlessness to demand dividends; the importance of legal personality; and the open-ended rules of corporate purpose.

Nevertheless, until recently, many corporate scholars have chosen to continue to embrace the principal-agent approach for the simple reason that they lacked a compelling alternative. The result has been a literature that emphasized the agency cost problem and especially how director governance creates conflicts of interest between shareholders and directors, and that tended to be blind to the problem of specific investment and how director governance may temper potential conflicts between and among shareholders, executives, creditors, and others who make specific investments in corporations.

Today the situation has changed dramatically. Although the principal-agent model still has great influence, corporate scholars are involved in an escalating debate over the best way to understand the modern public corporation. This debate increasingly recognizes the legal reality that public corporations are governed by boards and not by shareholders. It also recognizes recent developments in economic theory that teach that, in addition to the problem of agency costs, corporate production can raise important problems of encouraging specific investment.

These insights have inspired contemporary legal and economic scholars to explore new and different approaches to understanding the rules of corporate law. In this essay we have briefly touched upon two of these emerging alternative paradigms: the capital lock-in approach, and the team production model. In exploring these alternatives, we are not suggesting that the original principal-agent model is always useless and should be discarded. For some corporate problems the principal-agent approach may be just as useful as the capital lock-in or team production approach, and considerably easier to apply. Similarly, Newtonian theory is just as useful as (and considerably easier to apply than) Einstein's theory of relativity for many problems in physics. Nevertheless, there are important phenomena in physics that can only be explained and predicted using Einstein's approach. And there are likewise important indeed fundamental—phenomena in corporate law and practice the principal-agent model simply cannot account for.

In accord with Kuhn's thesis, these anomalies have attracted the attention of a new generation of corporate scholars. Rather than

trying to minimize or ignore the poor fit between the principal-agent model and the rules of corporate law, they have instead sought to develop new models. They have been aided both by new theoretical tools, and by new empirical findings, that highlight the essential role specific investment can play in determining corporate structure. In the process, they are working toward new visions of the corporate purpose that go beyond the simple rubric of shareholder wealth.

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FOOTNOTES

¹ Henry Hansmann & Reinier Kraakman, The End of History in Corporate Law, 89 Geo L. J. 439, 440-41 (2001) (arguing that academic, business and government elites now agree that "the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders ... and the market value of the publicly traded corporation's shares is the principal measure of the shareholder's interest"); see also R. Gordon Smith, The Shareholder Primacy Norm, 23 J. Corp. L. 277 (1998).

² Thomas Kuhn, The Structure of Scientific Revolutions (3d. ed., 1996).

Kuhn's book suggests humankind is a long way from completely understanding the universe, and in this sense all paradigms are to some extent social constructions and none are entirely "correct." Kuhn nevertheless clearly believes some paradigms are better than others at predicting real phenomena. Microbes are a better explanation for disease than witches, and it is more correct to say the earth revolves around the sun than vice versa. ⁴ See, e.g., Robert C. Clark, Corporate Law 17 (1986) (noting that U.S. corporate law fails to require directors to maximize shareholder wealth but stating this ought to be the corporate purpose).

⁵ Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ., 4, 305-360 (1976).

See e.g., Oliver Williamson, The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm (1964), Marris, The Economic. Theory of Managerial Capitalism (1964).

See Marris, supra note 6.

Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. P. Econ., 110-120 (1965).

See e.g., Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of A Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981); Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 5, 819-891 (1981). The leap from viewing managers and directors as shareholders' agents to concluding that managers and directors must stand willing to sell out the corporation to a highest bidder requires one more

assumption commonly accepted by proponents of law and economics. This additional assumption is that securities markets are both informationally and allocationally efficient, so that the market price of a company's shares reflects their "fundamental" economic value. Although during the 1980s the idea of fundamental value efficiency enjoyed widespread support, in recent years it has been subject to both theoretical and empirical challenge, and many finance economists no longer accept it. See generally Lynn A. Stout, The Mechanisms of Market Inefficiency: An Introduction to the New Finance, 28 J. Corp. L. 633 (2003).

¹⁰ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 Yale L. J. 698, 700-02 (1982); Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J. L & Econ. 395, 395-427 (1983); Frank H. Easterbrook & Daniel R. Fischel, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650 (1984). The ideas in these articles were later brought together in an influential book, Frank H. Easterbrook & Daniel

R. Fischel, The Economic Structure of Corporate Law (1991).

See id. at 11. Clearly most corporate participants do not actually bargain in this way, so the argument was an "as if" argument of the type legitimized by economist Milton Friedman when he claimed that it is acceptable to argue that economic actors "optimize" if the outcomes of their choices correspond to those that would obtain if in fact economic actors had consciously optimized. Milton Friedman, The Methodology of Positive Economics, in Essays in Positive Economics 3-16, 30-43 (1966). Even if shareholders do not literally bargain to be residual claimants, the argument goes, if in fact we see shareholders play this role, the result is the same.

See, Easterbrook & Fischel, Economic Structure, supra note 10 at 36-39, 185-191; see also Easterbrook & Fischel, Voting, supra note 10 at 396 ("shareholders are no more 'owners" of the firm than are bondholders, other creditors, and employees (including managers) who devote specialized resources to the enterprise").

Clark, supra note 4, at 105-106. See, e.g., Auer v. Dressel, 118 N.E. 2d 590, 593 (N.Y. 1954)(holding that directors have no legal obligation to respond to shareholder resolution demanding reinstatement of dismissed officer).

Clark, supra note 4, at 106, 594.

¹⁵ Clark, supra note 4, at 106, 191. See, e.g., In Re Disney Derivative Litigation, No. Civ. A. 15452, 2005 WL 2056651 (Del. Ch. August 9, 2005).

¹⁶ Clark, supra note 4, at 105-06, 136-37, 681-82. See, e.g., Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Civ. A. No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991)(upholding board discretion to pursue strategy that favored creditors' interests over shareholder's objections); Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968))(upholding director discretion to pursue strategy that favored local community over shareholder's objections); Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969)(upholding director discretion to make philanthropic contributions over shareholder's objection).

¹⁷ Clark, supra note 4, at 141-42 (discussing duty of

¹⁸ Id. at 123-129 (discussing business judgment rule). 19 See Lynn A. Stout, The Shareholder As Ulysses: Some Empirical Evidence on Why Investors In Public Corporations Tolerate Board Governance, 152 U. Pa. L., Rev. 667, 694-695 (2003) (discussing lack of active market for control); see also Lucian Arye Bebchuk Bebchuk et al., The Powerful Antitakeover Force of

Staggered Boards: Theory, Evidence, and Policy, 54 Stan. L. Rev. 887, 890-91 (2002) (study finding that between 1996 and 2000, no hostile bidders succeeded against firms that had adopted staggered board structure).

²⁰ See Smith, supra note 1, at 289 (discussing other constituency statutes); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)(discussing director discretion to consider interests of creditors, customers, employees, and community). ²¹ See Paramount Communications, Inc. v. Time, Inc., 571

A. 2d 1140, 1151-55 (Del. 1989)(discussing directors discretion to choose best "long-run" strategy). In an earlier case, the Delaware Supeme Court had suggested that in limited circumstance directors might be required to maximize share price. See Revlon v. MacAndres & Forbes Holdings, 506 A. 2d 173, 176 (Del. 1986). Paramount and other subsequent cases make clear that directors can easily avoid being subject to Revlon duties. Stout, supra note 19, at 696.
²² See Clark, Agency Costs versus Fiduciary Duties, in

Principals and Agents: The Structure of Business 55, 56 (John W. Pratt & Richard J. Zeckhauser eds.)(1985).

Cf. Clark, supra note 4, at 22 ("the relationship between shareholders and directors is not well described as being between principals and agents.").

Nor is it clear shareholders enjoy this status even when the firm is in bankruptcy. Lynn M. PoPucki, The Myth of the Residual Owner, 82 Wash. U. L. Q. 1341, 1343 (2004) (empirical study finding that even in bankruptcy reorganization, "no identifiable, single residual owner class exists").

Clark, supra note 4, at 106, 594.

²⁶ See id. at 594-602 (discussing Modigliani Miller approach to irrelevance of dividend payouts).

See, e.g., Clark, supra note 4 at 594 (stating that directors and not shareholders control dividends) and at 18 (stating that "it is the shareholders who have the claim on the residual value of the enterprise".)

See, e.g., Easterbrook & Fischel, Economic Structure, supra note 10 at 12 (arguing that "[t]he 'personhood' of a corporation is a matter of convenience rather than reality").

As late as 1986 the Uniform Partnership Act (UPA), which was the basis of most state law governing partnerships, was ambiguous on the question of whether partnerships had separate entity status. See UPA (1914), Sec. 6(1). The Revised Uniform Partnership Act (1997) clarifies that the default rule is that a partnership formed under the new act is given entity status. See Margaret Blair, Reforming Corporate Governance: What History Can Teach Us, 1 Berkeley Business Law Journal, 1, 1-44, text & notes 59-61 (discussing this evolution in the law and its implications).

See infra text accompanying notes 43-45, 65-67.

Oliver Williamson was among the first economists to explore the significance of investments in specific assets for the allocation of investment returns and the structure of ownership rights in long-term contracts. See e.g., Williamson, Transaction-Cost Economics: The Governance of Contractual Relations, 22 J. L. Econ. 233 (1979). Margaret Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century 249-271 (1995) highlighted the implications of specific investments in human capital for corporate governance.

See Clark, supra note 4, at 19 ("Rarely do common shareholders in public corporations have a right to force the corporation to buy back their shares. Nor are they able, on their own initiative, to force the company to liquidate and thus pay all the shareholders. Consequently, there is no risk, as there is in a general partnership, that the joint

exercise of such a right by a number of investors will kill the enterprise. Corporations. . . . are more likely to preserve the going concern value of large projects.") Clark, supra note 4, at 16.

³⁴ See, e.g., Del. Code Ann. Tit. 8, Section 102(a)(3).

35 Clark, supra note 4, at 17; see also id at 678 (noting that "perhaps surprisingly, the state business corporation statutes under which corporations are chartered generally do not say explicitly that the purpose of the business corporation is to make or maximize profits.")

⁶ Id. at 17, emphasis added.

³⁷ Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

³⁸ Clark, supra note 4, at 681-84.

³⁹ Id. at 686.

40 Id. at 682.

⁴¹ See, e.g., Symposium: Team Production in Business Organizations, 24 J. Corp. L. 743 (1999); Steven A. Bank, A Capital Lock-In Theory of the Corporate Income Tax, 94 Geo. L. Rev. (2005); Margaret M. Blair, Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century, 51 U.C.L.A. L. Rev. 387 (2003); Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 275, 278 (1999); Margaret M. Blair & Lynn A. Stout, Director Accountability and the Mediating Role of the Corporate Board, 79 Wash. U. L. Q. 403 (2001); Harold Demsetz, The Economics of the Business Firm: Seven Critical Commentaries 50-51 (1995); Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 Yale. L. J. 387 (2000); Peter Kostant, Exit, Voice and Loyalty in the Course of Corporate Governance and Counsel's Changing Role, 28 J. Socio-Econ. 203 (1999); Lynn LoPucki, A Team Production Theory of Bankruptcy Reorganization, 57 Vand. L. Rev. 741 (2004); Lynn A. Stout, Bad and Not-So-Bad Arguments for Shareholder Primacy, 75 S. Cal. L. Rev. 1189 (2002); but see Alan J. Meese, A Team Production Theory of Corporate Law: A Critical Assessment, 43 Wm. & Mary L. Rev. 1629 (2002); David Millon, New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law, 86 Va. L. Rev. 1001 (2000).

Basic corporate law casebooks also have begun to discuss the importance of specific investment and director governance. See, e.g., Robert W. Hamilton & Jonathan R. Macey, Cases and Materials on Corporations 2225 (9th ed.)(2005) (discussing team production model of corporation); Charles R.T. O'Kelley, Corporations and Other Business Associations 7 (4th ed. 2003)(discussing problem of team-specific investment). Stephen Bainbridge has also emphasized the importance of director governance for public firms, although for different reasons. See Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547 (2003)

⁴² See Margaret M. Blair, Human Capital and Theories of the Firm, in Margaret M. Blair & Mark Roe, Employees and Corporate Governance 71 (1999)(discussing asymmetry of canonical principal-agent problem). See also Paul Milgrom & John Roberts, Economics, Organizations, and Management 334-335 (discussing problem of getting employers to reveal accurate information so that employee incentive contracts can be enforced against them). Legal scholars rarely address the problem of mutual opportunism outside the close corporation context. See, e.g., Eric Talley, Taking the "I" out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties, 24 J. Corp. L. 1001, 1015-21 (1999); Edward B. Rock & Michael Wachter, Waiting for the Omelet to Set: Match-Specific Investments and Minority Oppression in Close Corporations, 24 J. Corp. L. 913,

914-15 (1999).

⁴³ See, e.g., Blair, Locking In, supra note 41 at 391("The creation of a separate legal entity allows businessorganizers to partition the assets used in the business. . . . [This means] participants and third parties are assured that the pool of assets used in the business will be available to meet the needs of the business first (such as, to pay the claims of the business's creditors) before these assets can be distributed to shareholders."); Blair & Stout, TeamProduction, supra note 41at 292 ("the firm can hold title to the property, and can thereby function as the repository of all 'residual' income from team production that is not actually paid out to team members.") 44 See, e.g., Stout, supra note 19, at 669 ("for some reason, participants in public corporations—including investors value director primacy. Just as the legendary Ulysses served his own interests by binding himself to the mast of his ship, investors may be serving their own interests by binding themselves to boards.") Of course, this analysis does not apply to corporations that have a single shareholder. However, most corporations of any significant size have multiple shareholders, even when those shareholders may be relatively few in number. ⁴⁵ See Armen Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 (1972). Other scholars who have done important work on this idea include Bengt Holmstrom, Moral Hazard in Teams, 13 Bell J. Econ. 324 (1982); Oliver Hart, Incomplete Contracts and the Theory of the Firm, 4, J. L. Econ. & Org. 119 (1988); Sanford Grossman & Oliver Hart, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, 94 J. Pol. Econ. 691, 693 (1986); Oliver Hart, An Economist's Perspective on the Theory of the Firm, 89 Colum. L. Rev. 1757 (1989); Oliver Hart & John Moore, Property Rights and the Nature of the Firm, 98 J. Pol. Econ., 1119 (1990); Raghuram C. Rajan & Luigi Zingales, Power in the Theory of the Firm, 113 Q.J. Econ. 387

- $\overset{\cdot}{\text{(1998)}}$. $^{\text{46}}$ Alchian & Demsetz, supra note 45, at 779.
- ⁴⁷ Id. at 781.

⁴⁸ Holmstrom, supra note 45, noted that ex ante agreements about the division of a surplus from production would give team members incentives to shirk and free ride on the efforts of fellow team members, while attempts to divide up the surplus ex post would lead to costly rent-seeking behavior. His proposed solution involved giving any surplus to an outsider not on the team unless the surplus was large enough to ensure that no team member had shirked. Such a solution provides perverse incentives to the outsider to undermine the contract by bribing a team member to shirk. For a more complete discussion of the development of theoretical work in economics on team production, see Blair & Stout, Team Production, supra note 41 at 265 -279.

⁴⁹ See sources cited supra note 45.

⁵⁰ See Hart & Moore, supra note 45, at 1149 ("[A]n agent is more likely to own an asset if his action is sensitive to whether he has access to the asset and is important in the generation of the surplus.")

⁵¹ See Rajan & Zingales, supra note 45, at 422 ("[I]f all the parties involved in production (i.e., including the entrepreneur) have to make substantial specific investments over time, it may be optimal for a completely unrelated third party to own the assets. . . . [T]he third party holds power so that the agents critical to production do not use the power of ownership against each other"). ⁵² See Blair & Stout, Team Production, supra note 41 at 276-287; see also Blair & Stout, Director Accountability, supra note 41.

⁵³ Blair & Stout, Team Production, supra note 41 at 274– 277.

⁵⁴ Blair, Lock-In, supra note 41.

55 See Blair & Stout, Team Production, supra note 41 at 298-308.

⁵⁶ See Kostant, supra note 41.

⁵⁷ See Blair & Stout, Team Production, supra note 41 at 292-97.

⁵⁸ See Lynn A. Stout, Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem, 55 Stan. L. Rev. 845 (2002).

⁵⁹ See LoPucki, supra note 41.

⁶⁰ See Bank, supra note 41.

⁶¹ As this discussion suggests, one can view capital lock-in primarily as a device that protects shareholders from the opportunism of other shareholders. We believe, however, that capital lock-in makes incorporation an attractive way to do business, not only because it protects shareholders from each other, but also because it protects the interests of nonshareholder groups that have made specific investments in corporations that cannot be protected by formal contracts. For example, without capital lock-in, shareholders as a class might pressure directors to pay excessive dividends. (Shareholders with diversified portfolios are indifferent to increasing firm leverage, even though increasing risk threatens the interests of creditors, employees, and other corporate participants who cannot diversify their human capital or other specific investments in the company.) From an ex ante perspective, shareholders may benefit from yielding power over dividends to directors who owe fiduciary duties to the corporation as a whole, because ceding this power enables the shareholders as a group to make a more credible commitment not to strip assets out of the firm prematurely or injudiciously, in turn attracting the important firmspecific investments of nonshareholder groups. This analysis can explain why corporate law grants directors the legal authority to ignore even a unanimous shareholder request for dividends.

⁶² See Blair & Stout, Team Production, supra note 41;
 Blair & Stout, Director Accountability, supra note 41.
 ⁶³ See Blair & Stout, Team Production, supra note 41 at 250 ("Our analysis rests on the observation—generally accepted even by corporate scholars who adhere to the principal-agent model—that shareholders are not the only group that may provide specialized inputs into corporate production. Executives, rank-and-file employees, and even creditors or the local community may also make essential contributions and have an interest in the enterprise's success" (footnotes omitted).)

⁶⁴ Joint stock companies used by business people in the eighteenth and nineteenth centuries before the corporate form was widely accessible sometimes used complicated trust arrangements to hold the assets used in the enterprise. This approach did not always achieve its intended purpose, as courts tended to treat such arrangements as a species of partnership and they would be broken up if a "member" died or wanted out. See Blair, Lock-In, supra note 41 at 421-23 and sources cited therein.

65 Clark, supra note 4, at 762.

⁶⁶ Id.

⁶⁷ See, e.g., Blair, supra note 29 at 239 ("Management and boards of directors should understand their jobs to be maximizing the total wealth-creating potential of the enterprises they direct"); Blair & Stout, Team Production, supra note 41 at 271 (arguing that primary function of mediating hierarch is to exercise control "in a fashion that maximizes the joint welfare of the team as a whole" (emphasis in original).

⁶⁸ See Blair, Lock In, supra note 41; see also Margaret M. Blair, Reforming Corporate Governance, 1 Berkeley

Bus.L.J. 1, 3 (2004) ("the decision of a firm's organizers to choose one organizational form or another, given the wide array of legal form choices available, should be taken as a signal that the organizers wanted the features of the form they choose In particular, . . . in choosing the corporate form, organizers opt into a series of rules and a body of law . . . that yields important decision rights to

corporate directors.")

69 See, e.g., Del. Code Ann. Tit. 8, Section 102(b)(3)(granting incorporators power to add charter provisions including "any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders....")

70 Stout, supra note 19, at 699.

71 Id. at ns. 73, 74 (citing studies). An even more extreme if anecdotal example can be found in the case of the recent Google IPO, in which Google issued stock with reduced voting rights to public investors. The shares sold readily and appreciated in value despite the lack of control rights. See Lynn A. Stout & Iman Anabtawi, Sometimes Democracy Isn't Desirable, Wall. St. J. at B2 (August 10, 2004)(discussing Google IPO).

72 See, e.g., sources cited supra note 41.

A New Era for Corporate Law

Using corporate governance law to benefit all stakeholders

BY KENT GREENFIELD

Often in discussions about the free market, competition, and the profit motive, we forget that the success of corporations is because of *law*. Both corporations and markets are creations of law, and their fundamental characteristics are legally created.

Distilled to its basics, the corporation is a way for people to come together collectively to pursue business efforts. Without such a form, everything that happens within big businesses—collecting and organizing resources, producing goods or services, getting those goods and services to customers—would have to be done in regular market transactions, with specific contracts dictating the terms and

Law is necessary not only for the existence of the corporation, but equally so for its success. understandings of the parties involved. That would be highly costly and inefficient. The existence of the corporation allows these transactions to be organized within the entity, where they can be supervised by managers who oversee the entire process. This is the explanation for the firm popularized by Nobel Laureate Ronald Coase. As he theorized, compared to a situation where people could work together only after negotiating a contract

for every task, the corporation is superior in that it allows various resources—labor and capital—to be collected and used without negotiating price and terms for each use. Other scholars building on Coase's work have focused persuasively on the ability of the corporation to gather resources from a variety of contributors and to organize those resources efficiently to create value.

But this process does not occur, and never has occurred, "naturally." The corporation exists

because the government has created the corporate form and endowed it with certain characteristics. These traits include, most importantly, the liquidity and transferability of shares; the protection of shareholders from personal liability for the debts of the business; and a perpetual existence of the corporation separate from its shareholders.

These characteristics are powerful. The easy transferability of shares allows thousands, or even millions, of small investors to finance the equity portion of a company. This, in turn, allows companies to amass enough capital to overcome high barriers to entry in a market sector, to take advantage of economies of scale in production or marketing, and to survive short-term downturns in the market.

Limited liability for shareholders reassures capital investors that they will not suffer personal liability if the company fails or is unable to pay its debts. The separate legal existence of corporations makes it possible for them to be sustained over time, even as shareholders, employees and management change. Moreover, the separate existence gives the corporation the capacity to sue and be sued, which allows it to protect its contractual rights in court and to reassure its business partners (not to mention workers, creditors, and the government) that it is subject to contractual and legal obligations that are enforceable in court.

But the legal characteristics bestowed upon the corporation comprise only part of the relationship between law and corporations. Law is necessary for all the various stakeholders in the firm to trust the company enough to be willing to give up control over their resources—whether money or labor or supplies—for the company to use. The law imposes obligations of disclosure and truthfulness on the corporation, so that financial investors have the information they need to determine whether they should invest in any given company. The law also requires companies to be truthful about their products or services and, if the company's products are flawed or dangerous, the law requires that the company redress the harm. The law prohibits companies from discriminating against employees on the basis of race, sex, disability, and the like, to help reassure workers that they

can invest their time and effort in a company and hope to be promoted and paid fairly.

In short, law is necessary not only for the existence of the corporation, but equally so for its success. Law creates the mechanism through which so many investors—whether they invest money or labor—can come together to create wealth. And, law is necessary to build the trust required for the mechanism to actually work.

The legal framework that creates corporations rightly is considered a subsidy for business, as

Why are shareholders the only contributors to the firm whose interests count in the directors' fiduciary duties?

it explicitly encourages and facilitates wealth creation. At a broad level, society establishes the legal framework in which corporations can succeed in order to empower them to be engines of wealth creation in the economy. Corporations are not the only engine of wealth creation, of course, as governments, universities, small businesses, individual entrepreneurs, inventors, nonprofit organizations, and even stay-at-home parents contribute to the creation of

wealth in its many forms. Public corporations do, however, occupy a special place. They are specially constructed so that making money is their comparative advantage. It is a mistake, therefore, to assume that corporations should act altruistically in the same way as churches, families, schools, or social service organizations. Corporations are institutions with a distinctive purpose, and that purpose is to make money. If they stop making money, they have failed. It is the law that facilitates the conditions in which they can achieve this goal.

The Management Team as Steward

Of course, the corporation itself is an artificial entity, and it has no capacity to do *anything* except through the actions of people. The law—specifically *corporate* law—steps in here as well, setting up the board of directors as the body that is responsible for managing the company and acting on its behalf. The board, in turn, delegates power to senior executives, who delegate it to middle

management, who delegate it to lower-level supervisors, and so on. This managerial structure has important efficiency benefits, helping the corporation create financial surplus by ensuring that professional managers with a high level of expertise oversee company operations.

Moreover, the very structure of the board is a critical aspect of corporate success. Instead of a hierarchy topped by a single autocrat, the apex of a corporation is occupied by a multimember body that functions as a group decision maker for the most important questions that the company faces. The benefits of group decision making are significant and, in many cases, so outpace individual decision making that the success of groups is not only higher than the average individual in the group but better than the best individual in the group. Scholars have presented various explanations for the superiority of groups in decision making, and they essentially correlate with what one would intuit from everyday human experience. Groups are able to identify and dismiss individual biases more quickly than individuals themselves. Groups can pool their best resources, creating multiplier effects among the abilities of the individuals in the groups. Groups take advantage of different perspectives. All this matches with what we see in wide areas of public life—from Congress, to administrative agencies, to universities. As it turns out, in most cases two heads are indeed better than one. A common challenge in corporate governance is how to utilize the distinctive capabilities of the management team most effectively without giving it so much independence that it will ignore the concerns of those who contribute to the company's success. Here, the law steps in again, and it does so in several ways. With regard to shareholders, the law requires that management owes them fiduciary duties of care (staying informed), loyalty (no stealing or self-dealing), and good faith (acting with pure motives). With regard to other stakeholders, the managers have no duties arising from corporate law, but they do have obligations arising from other areas of law, such as employment law, consumer protection law, environmental law, and the like. The kinds of obligations are different—more on that in the next section—but it is important to notice that law is both the grantor of the board's

authority, and the imposer of constraints on the boundaries of that authority.

The Tension Between Shareholder and Stakeholder Interests

Within the firm, management's principal mission is to bring together and coordinate the team of resources—including financial capital, human capital, and infrastructural support necessary to produce goods or services for profit. In order to gather these resources, management must establish trust with stakeholders so that they trust the management enough to hand over their resources to the firm. If trust is established, owners and financial investors, whether shareholders or bondholders, will provide money; employees will invest their time, expertise and sweat, and develop their skills to be more productive; and communities will build roads, sewers, and industrial parks. The company is the mechanism through which all of these investors come together to produce wealth, and the one thing that unites them all is that none of them are contributing to the company out of altruistic motives. They are all investing in the company in hopes that they will gain a financial or social return on their investment. How to make this a reality is the job of management.

Even though the management must organize the entire team for the corporation to succeed, under current law the fiduciary duties of management (care, loyalty, and good faith) run only to one part of the team; namely, the shareholders. The substance of the duties

A firm that makes money for shareholders does not necessarily create wealth for other stakeholders. relates to management's actions toward shareholders—for example, the duty of care obligates the board to be informed about the implications of board actions for shareholders—and only shareholders can sue to enforce the duties. In fact, many courts through the years have interpreted these duties to require not only that management look after the interests of

shareholders, but that they strive to *maximize* the return to shareholders. More importantly, the market power of shareholders is the

strongest of any corporate constituency, which means that shareholders' special legal status is further bolstered by their preeminent market status

All in all, what this means is that because of a mix of law, norms, and pressure from Wall Street, corporate managers feel obliged to put shareholders first, even if other stakeholders are harmed, and even if the benefit to the shareholders does not outweigh the harm to others. In concrete terms, if the board of directors of a public company makes a decision that benefits its employees financially but imposes even minimal costs on shareholders, for example by fully funding a pension fund where such funding is routinely avoided by the company's competitors, such a decision would not only make a lot of people on Wall Street very nervous, it would violate existing corporate law. The board would be violating its duties to shareholders even if it had determined that the benefits to the employees would far outweigh the costs to the shareholders

It is easy to understand the law's insistence that management look after the interests of shareholders. They are important contributors to the firm. When managers disregard the interests of shareholders, for example by taking exorbitant compensation unrelated to performance or by engaging in accounting fraud to overstate earnings, it is a serious matter and executives should be held accountable. (When they are not held accountable, there is a justified outcry, not only from Wall Street but from Washington as well.) But why are shareholders the only contributors to the firm whose interests count in the directors' fiduciary duties? Other stakeholders (employees, communities, creditors, suppliers) are investors in the firm as well, handing over valuable resources and trusting management to use those resources wisely to create wealth for all. So the question of shareholder supremacy is an important one: why does corporate law exclude concern for stakeholders other than shareholders?

The Question of Ownership

One might answer by pointing out that the shareholders are the owners of the corporation. But that is not true. Shareholders are not owners in any traditional sense of ownership.

Shareholders do not have the right: to gain access to the company's place of business; to exclude others from the property; to decide upon the use of the property on a day-to-day basis; or practically any other right usually associated with the ownership of a piece of property. Moreover, little distinguishes the contributions shareholders make to the firm from those of other stakeholders. Shareholders own their shares, of course, but bondholders own their bonds, suppliers own their inventory, and workers "own" their labor. Each of these owners contributes property to the corporate enterprise, not as a charitable act but as an investment from which each expects to make a profitable return. Further, the input of each is essential to the success of the firm.

To say that shareholders are the only "owners" is to say that there is something inherent in the act of contributing money to buy shares—or in the definition of "ownership" of shares—that distinguishes that act from the contribution of money to buy bonds issued by the company, the supply of raw materials to be refined by the company, or the investment of human labor to be used by the company. In any event, the notion of ownership is *itself* a legal construct. Whether shareholders should be seen as owners is, in effect, the question to be asked, not the answer to the question.

Trickle-down?

The next claim that is often made in support of shareholder primacy is that corporate managers need not worry about nonshareholder interests, since looking after shareholders will inevitably benefit other stakeholders as well. This is the argument that companies do well by doing good, or do good by doing well. At a simple level, this claim can be true. A failing company is not much good to anyone with any sort of investment in the firm, whether that investment be in the form of labor, money, or infrastructural support. But when we look past this narrow circumstance, the claim becomes much more dubious. A firm that makes money for shareholders does not necessarily create wealth for other stakeholders. Without a mechanism to force a corporation to absorb externalities or to share gains among all stakeholders, there is no automatic or necessary gain on the part of workers or society, even when the company is highly profitable. The trickle-down is not

inevitable. Indeed, shareholder profit could even result in a transfer of wealth *from* the company's employees, or from society generally, *to* the shareholders. For example, by some accounts, Wal-Mart employees' wages are so low that its workers must subsist on a range of government assistance programs. (According to one Congressional study, the federal taxpayers subsidize Wal-Mart by over \$2000 per employee per year.²) If this in fact is accurate, then government programs are subsidizing the profits of Wal-Mart shareholders. And the profits of Wal-Mart may be negatively correlated with social welfare, at least in this respect.

Moreover, a decision-making calculus that takes shareholder interests as its goal will result at times in decisions that are overly risky, from the standpoint of society as a whole. Remember that the law protects shareholders by limiting their liability for the debts of the firm. That means that shareholders suffer only a portion of the costs of the corporation's bad decisions. If a company throws the dice on a risky product in hopes of a big payoff, but the product results in heinous injuries to consumers, the company has to pay but the shareholders do not. If the company has no money left to pay those it has injured, then the victims are left to pay their own medical bills. Even if the shareholders are flush and the risks were taken in hopes of benefiting them. This creates what economists call a "moral hazard," which means simply that when the costs of bad decisions are not borne by those who influence the decision, more bad decisions will be made. When shareholder concerns dominate corporate decision making to the exclusion of other stakeholders, corporations will tend to make decisions that will be riskier than they would if other stakeholder concerns were weighed in the calculus. Shareholders may not have to pay for bad decisions, but someone does. On a societal basis, all costs have to be paid. There is no such thing as a "limited liability society" in which society contributes to the corporation in very meaningful ways (providing workers and property) without fear of bearing the negative impact of its operation. All this is to say simply that a rule that puts shareholders first is not necessarily a rule that benefits other stakeholders, or society in general.

More Responsibility Means Less?

Another argument made in favor of excluding non-shareholder stakeholders from the concerns of corporate management is that a broadening of corporate responsibilities is counterproductive because managers can use the additional responsibilities to avoid responsibility. To illustrate, if corporate managers have more than one master, they can play masters off of one another, as a child might do with parents. Instead of the manager actually serving all stakeholders, she will be loosed from obligation to any. Economists call this an "agency cost" problem. Managers are "agents" of the corporation, and they need to be monitored to make sure they do their job. If their job is to serve more than one "principal," or boss, then it is more difficult to tell if they are doing a good job and thus more costly to monitor them. The argument in the corporate setting is that, because of these extra monitoring costs, the corporation will be made worse off if managers are required to owe responsibilities to more than one stakeholder.

Broadening corporate responsibilities might be more effective than relying on the reactive power of government regulation.

It is worth remarking that this claim is in conflict with the trickle-down argument. If the interests of shareholders and other stakeholders are not in conflict, then agency costs will not rise much if the law requires managers to take into account the interests of other stakeholders. But the trickledown argument is not persuasive, and there is indeed conflict between the interests of shareholders and other stakeholders in a range of cases. This conflict, however, is not a reason to fear that managers cannot handle increased responsibility, or that it would be

impossible to know whether managers were doing their jobs well. It is true, in a simple way, that a person who has two responsibilities may have more difficulty meeting both than if she had only one. But people routinely have more than one responsibility, some of them conflicting, and we do not throw up our hands. In fact, humans are quite accustomed to having a range of obligations, and multiple obligations routinely exist in business institutions. Corporate directors and managers,

in actual practice, regularly balance a number of obligations, some arising from corporate law, some from other areas of law, and some from the market itself. Indeed, it is difficult to conceptualize a manager as doing anything *other* than coordinating myriad duties and obligations, especially in a corporate setting. As described above, the very nature of the corporate form is that it takes inputs from a variety of sources and *manages* them to create wealth by producing goods and services at a profit.

The existence of shareholder agency costs is not itself a persuasive argument, since other stakeholders have agency costs, too. Other stakeholders make important contributions to the firm, and all of them depend on management to use those contributions to create wealth. All stakeholders depend on managers and, therefore, have an incentive to monitor them. A shareholder primacy rule makes it more difficult for these other stakeholders to depend on management, which raises the stakeholders' agency costs. A relaxation of the shareholder primacy model might increase the agency costs of shareholders, but it will decrease the agency costs of non-shareholder stakeholders, which are just as important as shareholders' agency costs.

In a collective enterprise such as a corporation, a shared obligation to a variety of stakeholders makes eminent sense. The "agency costs" that matter are not the costs of monitoring whether the managers do well by the shareholders, but are doing well vis-à-vis the entire enterprise. And enforceable duties running to the entire enterprise would reduce the costs of monitoring whether management were doing well vis-à-vis the entire enterprise. Expanding their duties in this way may make it less likely that management will act like agents of the shareholders only. But that simply begs the question of whether managers should serve only the interests of the shareholders, which is the question with which we started. One cannot answer the question circularly: it makes no sense to argue that shareholders should be supreme because any other rule makes it harder for them to be supreme. To say that only shareholders should have a rule that lowers their agency costs assumes shareholder primacy. In other words, we cannot justify the rule of shareholder supremacy by pointing to

shareholder agency costs, unless the agency costs of other stakeholders are discounted. And they can only be discounted if shareholders are supreme.

The only way that having more and broader responsibilities would make it easier for managers to avoid responsibility is that they could use one obligation as a defense to a claim that they failed to satisfy another. But, this is not a function of the number and scope of responsibilities, but rather how they are enforced. And corporate law duties are simply not enforced in a way that would allow managers to play one duty off the other. Corporate law fiduciary duties have been reduced in recent decades to essentially procedural obligations—to investigate various alternatives, to look at the various possible outcomes, to take the time necessary to make a good decision, to make decisions untainted by self interest, to act in good faith.³ These obligations would not be weakened if they were owed to more stakeholders. On the contrary, adding to the number of people who benefit from managers' fiduciary duties will make it more difficult for managers to violate those duties. More corporate stakeholders will have an interest in monitoring and remedying managerial misconduct. A violation of fiduciary duty owed to all the firm's stakeholders is no more defensible in court than a violation owed to the shareholders alone. It simply would make no sense for an executive to defend against a fiduciary claim by saying he was careless with his duties or disloyal to the company because he owed those duties to more than one stakeholder. Whether by way of carelessness or intent, a theft from both shareholders and employees is no more defensible than a theft from shareholders alone.4

Using Corporate Law to Benefit All Stakeholders

The question of whether corporate law should take into account the interests of non-shareholder stakeholders comes down to whether it is more efficient to regulate corporations from the "outside" or from the "inside." In other words, since the corporation is a creature of law, and is already pervasively regulated, the question is simply whether it would be more efficient to use *corporate* law to oblige businesses to consider the interests of

non-equity investors or to continue to use the existing regulatory structure, which leaves their interests to be protected through costly, ad hoc regulatory initiatives external to the corporate form.

Perhaps it is useful to begin with the acknowledgement that this "external" versus "internal" dichotomy is too simple. Regulations of corporations come in a multitude of forms. Even ones that are seen as external—tax law, for example—often have as a goal the adjustment of behavior within the firm. It is more correct, as a matter of regulatory theory, to characterize the regulation of the corporation as falling into three categories: (1) regulation requiring or encouraging certain results (e.g., pollution laws that prohibit the discharge of certain effluents); (2) regulation requiring or encouraging certain processes or actions (e.g., disclosure laws, nondiscrimination laws); and (3) regulation requiring or encouraging certain internal structures (e.g., a board that is elected by shareholders). When characterized this way, it becomes clear that the non-equity investors typically have to depend on regulatory initiatives that focus on results and on procedures. The only stakeholder that has any significant structural protection within the corporate form are the shareholders. It is this reality that best reveals the norm of shareholder primacy.

Consider the following chart:

ILLUSTRATIVE EXAMPLES OF REGULATORY EFFORTS TO CONSTRAIN AND HARNESS CORPORATE POWER						
Stakeholders	Regulatory Focus					
	Results	Actions/Process	Structure			
Shareholders	Limited liability Profit-maximization "norm" Capital markets (Quasi- legal)	Duty of care Duty of loyalty Disclosure law Anti-fraud law (10b-5) Insider trading law	Shareholder voting for directors Right to sue derivatively Right to vote on major corporate changes			
Workers	Minimum wage OSHA	ERISA (regulates retirement benefits; limited protection only) Tort/ workers' comp law Anti-discrimination law Federal plant closing notification requirements Labor law (limited)				
Community/ Environment	"Command and control" environmental statutes; Superfund, Clean Air/Water Acts, etc.	Tort law Environmental Impact Statements Planning/permitting/zoning processes				
Customers	Contract law Consumer Safety law Regulatory protections (food & drug regs, consumer protection regs, air safety regs, etc.)	Anti-fraud law Tort law Antitrust law				
Creditors	Contract law	Good faith in Contract /Uniform Commercial Code Anti-fraud law Bankruptcy law				

One might think that this chart shows the extent of the regulatory efforts aimed at protecting stakeholders of various kinds, and that nothing else needs to be done. This response would be apt if the interests of stakeholders were, in fact, being adequately protected by these efforts. While some may disagree, another (and, I believe, more reasonable) response to this chart is to question why regulation of the corporate structure—the stuff of corporate law—is not being utilized to its full potential. The empty boxes in the rightmost column represent regulatory gaps and opportunities—presently ignored—to address employee, community and environmental concerns. Whether we should use them is a question of whether the corporation's structure can be adjusted so that its distinctive abilities can be put to greater use.

Of course, the first question is whether there is a *need* to use the distinctive capacities of the corporate form. Even law professors do not

believe regulation is a good in and of itself. Regulation is a tool to address public policy ends, and the questions of what problems demand a public policy response and how best to mold that response should always be asked. The answer to the first question—what problems demand a response?—will be obvious to some, and less obvious to others. Those who need convincing should look to other papers in this series, and to the foundational materials developed by Corporation 20/20 (www.corporation2020.org). In summary,

many people are increasingly convinced that "failures in [corporate] accountability and governance," to use a Corporation 20/20 phrase, have contributed to a number of serious public policy problems. Two worries are particularly acute. First, environmental degradation generally, and global warming in particular, have in part come about because of companies' disregard of the long-term environmental implications of their products, services, or internal operations. Second,

economic disparity, both domestically and internationally, can in part be traced to companies' fixation on the financial wellbeing of the managerial and shareholding elite. The financial windfalls going to the wealthiest among us over the past generation come in part from increased labor productivity, the gains from which have not generally been shared with working people, whose wages have been stagnant for the past 30 years.

So, if we believe that there are public policy problems that are presently in need of further attention or of being addressed more effectively, there is reason to be hopeful that changes in corporate governance law is indeed an important tool to consider. It is often cheaper to avoid a problem than to rectify it later, and it is often better to give the responsibility to avoid a problem to the person who knows most about it and can avoid it at the least expense. As such, corporate law may have comparative advantages over other kinds of law in addressing the concerns of its stakeholders.

For example, because the central purpose of the corporation is to create wealth, broadly defined, it is likely to be more efficient to have the corporation distribute it among those who contribute to its creation rather than having government redistribute the wealth after the fact. Making sure all Americans have sufficient resources to live in dignity is an important public policy objective, and it may be more efficient to distribute the corporate surplus fairly as an initial matter by using the internal mechanisms of corporate governance rather than settling up after the initial distribution by using tax and welfare laws to achieve economic fairness.

Further, a fair distribution of corporate profits to employees, for example, will likely have significant positive multiplier effects (such as workers being more productive because they feel they are being fairly treated) that would not likely occur with later governmental redistribution initiatives. Moreover, in dealing with issues such as economic wellbeing or environmental sustainability, corporate managers may have expertise that government bureaucrats do not, and there may be efficiencies and innovation in a corporate setting that do not exist in a governmental setting. A broadening of corporate

responsibilities would allow corporations and their management to be proactive in addressing issues of social concern which, in turn, might be more effective than relying on the mostly reactive power of government regulation.

In the end, if we believe that non-shareholder stakeholders need more regulatory protection than they now receive, then it is foolish and inefficient as a matter of public policy to leave corporate law as an untapped resource. Using corporate law to adjust the composition or duties of the board to force the consideration of stakeholder interests could be a powerful tool, not only to rein in the worst excesses of the corporation but also to take advantage of the unique capabilities of the corporation to achieve important gains in social welfare.

The Benefits of Stakeholder Governance

To bolster this point with a concrete example, let us examine how adjustments in corporate governance could be used efficiently to bring about gains in societal wealth. Start with the reminder of our initial assertion, that the corporation is immensely successful in creating wealth. But because of the narrow fixation on shareholder benefit imbedded in the market, social norms and corporate law, non-equity investors (employees, communities, etc.) are often shortchanged in the distribution of the wealth they help create. Even though the corporation is a collective enterprise when it comes to inputs, the distribution of the outputs is determined by a body—the board—that is dominated by representatives of only two stakeholders: the shareholders and the senior management. Changing this arrangement has the potential not only of improving the corporation's ability to create wealth, but also of addressing serious and enduring social and economic ills. Almost certainly, if senior managers were required to consider the interests of the firm more broadly—to include the well-being of all investors, equity or non-equity—in their decision-making calculus, the firm would be more successful in satisfying the social goal of creating wealth, broadly defined.

Stakeholder concerns could be added to the firm's decision-making calculus in a couple of ways. First, the fiduciary duties of

management could simply be expanded to include a requirement that management owes a fiduciary duty to the firm as whole, rather than the shareholders alone. Once the fiduciary duties run to the entire firm, and the firm is seen as a collective enterprise, then managers will be unable to meet their duties by fixating solely on the interests of shareholders.⁵

A more powerful change would come when it is acknowledged that a duty to the firm as a whole—which includes a duty to a range of stakeholders—would be best effected by providing some mechanism for non-shareholder stakeholders to elect their own representatives to the board. While the duties of care and loyalty are crucial, they have little connection to the problem of fair allocation of the corporate surplus. The best way to have the board make such decisions is to have the important stakeholders represented there.

The benefits of stakeholder representation on corporate boards would be significant. First, it would be better for firms themselves over time. Because corporations are a collective effort, the key to sustainability is for those who contribute to the firm to believe that the firm can be trusted. Broadening stakeholder representation will help build this trust, ensuring that all stakeholders will be willing to make investments in the firm (whether by way of financial investments or investments in terms of labor or expertise). For example, workers who believe they are treated fairly tend to work harder, be more productive, obey firm rules more often, and be more loyal to their employers. This, in turn, likely makes those firms more profitable than they would have been absent such fair treatment.

Second, this change likely would benefit society broadly by distributing corporate wealth more fairly and more efficiently. Current public policy tools that redistribute wealth and income tend either to take effect after the initial distribution of financial wealth (e.g., taxes, welfare policy), or tend to benefit only those at the lowest rung of the economic ladder (e.g., the minimum wage). These mechanisms are notoriously inefficient. A stakeholder-oriented corporate governance system would operate at the initial distribution of the corporate surplus and would benefit stakeholders up and down the economic

hierarchy and earlier in the wealth creation process.

Stakeholder governance would also improve managerial decision making. The success of corporations comes about in part because of their dependence on a group decision maker at the top of the hierarchy. But the benefits of group decision making are drastically diminished, and sometimes undermined completely, when the group is too homogeneous. In fact, more and more studies show that good decision making requires a diversity of viewpoints. As Cass Sunstein has observed, conformity among people in a decision-making group inevitably breeds error. Dissent is essential, and sometimes "social bonds and affection" can suppress dissent. Sunstein notes, "if strong bonds make even a single dissent less likely, the performance of groups and institutions will be impaired." He extends the points to corporate boards: "The highest performing companies tend to have extremely contentious boards that regard dissent as a duty and that 'have a good fight now and then."8

If homogeneity is a flaw, then corporate boards are indeed suboptimally constituted. At present, corporate boards are among the least diverse institutions in America. A 2002 survey found that 82 percent of the director positions on Fortune 1000 companies were held by white men, while only 11 percent were held by white women, 3 percent by African-Americans, 2 percent by Asian-Americans, and 2 percent by Hispanics. Only 8 percent of public companies have three or more female directors, and only 6 percent of public companies have three or more directors who are ethnic minorities. 10 These statistics reference only racial and gender diversity, but the point is likely even stronger when it comes to diversity of perspective and background. This homogeneity is a function of legal decisions—giving the right to choose board members to shareholders, and shareholders alone. But this could be changed through law,

Making the board less homogeneous may make decisions less tidy, since more views will have to be taken into account. The board will be forced to compromise so that decisions are acceptable to a majority or plurality of stakeholders. Decision making will thus be

more deliberative and perhaps slower, but is this necessarily injurious to the firm? That decisions will be more deliberative is not, in itself, a reason to refuse to improve boards by introducing a range of views and perspectives. The real question is whether additional diversity results in decisions that are worth the extra effort.

On this point we can gather insight from our experiences outside of business. The notion that decisions produced by a finely wrought process of dialogue and compromise are better than decisions made unilaterally by a uniform group of individuals is widely accepted by institutions other than corporate boards. We recognize in legislative bodies, administrative agencies, school faculties, and non-profit boards that a diversity of viewpoints increases the likelihood that dissent will be welcomed, important perspectives will be heard, and decisions will be more fully vetted. Notwithstanding the unique attributes of the corporation and the intense competitive environment in which it operates, one may make the case that the same is true in corporate governance.

Conclusion

Corporations are a creation of law, and they are regulated pervasively by various aspects of the legal system. Law is essential to make the corporation successful as an institution that collects various inputs and uses them to create wealth. At present, *corporate* law takes a very narrow view of the obligations of corporate management and, in discussing ways to reform the corporation, it is essential that *corporate* law be a focus of the conversation.

Corporate law reform represents an area of significant promise in addressing issues of social concern. If corporate management were required to owe fiduciary duties to the firm as a whole, or if corporate decision-making bodies included representatives of various stakeholders, the unique and powerful capabilities of the corporation could be put to use to create wealth and to distribute it broadly, and to do so more efficiently than through existing regulatory options.

Under present law, a corporation meets its obligations if it creates wealth only for its shareholders. But this is a stingy and narrow view of the corporate purpose. As Jonathan Swartz, President and Chief Executive Officer

of Sun Microsystems said, "[B] eing a responsible corporate leader is all about creating value. For shareholders, employees, customers, and the communities in which we operate." 11

For this goal to be made real, law needs to be changed so that the law embodies the principle rather than obstructing it.

FOOTNOTES

- 1 See generally Margaret M. Blair and Lynn A. Stout, *A Team Production Model of Corporate Law*, 85 Va. L. Rev. 247, 1999.
- 2 George Miller, Everyday Low Wages: The Hidden Price We Pay for Wal-Mart, House Committee on Education and the Workforce, Feb. 14, 2004. Available at http://edworkforce.house.gov/democrats/WALMARTREP ORT.pdf.
- 3 See Stephen Bainbridge, "Corporate Decisionmaking and the Moral Rights of Employees: Participatory Management and Natural Law," 1998, (Available at SSRN: http://ssrn.com/abstract=132528) at pp.v52-54 (discussing procedural requirements of duty of care).
- 4 A more developed version of this argument can be found in Kent Greenfield, *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities*. Chicago: University of Chicago Press, 2006.
- 5 Some scholars believe that this is in fact the best statement of current law, and there are cases that seem to stand for that proposition. See generally Blair and Stout, *supra*. I do not agree with their descriptive claim that current corporate law protects all stakeholders, but the fact that there is discussion at all means that this adjustment would be less stark than one might suppose at first glance. 6 For a more detailed analysis, see Kent Greenfield and Gordon Smith: *Debate: Saving the World with Corporate Law?*, forthcoming in Emory L.J., 2007.
- 7 Cass R. Sunstein, *Why Societies Need Dissent*, Cambridge: Harvard University Press, 2003, p.27. 8 Ibid. At 28, quoting Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, 80 Harv. Bus. Rev. 106, 111, Sept. 2002.
- 9 Microquest White Paper, Shattering the Glass Ceiling, available at http://www.mqc.com/glass_witeppr.html. 10 Ibid. See also Humprey Taylor, The Harris Poll, The Enron Effect: The American Public's Hostile Attitudes Toward Top Business Managers, (2002) available at: http://www.harrisinteractive.com/harris_poll/index.asp?PI D=334.
- $11\ See\ http://www.sun.com/aboutsun/csr/2006 report.pdf$

More Than Corporations

A new economy for a new era

BY DAVID C. KORTEN

The day of reckoning for our reckless human ways has arrived. Global warming, the end of cheap oil, exhaustion of fresh water, and spreading social dislocation are all consequences of monumental imbalances we humans have created in our relations with one another and with the earth.

The choices we make as a species at this defining evolutionary moment will determine whether the inevitable correction plays out as a last-person-standing competition for what remains of the earth's resources or a

Change begins with looking to life, rather than money, as the true measure of wealth.

cooperative stewarding and sharing of those resources to secure the health of all our children, families, communities and natural systems for millennia to come.¹

Reversing the present downward spiral of accelerating social and environmental disintegration will require a

deep transformation of economic priorities and institutions to democratize economic power and achieve a radical reallocation of the earth's diminishing resource base from uses that serve money-making to those that serve life. Curbing the abuse of corporate power is central to the needed transformation, but is only one piece of a larger agenda—a work of epic proportions best understood in its deeper historical context.

Empire vs. Earth Community

For 5,000 years, we humans have organized our relationships with one another and with the

earth by a dominator hierarchy, denying the humanity of the many to privilege the few, and devoting precious resources to the armies, propaganda, and retainers required to secure elite rule. The resulting hierarchy of power and privilege creates a winner-take-all, rule-or-beruled, win-or- perish dynamic of violence and oppression. This has been the human way for five millennia. Call it the Era of Empire.

The favored institution of imperial rule has morphed from the city states of ancient time, to the nation states of modern time and, most recently, to the global corporations that presently dominate economic life. The underlying pattern of exclusion and domination, however, has remained largely unchanged.

The imperial economy has created unsustainable social imbalances between rich and poor and environmental imbalances between human demands and the regenerative capacities of Earth. Changes that merely tweak the rules of the old economy at the margins may slow the downward spiral, but they will not in themselves restore the dynamic balance required for long-term survival and prosperity. The defining challenge of our time is to transform our economic system from the bottom up by bringing forth living economies that root power in community, balance individual and community interests, and support a cooperative sharing of resources. Simultaneously, we must reallocate available resources from uses that fuel the imbalances (military, advertising, and financial speculation) to uses that restore balance (environmental regeneration, health, education, and productive investment), and give priority to the needs of those the old economy excludes and represses (the desperate, hungry and indentured). Success will depend on changing the story that currently frames public debate about economic policy choices.

Competing Prosperity Stories

The legitimacy of the imperial global economy rests on a particular story of prosperity and the path to its achievement. I call it the Empire prosperity story. The following are its basic tenets:

- Money is the measure of wealth and the proper arbiter of every choice and relationship.
- Unregulated markets allocate resources to their most productive and highest value use.
- Economic growth fills our lives with limitless material abundance, lifts the poor from their misery, and creates the wealth needed to protect the environment.
- Economic growth depends on wealthy people who have the financial assets to invest in creating the new wealth that enriches us all as the benefits trickle down. Celebrate the good fortune of the rich and free them from the taxes and regulations that limit their incentive and capacity to invest. Inequality is an essential condition of prosperity.
- Poverty is caused by welfare programs that strip the poor of motivation to become productive members of society willing to work hard at the jobs the market offers.
- Eliminate market regulations, economic borders, taxes on the wealthy, and welfare programs and we all prosper.

This story conditions us to accept an economic system designed to make rich people richer as just and beneficial to all, and to believe that community and collective action are sources of oppression that limit freedom and progress. Endlessly repeated by corporate media and taught in economics, business, and public policy courses in our colleges and universities almost as sacred writ, it creates a cultural field that dulls our ability to envision alternatives.

Change begins with an Earth Community prosperity story that looks to life, rather than money, as the true measure of wealth, and celebrates our potential to create peaceful, caring, and compassionate societies in which humans live in balance with one another and Earth. Here are some of its essential elements:

 Healthy children, families, communities, and ecological systems are the true measure of wealth.

- Mutual caring and support are the primary currency of healthy families and communities and community support is the key to economic security.
- Wealth is created by investing in the human capital of productive people, the social capital of caring relationships, and the natural capital of healthy ecosystems.
- A finite world with over-stressed ecological systems can end poverty and heal the environment only by reallocating material resources from rich to poor and from lifedestructive to life-nurturing uses. Equality is an essential condition of social stability, environmental health, and democracy.
- Markets have a vital role in a healthy community, but democratically accountable governments must secure community interests by assuring that everyone plays by basic rules that internalize costs, maintain equity, and favor human-scale local businesses that honor community values and serve community needs.
- Economies must serve and be accountable to people, not the reverse.

Although rarely heard, most people immediately recognize this story's profound truth, which negates many of the central premises of the imperial prosperity story that currently shapes economic policy and practice.

The contrasting stories of Empire and Earth Community reflect very different defining beliefs about the nature of prosperity, economic growth, human nature, the human interest, and the desired structure of society. The Empire prosperity story reduces life to a commodity valued only for its contribution to making money. Furthermore, it assumes that humans are inherently competitive, violent, and individualistic beings incapable of living as responsible members of caring communities in the absence of a dominator system of elite rule. The Earth Community story affirms the integral human connection to the larger community of life. It embraces life as the measure of value and love as the primary currency, and it recognizes the inherent human capacity for cooperation, compassion, and responsible citizenship. See Table 1 for a

summary of key distinctions between the contrasting belief systems.²

Table 1: Defining Beliefs

	Empire Economy	Earth Community Economy
Prosperity	Prosperity is measured by the rate of growth in the money value of economic output.	Prosperity is measured by the health and productive potential of human, social, and natural capital.
Economic Growth	Economic growth is a process by which rich people create more wealth for all by investing to increase economic output of goods and services as measured by market value.	Economic growth is a process by which the rich expropriate resources to make money for those who have more than they need. The resulting imbalances lead to social and environmental breakdown.
Human Nature	Humans are by nature individualistic, violent, greedy and competitive.	Psychologically healthy adult humans are cooperative, caring, creative, and find meaning in service.
Individual vs. Group Interests	We are each on our own. Compete to win at any cost. Victors prove their superiority and justly deserve the spoils.	We are in this together. Cooperate to create a world that works for all. Service is the path to mutual prosperity, security, and happiness.
Investment Priority	Grow financial assets.	Grow human, social, and natural capital.
Favored Class	Prosperity and democracy depend on a wealthy investor class with financial resources to invest in economic expansion. <i>Inequality</i> is essential to social order and prosperity.	Prosperity and democracy depend on a strong middle class with minimal extremes of wealth and poverty. <i>Equality</i> is an essential condition of justice, sustainability, and social health.

Once we begin to look at investment decisions through the living lens of Earth Community rather than the financial lens of Empire, we begin to see enormous potential for the beneficial reallocation of real resources. We can reallocate from military expenditures to health care and environmental rejuvenation, from automobiles to public transportation, from investing in suburban sprawl to investing in compact communities and reclaiming forest and agricultural land, from advertising to education, and from financial speculation to local entrepreneurship. For the vast majority of people this reallocation will bring significant improvements in the quality of their lives even as the quantity of their consumption declines.

The champions of Empire dismiss any such reordering of priorities on the ground that it will bring economic disaster and unbearable hardship. They ignore the simple fact that those results are already the lot of roughly half of our fellow humans. The proposed reordering can avoid the spread of that hardship and begin to alleviate the existing suffering.

Economic reallocation and democratization are no longer simply moral issues. They are imperatives of human survival and must replace economic growth and the pursuit of financial gain as the defining purpose of economic life.

The work of bringing forth a new economy grounded in living system principles begins with spreading the Earth Community prosperity story. Although a story so contrary to the prevailing Empire story is likely to be greeted with initial skepticism, the Earth Community economy story enjoys the ultimate advantage, because it expresses the truth most of us recognize in our hearts that if our children, families, communities, and natural systems are healthy, we are prosperous. In an economy with a properly designed money system, whether conventional financial indicators such as GDP or the Dow Jones Stock Index rise or fall would be irrelevant.³

False Prosperity

The Empire prosperity story makes money the sole measure of value and embraces money making as the primary goal of economic life. In so doing, it legitimates both the predatory

behavior of for-profit corporations and an economic system designed to maximize returns to money—to people with money—and to disregard social and environmental consequences.

Global economic growth has tripled the market value of economic output since 1970 which, by the reckoning of the prevailing prosperity story, would indicate that we humans have tripled our wealth and well-being. This growth feeds a global financial system now awash in financial capital—money—looking for returns of upwards of 10 to 20 percent a year. By money indicators, it seems we are a very wealthy species.

In contrast to the indicators of financial capital, indicators of health of the planet tell a very different story. The Living Planet Index, an indicator of the health of the world's freshwater, ocean, and land-based ecosystems,

Economic output has tripled since 1970, while the Living Planet Index has declined by 30 percent.

declined by 30 percent since 1970.⁴ According to the Millennium Ecosystem Assessment, 15 of 24 ecosystem services examined "are being degraded or used unsustainably, including fresh water, capture fisheries, air and water purification, and the regulation of regional and local climate, natural hazards, and pests."⁵

Indicators of human capital—the skills, knowledge, psychological health, capacity for critical thought, and moral responsibility characteristic of the fully functioning person—and of social capital—the enduring relationships of mutual trust and caring that are the foundation of healthy families, communities and societies—point to equally unfavorable trends. By the measure of financial capital, we humans are on a path to limitless prosperity. By the measure of living capital, the aggregate of human, social, and natural capital, we are on a suicidal path to increasing deprivation and ultimate self-extinction.

Financial capital, or money, is only an accounting chit, a number of no substance or inherent utility or value except for the fact that

we are culturally conditioned to accept it for things of real value. It has no existence except in our minds.

By contrast, measures of living capital are measures of healthy human development, social cohesion, and the capacity of the planet to sustain life. They are the measures of real wealth. Growth in financial capital claims against the shrinking pie of real living capital wealth essential to life increases competition for what remains of this shrinking pie and accelerates the depletion.

At the societal level, we properly focus on growing the real wealth of living capital as our measure of economic performance. Measures of financial capital should be of interest primarily for assessing performance on equity, and for keeping money supply in balance with what is needed to facilitate the exchange of real goods and services. We have for far too long confused measures of real wealth with measures of money, the accounting chits we agree by social convention to accept a medium of exchange.

The High Cost of Making Money

Two other trends accelerate the crisis. First, population growth continues to diminish percapita shares in the shrinking pie of living capital resources on which our lives depend. Second, there is a growing concentration of the claims to that shrinking pie.

According to a recent UN study, the richest 1 percent of the world's adults now own 40 percent of all global assets. The poorest 50 percent own only 1 percent. This distribution of ownership is a proxy measure for the global distribution of power—and the gap is growing at an accelerating rate. The greater the inequality, the greater the power of the privileged minority to change the rules to accelerate their expropriation of the declining pool of real wealth, and the greater the hardship and desperation of those excluded.

It took me many years in my work abroad as a member of the foreign aid establishment to wake up to the obvious fallacy underlying the idea that advancing economic growth by maximizing returns to money is the key to ending poverty and healing the environment. It begins with the simple truth that maximizing returns to money means maximizing financial

returns to people who already have money; i.e., making the rich richer. All too often, what conventional economic growth indicators actually measure is the rate at which the rich are expropriating the resources on which the majority of the world's people depend for their modest livelihoods, and converting them to products destined for a garbage dump after a brief useful life, to generate financial assets for people who already have more money than they need.

Perhaps the most perverse of the many distortions of the Empire prosperity story is the idea that the market rewards people with money in proportion to their contribution to creating new wealth that eventually trickles down to benefit everyone. Therefore, so the advocates of market fundamentalism would have us believe, it is petty, perhaps even immoral, to begrudge the wealthy their just reward.

A telling negation of this claim is found in the 2006 compensation packages of the heads of four major Wall Street hedge funds—each of whom received compensation packages of more than a billion dollars in a single year. According to the *New York Times*, the highest paid among them received \$1.7 billion, which is roughly the amount the U.S. federal government spent in that same year to maintain the vast network of national parks. Are we to believe that this hedge fund manager provided a comparable service to the nation and humanity by generating outsized profits from financial speculation?

Corporate behavior can range across the moral spectrum from saintly to sociopathic.

By design, the financial system of the Empire economy grows the financial assets of people who live by returns to money, while minimizing the financial rewards to those who live by returns to their labor. If financial speculation does not contribute directly to the depletion of living wealth, the extravagant lifestyles enjoyed by successful speculators and their clients surely do.

Promoting Immoral Behavior

A corporation is an artificial legal entity created by a government through the act of

issuing a charter that grants the holder the privilege of aggregating financial resources in the service of the corporation's defined purpose. The legally defined purposes can range from pure private-benefit to pure public-benefit—with many possibilities in between. Most city and municipal governments are corporations. Associations, unions, and cooperatives all have legal corporate identities. Corporate behavior, much like human behavior, can range across the moral spectrum from saintly to sociopathic.

Generally, the law sets saintly standards for public-benefit corporations and sociopathic standards for private-benefit corporations. Public-benefit corporations are expected to serve only public interests in disregard of any private interest of its officers. Private-benefit corporations are expected to serve only the narrowly defined private interests of its officers and shareholders in disregard of community norms and interests. That a government would grant to any entity a public charter bestowing special powers and privileges to serve purely private interests at the expense of public interests is a moral anomaly with an infamous history.

The legal form of the contemporary for-profit, limited-liability corporation is an invention of imperial kings eager to contract out to private entities the work of colonizing and exploiting the resources of distant peoples. The design, by intent, allowed the virtually unlimited concentration of financial power accountable solely to the monarch and a group of favored investors. Generations of corporate lawyers have worked diligently since to increase the legal privileges of for-profit corporations, narrow their purpose to the single goal of increasing the financial assets of their shareholders, and limit their liability for the resulting harms.

The British East Company, chartered in 1600 by the British Crown, was the original model. It conducted a thriving drug trade in China that precipitated the Opium War of 1839 and ruled India for many years as if it were a private estate. The Dutch Crown chartered the United East India Company in 1602 and vested it with sovereign powers to conclude treaties and alliances, maintain armed forces, conquer territory, and build forts to establish and enforce a monopoly over Dutch trade in the

lands and waters eastward from the southern tip of Africa to the southern tip of South America. These corporations were essentially criminal syndicates officially sanctioned by their home jurisdiction to engage in criminal activities in foreign jurisdictions.

Unlimited aggregation of financial assets means unlimited power. Globalization extends that power beyond the reach of accountability to any state or public body. Limited liability is an invitation to use that power irresponsibly. Public-share markets commodify corporate shares, depersonalize the relationship between the corporation and its owners, and eliminate the need for enduring commitment. A perceived legal requirement to manage the corporation in the exclusive short-term financial interest of its shareholders suppresses the innate human sense of moral responsibility, feeding an immoral culture

It should be no surprise that a world so driven by narrow financial self-interest is in serious trouble.

within the corporation. Together these features create an extreme form of absentee ownership that strips decision making of the constraints of conscience and public accountability.

Continuing reports of highlevel corporate crimes should not be surprising. It is wholly logical that the power-driven and ethically challenged are attracted to positions of outsized power

that largely absolve them from personal accountability for harms to others. It is also logical that institutions solely dedicated to shareholder return would actively recruit executives psychologically capable of firing thousands of employees, selling defective products, engaging in monopoly pricing of life-saving drugs, denying essential life-saving medical services to policyholders, and releasing toxic substances into the air and water without hesitation or regret. High-profile criminal prosecutions send a few of them to jail, but the risk of jail is miniscule relative to the lavish rewards corporate executives enjoy.

Fortunately, the ranks of politicians and corporate executives include individuals of a mature consciousness committed to maintaining the highest of ethical standards, but they often find themselves at a

disadvantage, competing against those unburdened by conscience.

It is also noteworthy that economists have crafted an intellectual justification for this moral bankruptcy. Milton Friedman, the Nobel Prize-winning leader of the Chicago School of Economics, has proclaimed that a doctrine calling on a monopolist to sacrifice his own interests to some larger public interest would "destroy a free society."

It should be no surprise that a world so driven by narrow financial self-interest is in serious trouble. Humans are capable of so much more.

Potentials of the Mature Consciousness

Persistent propagation of the idea that humans are by nature violent and greedy is itself a moral travesty. As every parent knows, we each come into this world as a self-centered being who lives wholly in the present—aware only of our immediate comfort and discomfort, incapable of recognizing and accepting responsibility for our own actions, and dependent on magical protectors for our survival. This is why children need parents. With the necessary emotional support from family and community, however, most of us grow up to be responsible, compassionate adults, capable of accepting moral responsibility for our actions and behavior as good citizens who play by the rules and contribute to our communities without expectation of material reward. Furthermore, we have the capacity in our full maturity to achieve the inclusive wisdom of the revered statesperson, teacher, tribal elder, or religious sage who feels a deep connection to all of creation and acts from a selfless commitment to advancing the well-being of the whole.

We humans do have a capacity for extremes of violence and greed. In adults, however, expressions of extreme individualism, greed, and violence are indicators of serious emotional dysfunction. Fortunately, they are more the exception than the norm.

Most of us know many people who are loving, compassionate, considerate, and ready to go out of their way to help others. A growing body of neurological and psychological research concludes that we humans are wired

to connect, to form and live in community and for good reason. If this were not the case, the human species would have expired long ago. Supportive communities are essential to our survival, as well as to our growth to physical and emotional maturity.

The culture of the corporate global economy encourages and rewards social dysfunction. Our species survival now depends on nurturing the healthy, mature human consciousness. This will require a sweeping cultural and institutional transformation. Rethinking the nature and purpose of the corporation is one of many important steps toward this larger goal.

Putting Life First

It is not sufficient simply to slow the rate of self-destruction by curbing corporate power. The imperative, if there is to be a human future, is to bring ourselves into a balanced relationship with one another and with the earth. The human future depends on bringing forth a new economy designed to:

- 1. Turn from money to life as the defining value; from growing financial capital to growing living capital; and from short-term speculation to long-term investment.
- 2. Shift the priority from advancing the private interests of the few to advancing the public interests of all.
- 3. Reallocate resources from supporting institutions of domination to meeting the needs of people, community, and nature

The following are some of the measures required:

- Replace money indicators with life indicators as the accepted measure of progress.
- Create and apply appropriate tools for making public investment decisions based on returns to living capital rather than returns to financial capital.
- Roll back concentrations of economic power and eliminate the division between workers and owners by implementing a progressive wealth tax on people and corporations, democratizing the ownership of economic assets, and placing strict limits on inheritance to

implement a modern version of the Jubilee that redistributes assets to restore social balance at the end of each lifetime.

- Limit political participation to real people, which means limiting the political participation of corporations of all types. End the practice of allowing corporate tax deductions for lobbying and advertising expenses.
- Issue new charters only to public-benefit corporations or shared-benefit corporations organized as cooperatives or as worker- or community-owned corporations, with a commitment written into their charters to balance private and public interests. Establish a mechanism by which private-benefit corporations can apply to recharter themselves as public-benefit or shared-benefit corporations, or convert to a non-corporate business form such as a partnership that does not confer special powers and exemptions. Set a schedule to retire existing private-benefit corporate charters.
- Enforce cost internalization through regulations, service fees, and enforceable liability claims against individual and institutional investors for harms caused by the private-benefit corporations they own.
- Discourage financial speculation by confiscatory taxation of short-term capital gains and all gains from purely speculative buying and selling of financial assets.
- Locate responsibility for setting economic rules and priorities in democratically accountable public purpose institutions of government and placing decision-making power at the most local level feasible.
- Replace the existing debt money system
 by which private banks create money by
 lending it into existence, with a socialcredit money system in which money is
 created by public entities spending it into
 existence to pay for public services and
 infrastructure. This is a complex issue in
 its own right, beyond the scope of our
 present discussion but essential to the
 outcome sought.

These are not modest proposals. Cultures and institutions that have been 5,000 years in the making and confer outsized benefits on privileged individuals will not readily yield. Nothing less than a total cultural and institutional transformation will suffice to save us from the folly of these five millennia. Corporate redesign initiatives make an essential contribution to reframing the public discourse on the path ahead and open the way to the larger discussion that eventually must be engaged.

FOOTNOTES

- 1. See David C. Korten, *The Great Turning: From Empire to Earth Community*. San Francisco: Berrett-Koehler Publishers and Bloomfield, CT: Kumarian Press, 2006.
- 2. The contrasting belief systems of Empire and Earth Community are also supported by contrasting security and meaning stories, as elaborated in Korten 2006, *Great Turning*.
- 3. The caveat that this would be true if we had a properly designed money system is crucial, because we do not have a properly designed money system. The design of the existing money system makes indicators of financial growth highly relevant, because we rely on a debt-based money system in which money is created by banks loaning it into existence. By design, such a system is subject to collapse if the demand for bank loans is not growing at a sufficient rate to generate the funds required to pay the interest due on previous bank loans. It is quite possible to create a social credit money system by which governments spend money into existence to fund public works and services without imposing this disability on society. Because no interest is due on this money, there is no artificial requirement to grow the money supply simply to avoid financial collapse.
- 4. World Wildlife Fund International, *Living Planet Report*. Gland Switzerland: WWF International, 2006, www.panda.org.
- 5. Millennium Ecosystem Assessment, *Ecosystems and Human Well-being: Synthesis*. Washington, DC: Island Press, 2005.
- 6. James B. Davies, et al., *The World Distribution of Household Wealth*, London, Canada: Department of Economics, University of Western Ontario, 2006.
- 7. Jenny Anderson and Julie Creswell, "Make Less Than \$240 Million? You're Off Top Hedge Fund List." *New York Times*, A-1 & C6, April 2007.
- 8. Milton Friedman, *Capitalism and Freedom*. Chicago: University of Chicago Press, 2002, p.120.

Internal Transformation of Corporations

The road to conscious capitalism

BY MICHAEL THOMAS AND BILL VELTROP

"It's simple really. In today's global economy, there's only one market and only one constituency. That market is the planet, and its citizens are all stakeholders of the 21st century corporation. Companies with this understanding are already outperforming their competitors, and those whose vision includes conscious capitalism will set the standard for the next generation of business leaders. We're being called to serve as generative leaders—to be stewards for the well being of all life affected by our corporations. We owe it to our shareholders, we owe it to our fellow citizens, and we owe it to our children and their future."

We believe that pervasive global issues are a result of the design limitations of organizations.

— Juniper Networks Chairman and CEO Scott Kriens

Public opinion has reached a tipping point in terms of recognizing the major environmental challenges we are facing throughout our planet. We may also be approaching that point with respect to pervasive social and economic issues. Collectively, we are becoming conscious of

the stark reality that the well-being of life on our planet is at risk. We are, however, much farther away from having a shared understanding of what it will take to reverse these ominous global trends.

This paper focuses on what we believe to be the root cause of our widespread environmental, economic and social issues,

which is organizational design. It has been said that every organization (and system of organizations) is perfectly designed—to get the results it gets. We believe that our pervasive global issues are primarily a result of the design limitations of our organizations. These complex and highly interdependent social forms (corporations, governments, institutions, etc.) have, for the most part, evolved from simpler forms based on simplistic and often mechanistic organization design principles. Few of our complex organizations have been designed to be, or are managed as, learning organizations; much less as conscious, empathetic, self-evolving social systems.

This design deficiency is at the heart of our global problems. If it seems as though our corporations are unconscious of their true net impact on the environment and on society, it is because they weren't designed to be conscious.

This article focuses on corporations and what will best support the metamorphosis of those organizations from their caterpillar-like tendencies (e.g., narrow field of vision, huge appetite for natural resources, self-centered nature) to their inherent but generally underdeveloped butterfly possibilities (e.g., wideranging field of vision, minimal use of the earth's resources, and contributions to the well-being of other life forms).

It is important to differentiate between *internal* metamorphosis-like transformation and *externally* sourced initiatives that are intended to create or support such transformative shifts. The authors conclude that corporate metamorphosis:

- Needs to be an inside job,
- Will be initiated by corporate leaders because it is a superior business model and better serves the needs of all stakeholders,
- Can be catalyzed and supported by welldesigned external initiatives, and
- Can be confounded by poorly designed external initiatives.

This just-in-time evolutionary shift will be driven in the same way the Industrial Age and the Information Age were driven—by entrepreneurs and "intrapreneurs"—or leaders who are beginning to see the exciting new

opportunities to do well by doing good. These leaders will see that they can strengthen their organization's financial sustainability by addressing rather than avoiding the major social, economic, and environmental challenges of the 21st century. These global crises are now providing a sense of urgency that will accelerate the shift to what has been called "conscious capitalism," where corporations function *for* the world.

Part I: Moving Toward Conscious Capitalism

As Patricia Aburdene writes in Megatrends2010: The Rise of Conscious Capitalism:

We've now become conscious of the uncalculated social, economic, and environmental costs of "unconscious" capitalism. And many are beginning to practice a form of "conscious capitalism," which involves integrity and higher standards, and in which companies are responsible not just to shareholders, but also to employees, consumers, suppliers, and communities. Some call it "stakeholder capitalism."

By conscious capitalism we mean a mature, responsible, accountable capitalism—an evolved form of capitalism that has outgrown the self-centered, toddler stage of development where it unconsciously creates messes for others to clean up. By conscious capitalism, we are referring to business organizations that are becoming conscious of the consequences of their choices, and that are making decisions that contribute to the true well-being of all affected, including future generations whose voice is not represented in the corporate board room. In contrast to the short-term perspective that afflicts companies and capital markets, they are organizations that understand and are committed to long-term creation of wealth that is fairly distributed among those responsible for its creation.

Conscious capitalism transcends the myopic vision of Milton Friedman, who advanced the view that the only legitimate social responsibility of capitalism was to increase shareholder profit. Conscious capitalism recognizes that the health and sustainability of

business organizations is interdependent with the health and sustainability of its ecosystem, which is the larger society and the natural environment. The purpose of business, in the era of conscious capitalism, will be to make a net positive contribution to societal wellbeing.ⁱⁱ

What is it about the design of our corporations that is producing the "uncalculated social, economic, and environmental costs of 'unconscious' capitalism"iii described by Aburdene?

There are at least three fundamental design flaws that contribute to organizational unconsciousness present in most corporations.

Design Flaw #1 — Narrow and Limited Definition of Success

This is the most insidious of the three design flaws. A narrow focus on financial results, combined with a myopic fixation on near-term results has guaranteed chronic corporate unconsciousness.

In his Nobel Peace Prize acceptance speech in 2006, Muhamed Yunus of Grameen Bank noted:

I am very unhappy about the conceptual restrictions imposed on the players in the marketplace. This originates from the assumption that entrepreneurs are onedimensional human beings, who are dedicated to one mission in their business lives—to maximize profits. This interpretation of capitalism insulates the entrepreneurs from all political, emotional, social, spiritual and environmental dimensions of their lives. This... stripped away the essentials of human life. Humans are a wonderful creation embodied with limitless human qualities and capabilities. Our theoretical constructs should make room for the blossoming of those qualities, not assume them away.

Yunus challenges us to rise above onedimensional definitions of who we are and who we can be. He is challenging us to design our businesses for wholeness and balance, in ways that support and enhance the full blossoming of all dimensions of life.

Design Flaw #2 — Mechanistic, Control-Over-People Organizational Cultures

We have inherited a tradition of control-overpeople organizational systems and cultures. Though sometimes, quite subtly, the "carrotand-stick" philosophy is still alive, well, and

The most insidious design flaw of corporations is their narrow definition of success.

pervasive. This control-overpeople philosophy virtually ensures that hierarchy will live in a bubble that insulates executives from what they don't want to see or hear. A control-overpeople culture is effectively a commitment to constrain consciousness.

Organizations designed, developed, and led in ways that equip all members to

control their piece of the business have invariably demonstrated extraordinary levels of performance and contribution. We have only begun to tap the unlimited potential of empowering individuals within the business enterprise. As we learn to develop and unleash this potential we can experience a renaissance of unparalleled social, environmental and technological innovation.

Design Flaw #3 — No provision for Ongoing Generative Design

We are still at a *very* early stage in the development of our potential as designers of corporate organizations. Much of our language of organizations keeps us trapped in a mechanistic, dominator worldview (e.g., "span-of-control," "chain-of-command," superiors/subordinates"). This, coupled with a general lack of capacity of organizational redesign and renewal and a complete lack of time for reflection and learning, keeps us stuck in the same level of thinking that created those problems in the first place.

Designing, developing and evolving our organizations should be inspired by the same efficiency, effectiveness, elegance and beauty as has evolved over billions of years in our

natural environment. Developing this capacity for self-reinvention within corporations can become *the* business strategy for the 21st century. It is the starting point for a virtuous circle: consciously evolving organizations growing a consciously evolving society growing consciously evolving organizations. It promises a future where we understand that economics, ecology and community wellbeing are all embedded in one another, where production is designed in a way that sustains rather than consumes our natural resources—that appreciates rather than depletes human resources.

The above three flaws have made many of our business organizations rigid and selfabsorbed—a millstone around the neck of global well-being. Our corporations are ripe for metamorphosis. The business case for corporations that touch the earth lightly, that are natural sources of cross-fertilization, and that fully tap human potential, has never been stronger. The core task before us as leaders and social architects is to learn how to create the conditions that support and accelerate such transformation.

Part II: Transformation From Within

It has been said that metamorphosis is an inside job. Transcending the above design flaws is central to creating a world that brings prosperity to all. This task calls for a metamorphosis of how we think about organizations—a transformation as significant as that from the caterpillar to the butterfly.

The shift *from* mechanistic, dominator-based organizations *to* vibrant and dynamic organizations that are equivalent to living organisms begins from within. External encouragement, guidance, and support can be helpful and, in some cases, essential. However, in the final analysis, transformation begins with the DNA of the firm. The cells that make up the caterpillar are somehow supported in taking on vital new roles, clumping and clustering in new ways with wondrous new results.

You've probably heard the story of the boy who saw the butterfly struggling to emerge from the chrysalis and tried to help by cutting open the cocoon. The butterfly died. Initiatives such as the Sarbanes-Oxley Act (SOX) may or may not improve the ethics of the caterpillar. What's more certain is that SOX will tend to reinforce bureaucratic behaviors and may undermine the trust which is the lifeblood of any successful organization.

Consider the possibility of corporations changing from within, shifting their very premise for existence from a singular focus on the shareholder to serving the highest needs of

The traditional legislative approach does not motivate transformative innovation among business leaders.

all their key stakeholders; from moving from a focus on shortterm earnings to applying their capacity for innovation to the task of transforming daunting social challenges into business opportunities.

The call for this quantum change is of such magnitude that it would seem to require a Herculean effort. While opinions vary as to the best strategy for achieving this objective, it is clear that the scope and the severity of the issues both demand an internal response. The traditional mechanistic, top-

down, legislative approach neither motivates nor supports those positioned within organizations to lead transformative innovation and change. In fact, it flies in the face of the first rule of organization change: obtain, at the beginning, the involvement and support of those needing to change. After all, it is not change that people are so resistant to, but rather "being changed."

What is needed is nothing less than a massive shift within corporations that involves their employees in the generative process of reinventing themselves as a company. This begins with a compelling purpose that energizes and inspires the workforce: one that satisfies the need for social, economic and environmental reforms while generating enormous opportunities for profits. What will make this seemingly impossible task more feasible is the acceleration of connectivity and consciousness that is moving us toward a new worldview.

Consider the following two cases. The first story hasn't been publicized. The second is

widely known. Both are stories of successful internal work by corporations that helped blaze the trail toward a more conscious capitalism:

Story #1—Procter and Gamble's Albany, Ga. paper plant was started in 1973. The company approached the design of this 1000-person organization using principles drawn from living systems and socio-technical design theory. The design they produced represented a radical departure from traditional thinking at that time:

- Their semi-autonomous technician team model was unprecedented in the level of control each team had over its production operations, safety, employee learning and development, planning, coordination, boundary management and more.
- Their workforce, drawn from the surrounding community (mostly rural), consisted of 40 percent African-Americans and 20 percent women, at a time and in a place when both race and gender were explosive issues.
- They wisely invested in using highly generative approaches to training and developing not only the technician team system, but also the support and managing systems, in ways that stacked the deck for success.
- They designed learning and change capacity into both the teams and the organization as a whole, in a way that helped ensure not only the ability to deal gracefully with inevitable change, but also to prevent a calcifying of obsolete structures.

Not only did the Albany plant demonstrate dramatically superior business results immediately upon starting up, they have sustained this collaborative advantage for the last 33 years. A few of the many side-benefits from their innovative philosophy/design include: 1) sowing the seeds and reaping the rewards from embracing diversity throughout P&G as a rich source of the energy of innovation; and 2) its contribution to the surrounding communities from the highly developed leadership capacities of these employees.

Story #2—Interface, a commercial carpet company, whose employees in the 1980s and 90s were empowered by their President, Ray Anderson, to recast almost everything in their company. By re-thinking every process with an eye towards creating *zero waste*, the company was able to eliminate millions of dollars in cost, find new markets, create an entirely novel economic model for leasing rather than selling their carpets, and achieve

What is needed is a massive shift within corporations that involves their employees in the process of reinventing themselves as a company.

their closed-loop and recycling goals. The workforce was inspired and energized in the process, which significantly increased employee retention and productivity. By addressing the major environmental impacts created by their business, the company has grown and prospered rather than hurt their financial bottom line

These pioneering corporate innovations, as radical as they were at the time, serve as exemplars of what is both possible and essential. It is important to notice that: 1) neither of these breakthroughs was a consequence of external

pressure and 2) both produced sustainable financial as well as social and/or environmental benefits.

Attempts to force corporations to change through mandates, regulation and litigation can generate a resistance of such magnitude that, at best, it will significantly slow the transformational process and, at worst, it will ensure that the initiative arrives with no chance of succeeding. Without the active participation of those within the organizations in the creation of the "Corporation of the Future," the possibility of a timely system transformation is decreased dramatically. We have learned through great pain that the best chance for any change initiative to succeed is if the impetus comes from within.

The question then becomes, what are the drivers that will catalyze this rebirthing process within corporations? After decades of focusing primarily on strategies for increasing earnings, what will cause corporations to want

to realign their purpose and reallocate their resources in a way that brings new energy and leadership to the resolution of long-term issues such as global warming, poverty, hunger, disease and terrorism?

Part III: A New Corporate Worldview Is Emerging

A new worldview is emerging within Corporate America and the global marketplace. As reported in the April 2007 issue of *FORTUNE* Magazine:

The days of mandate, regulate and litigate are almost over...Now we are at the threshold of a different era, one in which companies are trying to figure out how to profit by solving the world's big environmental problems.

Transitioning to a low-carbon economy will require new ways to generate power, run our cars, grow our food, and design, build, heat and cool our homes and offices. Only business is capable of innovation at that scale.

Entrepreneur John Mackey, co-founder and CEO of Whole Foods, writes:

Business is fundamentally a community of people working together to create value for not only themselves, but for other people including their customers, employees, investors, and the greater society. All the other professions put an emphasis on the public good and purpose beyond self-interest. Business owners and entrepreneurs should also emphasize this and need to view their business as a complex and evolving interdependent system, and manage their business more consciously for the well-being of all their major stakeholders while fulfilling their highest business purpose.

The increasing emphasis on Corporate Social Responsibility (CSR) and Environmental Management Systems (EMS) is an important indication that corporations are beginning to acknowledge that their responsibilities extend beyond the basic need to generate sustainable profits.

One particularly useful way to observe the emergence of a conscious capitalism is through the lens of a "Full Stakeholder Model." Mackey's comments above, as well as

the increasing emphasis on CSR and EMS, all point to a growing realization within corporations that their success and sustainability is ultimately dependent on their value-adding contribution to the well-being of *all* their stakeholders.

We could see it coming years ago if we had been looking for it. For instance, in John P. Kotter and James L. Heskett's *Corporate Culture and Performance*, their research showed stunning differences between corporations with adaptive cultures that focused on all major stakeholder groups and those with non-adaptive cultures that focused on only one or two stakeholder groups. The table below reflects the economics and social costs of non-adaptive, narrowly focused corporate cultures for the 1977-1988 period:

Table 1

	Adaptive Cultures (%)	Non-Adaptive Cultures (%)
Revenue Growth	682	166
Employment Growth	282	36
Stock Price Growth	901	74
Net Income Growth	756	1

A more recent study regarding the success of stakeholder-centered businesses clearly underscores the power of this new, conscious business model. The study, *Firms of Endearment: The Pursuit of Purpose and Profit*, iv identifies and tracks the results for 27 companies that are managed to optimize total stakeholder value, rather than focusing strictly on profits.

These firms started with human performance and worked forward rather than starting with financials and working backwards. As a result these firms were admired by all the stakeholders including the employees, customers, suppliers, environmentalists, the community and the governments. These "Firms of Endearment" have been rewarded for their efforts with a 1025 percent return to

investors over the past 10 years versus 122 percent for the S&P 500 and 316 percent for the companies profiled in *Good to Great*. Mackey suggests that this is no accident; rather, it is the result of all these firms creating a superior business model, the business model he believes will become the dominant business model in the coming century.

In an era of ever-accelerating connectivity and consciousness of stakeholder groups and their advocates, those businesses that are continually improving the quality of their relationships and agreements with all stakeholders will survive and thrive. Those that don't, won't. Those businesses that persist in exploiting any stakeholder group (consciously or unconsciously) are living on borrowed time. The sustainable "collaborative advantage" will go to those businesses that are helping to grow stakeholder connectivity and consciousness. This is the essence of the emerging new corporate worldview. This is the essence of a movement toward conscious capitalism.

As ironic as it may seem, the prevalent belief in the business community for the past three decades—that the only legitimate responsibility of business was to maximize profits—was not only dead wrong, but ultimately self-destructive. It now appears that being socially and environmentally accountable, rather than being dismissed as naïve or altruistic, simply makes good business sense. It lays the foundation for both a healthy and sustainable economy, while focusing the innovative power of corporations on becoming better students of, and stewards for, the natural and social environments in which they operate.

The Next Big Thing Isn't a Thing

The corporations that will survive and thrive in the coming decades are those that have mastered the art and science of creatively adapting to the true needs, aspirations, and potential of their various stakeholders. Owing in large measure to technological advancements, the rate at which these stakeholders are becoming connected and conscious is accelerating—on an exponential trajectory. This is an irreversible trend. Corporations can either become highly

adaptive and surf on this wave of consciousness, or they can choose to be rigidly defiant and wiped out by it.

The next big thing is the conscious corporation, where leadership realizes that the most enduring strategy for generating sustainable profits for their shareholders is to develop: 1) the highest quality relationships and agreements with all of their stakeholder groups; and 2) the capacity to adapt quickly and gracefully to the true needs, aspirations,

Companies have discovered that redesigning themselves around a full stakeholder model creates unparalleled opportunities.

and potential of these stakeholders. The conscious corporation is an organization that has evolved true partnerships with each of its stakeholder families. The conscious corporation knows that its sustainable strength lies in its distributed capacity to contribute to the well-being of the whole corporate organism, including all members of its immediate and extended stakeholder families. Just as a healthy growing human family is aware and responsive to the

opportunities, needs, aspirations, and the potential of each of its members, so it is true for corporations.

Granite Construction Company, a heavy civil contractor with 10,000 employees, headquartered in Watsonville, Calif., is a prime example of an organization that has dramatically increased its shareholder value while shifting its orientation to better serve the needs of its employees and the communities, and better manage its environmental impacts.

Granite was able to more than triple its share value over the past few years by focusing on building stronger relationships with all of its key stakeholders. The catalyst for its strong stakeholder stewardship has been a powerful set of core values originating in the 1930s from company founder Walter Wilkinson. He urged Granite employees to "boldly contend for that which is right, and firmly reject that which is wrong" and to "never participate in any deal that is not fair to all parties involved." This simple concept was clearly a forerunner to today's stakeholder model, honoring the

building of not only highways and bridges, but long-term relationships and agreements with all stakeholders.

A rapidly growing awareness is taking shape within corporations of their relationships with diverse stakeholders, and their dependence on these groups and the natural environment for their long-term survival. During the past decade, companies have discovered that redesigning themselves around a more conscious, full stakeholder model creates unparalleled opportunities for their businesses, including better cost control, new products, new markets and new ways to profitably employ their core competencies. They also have learned that an organization that values and contributes to the well-being of all its stakeholders is a magnet for top talent, and a powerful enabler that inspires the workforce to achieve their highest levels of performance and involvement. The growing awareness of the linkage between business purpose and a strategy that serves the needs and expectations of all stakeholders has shifted the notion of social responsibility to that of social opportunity, stirring the business development juices of entrepreneurs everywhere.

James C. Carse, *Finite and Infinite Games*, observes:

There are at least two kinds of games. One could be called finite, the other infinite. The finite game is played for the purpose of winning, an infinite game for the purpose of continuing the play. Finite players play within boundaries; infinite players play with boundaries.

The game of business can and must shift from being a finite game to becoming an infinite game—so that we not only get to continue to play, but that our grandchildren's grandchildren inherit a game that is truly worth playing.

Part IV: The Meta-design Challenge

What will accelerate our movement toward conscious capitalism? This is our meta-design challenge.

One critical need is for new creative metrics and other motivators. As Amory Lovins has written, "Economics as we know it is going to change in ways we can't imagine. We will have new ways of accounting, new ways of keeping score." Not everything that counts can be counted. Financial results, in addition to not telling the whole story, tend to be lagging indicators, describing *what was* rather than *what will be*. The evolutionary movement from our current finite game of business to a more conscious capitalism will include yet transcend financial metrics.

The evolutionary movement from our current finite game of business to a more conscious capitalism will transcend financial metrics.

Many businesses are learning that the best way to create a healthy financial bottom line is to focus attention on tracking and influencing the leading indicators, which are indicative of where a company is going in the future versus where it has been. These leading indicators include metrics tracking a company's performance in support of all the key stakeholders, including employees, customers, suppliers and sub-contractors. communities and the environment. Increasingly, these metrics are being built into performance goals as well as the management's

compensation formulas to ensure that the shift to a more conscious capitalism is reinforced through the company's performance and reward systems.

A good current example of using creative stakeholder metrics is TIC, a mid-sized industrial construction company headquartered in Steamboat Springs, Colo. In 2006 TIC redesigned its executive incentive system around a new set of "Built-to-Last" stakeholder metrics to create infrastructure for a more sustainable, stakeholder-based business model. With a core theme of "Powered by People," TIC's implementation of stakeholderbased incentives places it solidly on the track toward conscious capitalism. This is in marked contrast to other companies that have espoused strong stakeholder values, but have continued to compensate their executives based only on maximizing profits.

Various industry and cross-industry research and consulting groups have become critical sources of support for internal transformation processes. These we refer to as "General External Motivators," or GEMS.

The Great Place to Work Institute (GPTW)

Headquartered in San Francisco, this institute's primary focus has been on the treatment of employees within corporations. Through extensive research it has identified key elements in the policies, programs, and behaviors of organizations which contribute to a more satisfied, energized workforce. Interestingly, the questions used in its employee surveys capture a company's commitment to, and effectiveness in, supporting other stakeholder groups as well, including the broader community and, indirectly, the natural environment. Its survey instruments have become de facto metrics that help corporations measure the immeasurable.

Amy Lyman, co-founder and chair of GPTW, indicates that the research of the institute shows that the most important ingredient leading to employee satisfaction is trust. The treatment of all employees with respect and dignity, caring for them as individuals, and encouraging them to grow and do what they do best every day—this is what is essential to a highly effective and motivated workforce.

Many senior executives are highly motivated to have their companies nationally recognized as one of *FORTUNE Magazine*'s "100 Best Companies to Work For." This draws them to focus on the quality research of the Great Place to Work Institute which, in turn, provides internal Human Resource practitioners with the additional legitimization and support they need to create initiatives capable of growing healthy, effective, internal cultures.

The rewards for corporations that excel in this area are substantial. A 2005 study of public firms on *FORTUNE*'s list of "100 Best Companies to Work For" revealed that they returned 176 percent to the shareholders between 1998 and 2004, compared to 39 percent for the Standard & Poor's 500.

U.S. Green Building Council

Established by a collection of socially and environmentally responsible individuals from

the construction industry in 2000, the Green Building Council is one of the best industry group examples of enabling the internal transformation of corporations. Its influence on both the construction industry and many other businesses has grown exponentially through the design and implementation of a green certification process. The Leadership in Energy and Environmental Design (LEED) *Green Building Rating System* rates commercial and residential buildings (platinum, gold, and silver) for excellence in environmental design. This system has provided a blueprint for consciously designing structures in ways that will significantly reduce their environmental footprint while creating opportunities for long-term savings.

The message is increasingly clear: corporations that effectively serve the needs of their stakeholders will outperform their peers.

The LEED certification is a classic example of a Generative External Motivator—a real GEM with multiplying benefits for most stakeholder groups. Not only are they reducing the environmental footprint of the building industry (which accounts for 39 percent of our country's total energy use, 12 percent of the water, and 38 percent of carbon dioxide emissions), but they also are producing irreversible shifts in the

consciousness of organizations involved in new building construction.

In turn, going green generates new business opportunities by building new expertise and capacities needed for new markets and products. In addition, these companies are finding that their employees are more highly motivated because they are proud to be part of a company that is ethical and that demonstrates strong character through its support of communities and the environment.

Global Reporting Initiative

This historic, international, multi-stakeholder initiative has established standards for measuring and reporting on sustainability efforts at the level of the firm. The GRI process took steps toward standardized environmental and social reporting, so results

can be compared across companies and industries.

Increasing numbers of other enabling programs also have sprung up in recent years to support the work of internal transformation through higher standards and recognition programs. *Business Ethics* magazine's "100 Best Corporate Citizens," *FORTUNE*'s "Most Admired Companies," and *Forbes*' "Most Admired and Most Trusted Companies" are all examples of generative initiatives that contribute to a paradigm shift in the way corporations view their roles in the world. The accelerating expansion of socially responsible investment from \$12 billion in 1995 to \$178 billion in 2005 also is an important factor shifting how we see the game of business.

The message is increasingly clear: corporations that effectively serve the needs of all their key stakeholders will outperform their peers. Companies that focus on creating great workplaces that encourage innovation and creativity amongst their employees will thrive in the long run.

To this point, today's most commonly used metrics have been geared toward a 20th century manufacturing paradigm that no longer reflects the realities of the marketplace. These old metrics were designed in an age when capital was scarce, labor was abundant, and natural resources were unlimited.

Today, with the help of organizations such as Great Place to Work Institute, the U.S. Green Building Council, and the Global Reporting Initiative, there is a growing appreciation that the real drivers for creating stakeholder wealth in all its forms are the intangibles. Knowledge, know-how, commitment, innovation, relationships, character, and reputation are examples of what needs to be measured more precisely and strategically. Shifting from today's over-emphasis on lagging indicators of performance (financial results) to the leading indicators of future performance will enable the internal transformation of corporations to a more conscious form of capitalism.

The Pathway Forward

Corporations have evolved to a point where they can become planetary leaders for the benefit of all. The modern business corporation is probably the most adaptive institution humankind has ever devised. Successful businesses make it their business to adapt to changes in their environment, or else they perish. In addition, global corporations are positioned to become the first true planetary citizens—if they choose to play that role. They have worldwide responsibility and capability. Corporations work across traditional boundaries with much more ease and effectiveness than do political institutions, and businesses are much more flexible and adaptive than the slow moving, bureaucratic structures of our governments.

Why will they choose to play this role? We are moving into a new economic era, which can be termed conscious capitalism. This era of accelerating stakeholder consciousness and connectivity will make it an imperative for corporate leaders to master the art of organizational metamorphosis—of transforming their organizations from near-sighted, shareholder-centric systems to organizations designed to serve *all* of their stakeholders *all* the time. Those organizations that learn to make that shift will survive and thrive. Those that don't, won't.

What will best encourage and support this transformational shift? The question is no longer "Can the transformation happen internally?" but rather, "What kinds of external interventions will best accelerate the metamorphosis that is already underway in our corporations?"

We see a movement away from "Mechanistic External Drivers" (MEDs), toward GEMs." MEDs are designed to control and constrain. GEMs take on a life of their own because they are inherently value adding, and give life to the natural energy and genius of the people. Our collective challenge is to learn to get off the MEDs and create more GEMs. As we become successful in addressing this highlevel design challenge, corporations will respond in equally creative ways, making a larger contribution to the well-being of life than we could have imagined.

We are at a choice point of historic proportions. We can choose the disastrous course of keeping on keeping on, or we can choose to support the evolutionary shift to conscious capitalism. ■

FOOTNOTES

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Long-Term Investing

A proposal for how to define and implement long-term investing

BY STEVEN LYDENBERG

Many voices have been raised in recent years extolling the virtues of long-term investing, and condemning the short-termism in today's stock markets. Pillars of our financial and business community—including CFA Institute, the Business Roundtable, the Conference Board, the United Nations, the World Economic Forum, and the Aspen Institute—have all prescribed the long term as a cure for our short-term ills.

An excessive focus on short-term profits has various detrimental effects. It causes corporate

Indexers behave as though stock price and value of corporations are one and the same.

managers to misallocate assets. It introduces dangerous volatility into financial markets. It means society must divert productive resources to repairing environmental and social damage done in the headlong pursuit of profits.

In a 2006 report, the Conference Board speaks for many when it describes the dangers of the short term:

On a macro-economic level, short-term visions are the cause for market volatility and the instability of financial institutions. From the micro-economic standpoint, they undermine management continuity and expose a public company to the risk of losing sight of its strategic business model, compromising its competitiveness. In addition, the pressure to meet short-term numbers may induce senior managers to externalize a number of business costs (i.e., the cost of a state-of-the-art pollution

system), often to the detriment of the environment and future generations.¹

There are a host of useful remedies for the excessively short-term outlooks of the financial and corporate communities. These include:

- Reforming the reporting of quarterly corporate earnings and the compensation incentives of analysts and managers.
- Broadening fiduciary duties.
- Including social, environmental, and corporate governance issues into stock analysis and institutional investors' mandates.
- Increasing non-financial disclosure.
- Creating best-practice guidelines for pension funds.
- Revitalizing education on the virtues of the long-term approach.

Despite widespread concern, little real change is taking place. Financial professionals are aware of the trap in which they are caught. They can see ways out of it. But they are unable to act in ways that substantively change their practices. As Alain Leclair, president of the French Association of Financial Management has put it: "We...face a dilemma. In practically all aspects [of investing], although everything ought to direct us to adopt a long-term approach, we are forced to measure and act in the short term."

We might call this the Short-Term Measurement Dilemma. It goes to the heart of why long-term investing is currently so difficult to implement. When the market is valued according to a

When the market is valued according to a short-term measurement—that is, stock prices—and when managers' performance is measured against these prices, then long-term investing becomes impossible.

In particular, the liquidity, or ease of trading, in today's stock markets contributes to the short-term perspective. Stock market prices are measured daily, hourly, and by the minute. A market that offers participants instantaneous opportunities to measure and act on their price-based worth—that allows them to jump

in and out of stocks at little cost on the slightest bit of news or slimmest of rumors—deprives them of a perspective from which to measure the value of the companies over years or decades.³

Investors and corporate managers clearly can see the detrimental effects of this short-term perspective. What they cannot see, and what is keeping them from change, is a clear definition of an alternative long-term investing system and a system for implementing it. Without these two things in hand, real change will be impossible.

All the pieces for solving this puzzle are already on the table. Yet the change that is implied by a shift to the long term involves a new way of thinking for a financial community of tremendous size and power. Change inevitably will meet with resistance.

This paper proposes a simple, clear definition of long-term investing and explores its practical implications. This should bring new approaches to the financial world which will create true value and avoid the pitfalls of short-term price speculation. Although this paper does not deal with the similar problem of short-termism for managers in the corporate world, the dilemma and its possible solutions run parallel to those suggested here.⁴

A Definition of Long-term Investing

A comprehensive definition of long-term investing must address three issues:

- 1) the benefits of holding stocks for long periods of time;
- 2) the incorporation of environmental, social and corporate governance (ESG) factors into investing; and
- 3) the willingness to add value to investments.

The definition of long-term investing proposed here incorporates these three elements. It is as follows:

Long-term investors speculate on the value of corporations to society and the environment, while simultaneously seeking to enhance that value at the company, industry, and societal level.

This definition is intended to steer investors clear of the detrimental focus on price, and emphasize value. It works because the wealth corporations create is more than stock price. It corrects the conception that investors can function only as price takers, not value makers. It stresses that, like investors in other asset classes, stock investors have the capability—and the responsibility—to add to the social and environmental, as well as the financial, value of their investments. To do so, long-term investors in the stock markets must engage management on important social and environmental issues and set clear standards—that go beyond relative price—on how to allocate their investments.

We'll look at the three components of our definition, one at a time.

The Value of Long Holding Periods

Much of the despair about short-termism focuses on day traders, arbitrageurs, profit maximizers, and others who think the road to fortune lies in moving quickly in and out of stocks. As the Conference Board noted, the 40-plus participants in its summit on short-termism were unanimous on this point "stock investment speculation is a major cause of short-termism."

If speculation on price is the cause of the disease, why shouldn't a simple remedy—buying and holding stock for long periods of time—be the cure?

For many in the investment world, "buy long and hold long" is a sufficient definition of the long term. However, this definition does not go far enough.

Indisputably, holding stocks for longer periods of time can bring investors great financial benefit. Long holding periods reduce transaction costs and save on tax liabilities. But simply buying and holding for a longer period is not enough to create a stock market where a long-term view and speculation on value predominate. Two widely practiced, but somewhat contradictory, buy-and-hold strategies in today's markets demonstrate why this is true.

 Index investing involves buying a broadly diversified basket of stocks and holding them for long periods of time. Its underlying assumption is that you cannot beat the market. • Value investing involves selecting individual stocks that the market has not correctly priced and holding them for long periods. Its underlying assumption is that you can beat the market.

Neither captures the essence of the long term firmly enough to escape from the short term of our current marketplace. A closer look at index investing confirms this point.

Index investing is one of the most widely practiced investment techniques in the stock market today. It consists of buying diversified baskets of stocks and holding them more or less forever. Common benchmarks in which indexers invest are the Standard & Poor's 500 and the Russell 1000 indexes. These two indexes consist of the largest publicly traded stocks in the United States as measured by price. Literally thousands of other indexes capture various other markets and market segments around the world. Institutional investors today have invested trillions of dollars in these index funds.

Stock indexes are usually capitalization weighted—that is, the size of the holdings of each stock in the index is determined by its market price multiplied by its number of shares outstanding. Because index investors hold stocks for an essentially unlimited time, it seems logical to consider them the embodiment of long-term investing. Indeed, many pension funds that use indexing strategies consider themselves long-term investors.

However, simply holding stock for a long time does not guarantee that one is free from short-termism. As Simon Zadek has observed: "When pension funds say they are long-term investors, what they mean is that they have rolling investments in largely indexed linked funds. To speak accurately this makes them *perpetual investors* making short-term investments, forever." 5

Or more accurately, indexers are exactly as short term or as long term as the stock market is at any given moment. When indexers buy and sell stock, they do so at whatever the market price is that day, without attempting to determine if these stocks are overvalued or undervalued. They therefore reflect, and indeed amplify, any pricing irrationalities of

the markets at any given time. If there is a speculative bubble, if stocks are wildly overvalued or undervalued, indexers participate in that irrational exuberance or despair to exactly the extent of other market participants.

Professor Alfred Rappaport goes to the heart of the problem of index investing when he notes that "Index funds make no independent contribution to allocatively efficient prices because indexing requires no valuations."6 Indexers make no attempt to determine the value of the stocks they are purchasing because they believe that stock price and the value of corporations are one and the same. Their most fundamental belief is that investors cannot beat the market by making educated guesses about when stock price deviates from underlying value. They just buy the market. Indeed, the only way for indexers to add value to their portfolios is to reduce transaction costs.

By abandoning any attempt to actively value the market, indexers make it more speculative in two ways. First, they increase the percentage of speculators in the marketplace by withdrawing themselves and others who might potentially be interested in long-term valuation from the setting of stock prices, leaving that role to short-term speculators. Second, they force even those managers left in the market who are attempting to value stocks with a view toward the long term into mimicking whatever prices may be set by the short-term speculators. As one fund manager and participant in the World Economic Forum's working group explained, "As long as client [e.g., pension fund trustees] mandates require us to deliver performance benchmarked against short-term market tracker indexes, we will of course remain short term in our outlook."7

If we want stock markets to assess the longterm value of corporations, index investors will be of no help. We must look elsewhere. One place is to the value investor. Value investors are long term in their perspective and help counteract the short-termism of today's markets. They are stock pickers who evaluate the underlying, intrinsic value of a company, which they usually define as its long-term earnings potential, and compare that to today's stock price. Because earnings potential over the long term is their measure of value, value investors usually buy and hold. Put differently, because the markets can take a long time to come around to value investors' point of view, they tend to hold for long periods of time.

Robert A. G.
Monks offers an example of relationship investing, using one's influence to improve the corporate governance of firms.

Warren Buffett, the chief executive of Berkshire Hathaway and a widely recognized long-term investor, has reportedly asserted that his favorite holding period is "forever."

The great virtue of value investors is that they are willing to take an alternative view of the intrinsic value of a corporation to that of the short-term markets. They sell when they think stocks are overpriced and buy when they believe they are undervalued. They can counterbalance the wild swings of markets that are purely speculative-markets that overshoot because investors become irrationally optimistic or pessimistic about what companies are worth. If long-

term investors can predominate in the market, they can send signals to managers about which corporations are allocating their funds in an economically productive way and which are not. It is therefore crucial, as Keynes has wisely observed, that those with a long term predominate in the marketplace.⁹

If this function of the long term in the marketplace is so important, why isn't the market set up so that value investors can predominate? One might think that value investors would be rewarded for their diligence and the wisdom of their approach, that they would consistently turn in superior performance results to their irrationally speculative peers, and that institutional investors would rush to place their funds in the hands of such wise and productive managers. The answer is both paradoxical and discouraging. Value investors in the aggregate cannot, by definition, turn in better price-based performance results than the indexers over long periods of time. Although a select few active managers may be able to beat the markets consistently, institutional investors find it difficult to justify making substantial use of them as a whole. Index investors derive great satisfaction in pointing out that if value investors' returns are measured against the

performance of capitalization-weight benchmark indexes, on average and over the long-haul they cannot "beat the market." For this reason, indexers assert that value investors do not add value. This is devastating for advocates of long-term investing. It is also the reason that the Short-Term Measurement Dilemma is real and difficult to resolve. This dilemma for value investors arises because, although some value investors will always beat the index benchmarks, it is impossible to beat price-based market averages all the time. Two considerations make this inevitable. First, it is logically absurd to imagine a market where some managers outperform all the time and others underperform all the time. No intelligent investor would stay forever with a manager who underperforms all the time. Underperforming managers will either lose their clients and go out of business or change their tactics. Once managers' performance is measured against market prices set by counterbalancing buyers and sellers, by definition, half will outperform and half will underperform over time.

Second, value managers must incur an extra cost that index investors do not pay. That cost is research. This means that indexers have a cost advantage in the marketplace that will cause them to outperform over time and on average. Value investors, each trying to beat the performance of the others, must actually research the companies in which they invest. As hard as it is to believe, indexers do no research at all. Without this expense, index investors on average and over the long haul inevitably outperform the active value managers. Indexers, by definition, will outperform those who set the prices because they don't have to bear the cost of the research necessary to set the prices.

As John Bogle, the founder of the Vanguard mutual fund company and a fierce advocate of index investing, has succinctly put it, "For all investors as a group, then, beating the market *before* costs is a zero-sum game; beating the market *after* costs is a loser's game" (emphasis in original). In other words, the market is a zero-sum game: some participants gain at the expense of others, with none adding any true value. In such a market, those who incur costs by trying to determine the value of companies will inevitably underperform those without these costs. In

Keynes, an advocate of the long-term approach to investing, was despairingly articulate on this point:

Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes. There is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable. 12

The long-term value investors about whom Keynes is speaking will always find themselves at a competitive disadvantage in today's stock markets and never predominate as long as their performance is measured against stock price.

Long-term value investors cannot escape from the price-based measurement trap because it is price, as related to long-term earnings potential, by which they still judge their own performance. Their investment time horizon may be "forever"—or Judgment Day, another horizon line by which Buffett likes to calculate the earnings power of corporations—but price is still the ultimate measurement of returns. ¹³

Thus, the Short-Term Measurement Dilemma cannot be resolved by simply looking to long-term earnings potential. Other factors must be introduced if we are to give the long term a deeper meaning and more influence in our markets today.

The Materiality of Social and Environmental Factors

In determining the value of corporations, it is vital for long-term investors to consider factors other than price and earnings. Environmental, social, and governance (ESG) factors inherently impose a longer-term perspective. They take into account issues well-suited to a long-term perspective, and these issues often cannot be clearly tied back to price. Any definition of the full potential of long-term investing must incorporate these factors.

ESG-based evaluations of companies reach beyond those from traditional stock analysts because they encompass the less tangible aspects of a company's value. Generally, ESG factors relate to a company's relations with its stakeholders such as employees, customers, communities, suppliers, and the environment. Specifically, they include issues such as workplace safety, employee training, product quality, charitable giving, vendor labor standards, carbon emissions, and pollution prevention. These factors can lead to the exclusion of particular companies from investment consideration when they fail to meet certain stakeholder-specific standards. In addition, ESG considerations can help evaluate the role of whole industries in a sustainable society. Involvement in the production of weapons of mass destruction or tobacco, for example, might lead to exclusion.

Some ESG factors can be directly related to a company's stock price and some cannot. Those that can be tied to stock price are usually referred to as financially "material." Those that cannot are sometimes referred to as factors that have "non-financial materiality." ¹⁴

Another way of describing these non-financially material ESG factors is to use the economists' conception of positive or negative externalities, describing them as factors that create costs or benefits that cannot be translated easily into market price. However they are described and whatever their relationship to materiality, ESG factors are inherently long-term in nature and contribute to the definition of long-term investing. ¹⁵

ESG factors help direct the market to the long term because they frequently focus on issues where risks and rewards are best measured in years and decades, not months and quarters. Environmental issues with such long-term horizons include climate change, ozonedepletion caused by industrial chemicals, development of alternative energy sources, changes in environmental regulation, environmental life-cycle analysis for products, energy efficiency, and the effective implementation of company-wide environmental management systems. Social issues with similarly long horizons include the availability of clean water in the coming century, the adequacy of labor standards at suppliers in developing nations, the incorporation of women and ethnic minorities into corporate workforces, the balancing of the pressures of the workplace and the demands of family life, investments in a highly trained

workforce, and support for community economic development.

If stock price appreciation is the only goal of relationship investing, investors are back in the trap of short-termism.

A growing number of investors state clearly that they consider ESG factors as relevant to their investments and corporate valuation. For example, Asset Management Working Group in 2004 reported that at the nine major brokerage houses that they commissioned for analyses of the role of ESG factors in stock valuations, "Analysts agreed that environmental, social, and corporate governance criteria impact both positively and negatively on long-term shareholder value."16.

In an encouraging development along similar lines, a number of major investment houses increasingly are hiring in-house staff to promote the integration of ESG research into their analyses for the mainstream investment community. For example:

- Citigroup. This firm's Smith Barney office in London has a team of analysts dedicated to publishing research on "sustainable investable themes." In 2005, this team's report, *Crossing the River*, documented its approach to finding "bridges" which it envisions as steppingstones in a river between environmental and financial performance.
- Societé Générale. This French investment bank has a five-member research team at its Paris headquarters that follows sustainability issues, track their financial implications, and integrates this research into stock analyses.

These investors and analysts are incorporating ESG factors because they believe doing so will make them better stock pickers in the long run. In this sense they are like value investors, looking for buying and selling opportunities when ESG factors show that a company's intrinsic value has deviated from its current price.

It should be noted that simply because ESG factors look to the long term, they do not automatically protect the stock markets from short-term price speculation. In fact, the more ESG factors become incorporated into current price/earnings models, the more likely they are to fall prey to the short-term speculation those models produce. This is true because highly liquid markets invite speculation when price is the only consideration.

Take, for example, the investment opportunities offered by the development of alternative energy sources. The exact prospects for wind-power companies are unknown today, but that doesn't keep the markets from speculating on them and driving their stock prices up sharply. In France in early 2007, for example, strong performance of wind power and other green stocks prompted a *Le Monde* story headlined "Is There a Green Stock Bubble?" ¹⁷

While some ESG factors clearly are related to stock price, other ESG factors clearly cannot be related to the price of individual stocks or the market valuation of whole industries. This type of factor can be described as non-financially material or as an externality.

Externalities are costs (or gains) that are borne (or shared) by those not involved in a particular transaction. In other words, externalities are costs and benefits that are not captured in the marketplace and cannot be measured by price. An example of a negative externality would be the health damage that tobacco products cause, costs that are borne by society. A positive externality would be the cost of training employees in skills that they could then take elsewhere.

Ironically, considerations of externalities can, in theory, lead to investing in companies that cause harm and to shunning companies that produce societal benefit. Jeremy Siegel reports that the best performing U.S. stock of the past 75 years has been Philip Morris (now Altria). Furthermore, Siegel argues that investors are not rewarded for investments in companies that enhance productivity in the economy.

Once a factor that has been an externality—carbon emissions, for example—becomes priceable in the markets, it will no longer be an externality. As long as price is the measure of stock value, markets cannot account for

externalities. This is simply a restatement of one of the most painful aspects of the Short-Term Measurement Dilemma.

However, if investors make their primary concern the economy as a whole, not the price performance of a single stock or industry, many of the complications of factoring in externalities disappear.

This is the argument for the concept of universal investing, initially propounded by Robert A.G. Monks and Nell Minnow, and subsequently elaborated by Professors James Hawley and Andrew Williams. 19 Universal investors can be defined as pension funds or other institutional investors so large that they are invested across all asset classes. Universal investors essentially "own the economy." It does not profit them to invest in a company that increases earnings by externalizing environmental or other social costs onto other companies or the economy. The company's earnings may rise, but that gain will be offset by losses at other firms that will affect the investor's portfolio. As Hawley and Williams put it:

For a universal owner, and thus for its beneficiaries, the whole may well be greater than the sum of its parts since long-term profit maximization for the portfolio of a universal owner involves enhancing not just return on a firm-by-firm basis, but enhancing productivity in the economy as a whole. This approach to the role and responsibility of universal ownership simply takes two basic ideas, externalities and portfolio theory...and combines them.²⁰

By factoring in ESG externalities, long-term investors remain aware of the effects of their investments on the economy as a whole. Being able to factor these externalities into assessments of positive and negative effects on the environment and society depends, of course, on the availability of data. Progress on disclosure of this data is being made by the groundbreaking work of such organizations as the Global Reporting Initiative and the United Nations Global Compact. Progress on the analysis of this data is being pioneered by research firms such as Trucost who are figuring out how to measure potential long-term costs.

Investors who factor in both financially and non-financially material ESG factors can be said to be long-term investors. Those who only factor in financially material, price-related ESG factors will not, however, entirely escape from the traps laid by price-based performance measurements. Those who factor in the non-financially material externalities will need to take one additional step to act like a long-term investor in the deepest sense. That step is to "add value" to their investments by actively discouraging negative externalities and encouraging positive ones.

Adding Value to Investments as the Key to the Long Term

The final piece of the puzzle of defining long-term investing is about investors using ESG factors as a tool to add value to the companies in which they are investing. This value can be reflected in many different ways. It may show up in short-term stock price appreciation, long-term price appreciation, the creation of intangible company assets, the enhancement of reputation, increased prosperity for local or national economies, enhanced trust between corporations and society, a healthier and more sustainable environment, or many other benefits for society and the environment.

It is this willingness to include value enhancement as a legitimate part of the investment process that allows long-term investors to escape from the dictates of price-based benchmarks. Value can be added at the industry, societal, or environmental levels by minimizing negative externalities (avoiding companies or industries with ESG risks), or by maximizing positive externalities (emphasizing companies or industries that make long-term investments in their stakeholders).

Adding to the value of investments is not a radical idea. In certain asset classes other than equities, investors are expected to add value. Venture capital investors and private equity managers, for example, actively manage the firms in which they invest, placing representatives on boards of directors, hiring and firing top managers, or making strategic management decisions. Similarly, real estate investors frequently invest in the properties they own to enhance their value in the marketplace.

The stock market, however—because of its liquidity and because investors are separated from the managers of the corporations in

Social investors are not aiming to create long-term value on their own, but in conjunction with other players in society.

which they invest-does not lend itself easily to value creation by investors. That is not to say that such value creation is impossible. When Solomon Brothers was embroiled in a major scandal involving illegal trading in the bond market, Warren Buffett as a major long-term investor agreed to take a seat on the company's board to help restore confidence. But Buffett is not likely to argue that this is a model

that should be widely replicated. A more widely accepted example of value creation by investors is that of relationship investing. An example is the work of Robert A.G. Monks through LENS Investment Management (now LENS Governance Advisors) and Ralph Whitworth through Relational Investors LLC. Such relationship investors take substantial stakes in companies they believe have performed poorly and use their influence to improve the corporate governance of these firms.

More generally, institutional investors such as public and union pension funds have in the past 15 years increasingly sought to add value to their investments by urging changes in corporate governance. For example, the Council of Institutional Investors each year creates a "Focus List" of companies whose poor financial performance can be helped by governance pressure from its members. A similar list is maintained by the California Public Employees Retirement System (CalPERS).

Relationship investors say their strategy pays off financially. From 1992 through 2000, when it closed shop as a money management firm, LENS' portfolio outperformed the Standard & Poor's 500 Index.²¹ Similarly, Brad Barber, in his 2006 study of the activism program of CalPERS, says that CalPERS imprecisely estimates the wealth creation from its shareholder activism to be \$3.1 billion between 1992 and 2005.²²

However, if stock price appreciation is the only goal of relationship investing, investors are back in the trap of short-termism. They're no different from those they often criticize, the hedge funds and private equity firms that seek to add short-term value to their investments through cost cutting. These are the venture capitalists that German government officials described as "locusts" and whose managers are portrayed in the press as heartless, short-term profiteers.

What distinguishes the value created by relationship investors such as LENS and CalPERS is that they add value, not only to their particular investments but to the stock markets in general, by raising the standards of corporate governance. They often seek to create models of best practice and to create more honest and transparent financial markets.

This form of engagement with corporate management has its parallels on the environmental and social sides. Socially responsible investors with a long-term view seek to better the management of firms in part to improve their financial performance, but also to create models of best practice that can be replicated and bring broad societal benefit. They are creating positive externalities from which other investors and society may benefit.

These externalities can be created either through engagement with companies on ESG issues or by setting ESG standards for investment selection. These two tools function somewhat differently, but both can add value at the corporate, industry, and societal level.

Engagement on ESG issues follows the pattern of engagement by activist relationship investors. By engaging on issues such as carbon emissions, vendor standards, and equal opportunity employment, long-term investors seek to add value not only to a particular company's operations but to those of its industry as a whole.

This engagement can take the form of private dialogue with corporations, or more public confrontations. At the company level, for example, Domini Social Investments joined with other investors and non-profit organizations to successfully pressure Procter & Gamble to introduce a line of fair-trade coffee, a dialogue that ultimately resulted in

the launch of P&G's Millstone line of fair-trade coffees.

On an industry level, a coalition of responsible investors representing trillions of dollars in assets has come together under the aegis of the Carbon Disclosure Project to urge emissions disclosures by the largest corporations in the world. A similar coalition has formed under the banner of the Extractive Industries Transparency Initiative, to urge companies to disclose payments to governments, particularly in the developing world. In the U.S., the Investors' Network on Climate Risk is a coalition of institutional investors working with U.S. energy companies and utilities.

In the United Kingdom, engagement is now a widespread practice among large money management companies committed to sustainability. Among the major firms committed to substantial engagement

For long-term investors, a stock can be seen as worthless at any price.

programs are Insight Investment (part of HBOS) and Morley Fund Management (Aviva). These firms communicate with hundreds of companies on dozens of social and environmental issues each year. F&C Asset Management—one of the earliest and most thorough proponents of engagement—offers a separate investment management product called "responsible engagement overlay," or "reo." Through this service, F&C will engage corporate managers on

sustainability issues, whether or not F&C actually manages the client's funds. In 2006, F&C recorded 268 milestones, or instances in which "a company improves its policies, procedures, or performance following engagement by F&C's Governance and Sustainable Investment (GSI) team."²³

A second means of adding value is standard setting. Whereas mainstream investors will purchase any stock if the price is right, long-term investors let consideration of ESG factors limit or focus the number of companies in their investment universe. These investors can limit their universe, for example by eliminating industries such as tobacco and nuclear weapons that externalize costs onto society. In addition, they can seek to add value by shunning companies that do not meet internationally recognized labor standards or

whose sustainability practices are sub-par. They also can focus their investments on companies that address emerging ESG issues such as alternative power generation, access to water, health, or sustainable agriculture.

The most dramatic example of how standard setting by investors can add unquantifiable value to society was that of the South Africa divestment movement of the 1980s and early 1990s. At that time, institutional investors around the world joined in a broad campaign to help dismantle the apartheid legal system in South Africa. This standard setting and divestment movement by institutional investors was made possible by the Sullivan Principles, devised to assess the quality of labor practices in that country. These principles served as the basis for exclusion of companies by investors when firms failed to meet levels of acceptable performance. The long-term goal of these standards, however, was not improved financial performance. The goal was the creation of a just society.

The Sullivan Principles have been a positive model for an ever-expanding series of standards and principles. The Ceres Principles were launched in the late 1980s explicitly to do for environmental issues in the U.S. what the Sullivan Principles had done for labor practices in South Africa. More recently, labor standards for specific industries as diverse as apparel, toys, cocoa, and rugs have been widely promulgated. Environmental standards and best ESG practices have been developed for the mining, construction, and banking industries.

Long-term investors broadly defined use of these standards to help assess the value of companies and base their investment decisions in part on these assessments. In doing so, these investors are not only seeking to identify companies with superior prospects for long-term financial performance. They also are seeking to achieve three additional goals:

- 1) avoid companies that pose long-term ESG risks to society;
- 2) help create positive externalities that benefit society; and
- take a constructive part in a broad societal debate about the relationship between corporations and society.

When KLD's Domini 400 Index or the FTSE4Good Global Index series exclude manufacturers of nuclear weapons from their investable universe, they are not only avoiding companies with long-term ESG risks, but also are weighing in on the question of negative externalities. This question is not one that markets can resolve, nor is it the intention of these indexes to solve these problems. Instead, their exclusion policy is an implicit recognition that international governmental initiatives are needed to address negative externalities.

Social investors' efforts take place within the context of broader movements for change. They are not aiming to create long-term value on their own, but in conjunction with other players in society.

A desire to add value to investments in the public equity markets cannot be accounted for by current theories of investment management. It is beyond the scope of this paper to discuss the relationship between Modern Portfolio Theory (MPT) and a fully developed theory of long-term investing. However, it can be observed here that MPT addresses issues of holding period (longer is more efficient because you cannot beat the market by active trading) and ESG factors (matters of personal taste should not be factored into purely financial investment decisions). MPT is essentially silent on the issue of whether investors in the stock market can add value to their investments.

In addition, the value created by long-term investing as defined here contrasts sharply with the value that either short-term speculators or classical long-term value investors create. Short-term speculators arbitrage away short-term anomalies in the market. Long-term value investors minimize transaction costs, save on taxes, and capitalize on long-term market anomalies. The latter in particular can be said to reward corporations that are using their assets most efficiently to drive up earnings and hence stock price. Neither, however, addresses the question of externalities and the ability of investors to add value to their overall portfolio by minimizing the negative externalities and maximizing those that are positive.

Keith Ambachtscheer, a noted pension consultant, recently has suggested that the next

step in the development of Modern Portfolio Theory might be the consideration of how investments can be used to create broad societal wealth. Ambachtscheer describes how investment can realize "the promise of a higher rate of societal wealth creation" as "the biggest prize of all."²⁴

The implications of the broad definition of long-term investing envisioned here are substantial. This definition, although simple in form, implies three essential changes: a fundamentally different approach to assessing the value of companies; adopting active steps to increase the value of investments; and developing new means of measuring and managing ESG risks and rewards.

How Long-term Investing Affects Selection of Investments

Long-term investors will make active investment choices when they perceive that the value of companies or industries differs from that implied by today's price-driven markets.

In some regards, these investment decisions will resemble those made by traditional value investors. In two notable regards, however, they will differ. First, they will take ESG factors and externalities into account. Second, based on ESG factors, they will exclude individual companies and whole industries from their investment universes, regardless of cost. Consequently, from the perspective of the price-determined benchmarks that dominate today, they may appear more speculative and risky than traditional investors. This apparently increased level of risk arises both because the longer out investors look the more speculative they necessarily become, and because ESG factors call for a mixture of art and science in their evaluation.

These valuation techniques are a radical departure from today's mainstream. They imply a separation of price from value that can, under certain circumstances, be absolute. That is, for these long-term investors a stock can be seen as worthless at any price.

Augmentation of Value

Long-term investors seek to add value to their holdings in ways that are not solely related to price. These value-enhancing tactics include engagement and standard-setting practices such as one-on-one dialogues with management, participation in coalitions of investors addressing social or environmental issues, alliances with stockowners concerned about corporate governance, advocacy for the adoption of standards for social and environmental behavior, exclusion of companies from investment consideration, and participation in public policy discussion.

Value-creating stockowners look beyond questions of price to questions of just and sustainable societies. This active approach to adding value is a radical departure from today's mainstream. Most investors in today's stock market believe their role is to reflect value, not to create it. Those that seek to create value do so solely by capitalizing on market or management inefficiencies, seizing mispriced stocks or pressuring management to maximize short-term profits. Both approaches are essentially part of short-term, zero-sum games where no value need be added to society.

Long-term investors approach value creation as a more collaborative effort between corporations and society. Whether the issue is apartheid in South Africa, CEO compensation, energy conservation, or equal workplace opportunity, value-creating stockowners look beyond questions of price to questions of just and sustainable societies.

Measurement and Management of ESG Risks

Finally, long-term investing will depart radically from current investment practice in its measurement of risks and rewards. By seeking to minimize ESG risks and maximize positive externalities, long-term investors inevitably confront issues that markets have difficulty pricing. They cannot remain content to have their performance over the long term measured solely against price-based benchmarks. They must seek to assess value through other measurements.²⁵

This involves the assessment of how in the long term companies can best add value to society. Such value can be difficult to measure in ways other than price, but that difficulty must be overcome if long-term investing is to become reality.

As Keynes wisely observed in *The General Theory of Employment Interest and Money*, it matters greatly whether the long term or the short term predominates in our financial markets. This observation is no less true today than it was 70 years ago. If short-termers predominate, the social and environmental risks posed by corporations will go unmanaged. Given the size and power of our financial markets, and their increasing influence over the social and environmental quality of our lives, it is crucial that long-term strategies ultimately prevail.

To some, today's laser-like focus on price as a measure of value might make the dominance of the long term seem an unrealistic dream. Given the power and vested self-interests of those currently at the steering wheel, the prospects of turning this ship around seem dim.

Yet relatively simple changes in the definitions of what finance should do, and a clear vision of how to implement these changes, can alter the fundamental nature of the system. It starts by recognizing that the decision to equate value with price inevitably leads to short-termism. When we see this, the means to create a more value-based marketplace become more apparent. If we incorporate progress in financial risk management to increase value in the present, and build on growing understanding of the environmental and social factors that enhance our common future, we should be able in relatively short order to change the behavior of investors.

Finally, incorporating the long term into equity investing is only the start, not the end, of our journey. Similar approaches to the long term can be developed for other asset classes as well. Real estate, venture capital, private equity, cash, bonds, and commodities—all are subject to similar questions about the short and long term. The long term matters across all aspects of our financial activities. Progress in one asset class will support progress in all. Through this process, long-term investment can move from a goal devoutly wished for by some to a reality incorporated by all.

FOOTNOTES

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- ⁷ World Economic Forum 2005, op. cit.
- ⁸Jeremy J. Siegel, The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New. New York: Crown Business, 2005, p.xi.
- ⁹ Keynes 1997, op. cit.
- ¹⁰ John C. Bogle, *The Battle for the Soul of Capitalism*. New Haven, CT: Yale University Press, 2005, p.159.
- ¹¹ As Peter Bernstein has pointed out, index investors do not actually believe that the market is a zero-sum game. They just act as if it is. They believe that the economy, like a rising tide, will benefit all players in the stock market. They believe in betting that the tide will rise, but not on betting that one ship will rise faster than another (Peter Bernstein, Capital Ideas: The Improbable Origins of Modern Wall Street. Hoboken: John Wiley & Sons, 2005, p. 120-121).
- 12 Keynes 1997, op. cit.
- ¹³ See the Berkshire Hathaway 2005 Annual Report, page
- ¹⁴ John Sabapathy (ed.), Accountability Forum: Material Futures "Editor's Note." Issue 11, Fall 2006, p.6.
- ¹⁵ Space considerations preclude a full discussion of issues of materiality here. Many alternative definitions of the concept exist. For example, material information has been defined by the U.S. accounting profession as that which would affect the investment decisions of reasonable investors. In the United Kingdom, information is deemed material if it is relevant to considerations of a business' prospects for success. Alan Knight, the head of Standards and Related Services at AccountAbility, has described materiality as, among other things, encompassing "issues likely to be important now and in the future." Jed Emerson and Tim Little have argued that issues of materiality are often "subjective, based upon the particular goals of a given investor" (Emerson: 4). Whatever the definition, however, a distinction can be made between materiality that relates directly to stock price and materiality that is useful in broader valuations.
- ¹⁶ UNEP Finance Initiative Asset Management Working Group. The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing: 11 sector

- studies by brokerage house analysts at the request of the 2004 Report.
- ¹⁷ Jérôme Porier, "Existe-t-il une bulle des valeurs vertes?" Le Monde Argent April 1-2, 2007: 2.
- ¹⁸ Jeremy Sigel, The Future for Investors: Why the Tried and the True Triumph over the Bold and the New, New York: Crown Business, 2005.
- ¹⁹ Robert A.G. Monks and Nell Minnow, Watching the Watchers: Corporate Governance in the 21st Century. Philadelphia: University of Pennsylvania Press, 2000. James P. Hawley and Andrew T. Williams, The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic. Philadelphia: University of Pennsylvania Press, 2000.
- ²⁰ Hawley and Williams 2000, op. cit.
- ²¹ See LENS website at http://www.lens-inc.com.
- ²² Brad M. Barber, Monitoring the Monitor: Evaluating CalPERS Activism. November 2006. Available at SSRN: http://ssrn.com/abstract=890321
- ²³ F&C Asset Management, 2006 Corporate Responsibility Report, page 6, available at http://www.fundworksinvestments.com/fn filelibrary//File /co gen csr annual report 2006.pdf (last visited May 17, 2007)
- ²⁴ Keith Ambachtscheer, Financial Analysts Journal, January/February 2005, Vol 61 No. 1.
- ²⁵ Various alternatives to today's capitalization-weighted benchmark indexes exist. These include those weighted by financial factors other than price. Robert Arnott's fundamental indexes (Arnott) and Jeremy Siegel's indexes keyed to dividend payments (Siegel) are two such examples. Other examples including indexes such as those maintained by KLD Research & Analytics, Dow Jones and SAM Group, and FTSE4Good, use social and environmental criteria to limit the universe of stocks included in price-weighted indexes. These alternatives are steps in the right direction for those interested in long-term investing.
- ²⁶ Keynes 1997, op. cit.

The Next Generation of Stock Exchanges

Creating local stock exchanges as hubs to support local living economies

BY JOHN KATOVICH

Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of "liquid" securities. It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investment to-day is "to beat the gun", as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow.

John Maynard Keynes¹

The tremendous engine of public stock trading is not available to smaller companies, which reduces their ability to reach their full potential.

As the movement toward larger and more profitable stock exchanges continues, one major gap in capital markets looms large: the supply of capital to the small local companies that are the source of a significant fraction of job and income creation. The lack of equal access to capital for worthy small and medium enterprises (SMEs) reduces their ability to reach their full potential. This paper explores possible new models to fill this gap, in ways that foster sustainable development at the local level and nurture

responsible business. It proposes that not every stock exchange must move toward the global but, instead, could reverse course and become a pivotal hub for the support of local living economies

The Current State of the Markets

The financial services industry is an enormous part of the U.S. economy. Current estimates by the U.S. Bureau of Economic Analysis show that this industry contributed \$958 billion to the U.S. Gross Domestic Product in 2005, or about 7.7 percent. The estimates for the number of people employed in this industry range from 800,000 to 1 million, and the demand for trading securities and other financial products has shown no indication of slowing. Today, seven U.S. exchanges are publicly traded, sporting an average valuation of 39 times estimated 2008 earnings.

Daily trading volume has grown exponentially in the U.S. as well as around the world. At the New York Stock Exchange, trading was approximately 40 million shares daily in the 1980s but is almost 3 *billion* shares today. And, when combined with NASDAQ, the two comprise almost 6 *billion* shares traded *every single day*. This amount of daily volume shows that investment has been far overshadowed by speculation today. The concept of shareholders and their rights takes on an entirely new meaning when the time that shares are held becomes days, or even minutes or seconds.

Companies that can afford to list and trade on the primary exchanges have enjoyed great success in recent years. Raising capital through an Initial Public Offering becomes a much easier task when investors trust that liquidity is strong, and that the path to an exit—that is, selling shares in a company—is readily available. Investors are reassured by knowing that the U.S. primary markets are held to some of the highest standards anywhere in the world. And a new trend of taking companies back private, only to offer them out publicly later, adds yet another dimension to the financial alternatives available to large corporations today.

The tremendous engine of public stock trading is not available to smaller companies. They have few options for raising capital beyond typical debt financings and via the accredited investor community.

To Be or Not To Be Public

A public offering is an excellent way to accommodate growth by offering equity in a company in return for capital. Once public, companies might find they can do additional offerings if their stock performs well. Successful public offerings also increase a company's net worth and growth prospects, and improve its debt-to-equity ratio. In addition, going public provides founders and principals with a way to value and market the stock they own.

Public offerings grossing less than \$30 million are impractical today due to the myriad expenses a company incurs in going public. But companies must consider a number of factors before deciding to become a listed publicly traded company. Without several years of growth and consistent financial performance, underwriters will not consider their equity securities acceptable to public investors. Flat or adverse financial performance makes a company unattractive as an initial public offering candidate. The common rule today is that public offerings

grossing less than \$30 million dollars are impractical due to the myriad expenses that a company must incur. As a result, underwriters will typically only take on the fast-growth, rising stars with big hockey-stick growth patterns and scintillating exit strategies.

Companies also need to understand what it takes just to prepare for a public offering, including months of planning and retaining new finance, accounting, and legal experts to ensure that all major financial transactions and customer arrangements have been properly prepared. The company might need to amend existing bylaws and review the minutes of all board meetings to ensure they are clear and complete. They might need to terminate certain leasing and licensing arrangements with shareholders, and amend or forfeit certain internal owner or employee agreements. They also might need to draft contracts for key personnel to ensure their continued employment and loyalty. In addition, they

might need to revise their capital structure, add shares, change or remove certain classes of stock, and eliminate tax structures. Finally, they must be prepared to incur new costs, including the underwriter's compensation, outside legal and accounting fees, printing charges, and transfer agent and filing fees. To go public with a high-quality offering today, companies should anticipate spending anywhere from \$300,000 to \$1,000,000, excluding underwriter's commissions.

Once public, companies must begin to disclose results of operations, financial conditions, and information regarding its officers, directors and certain shareholders. This information might include company sales and profits by product line, salaries and other compensation of officers and directors, as well as data about major customers, the company's competitive position, and any pending litigation and related party transactions. All of this information becomes available to its competitors, customers, employees, and to the general public through the initial registration statement that is updated yearly through annual reports, 10-Ks, proxies, and other public disclosure documents.

And then there are the internal and external pressures to maintain earnings and growth patterns. Many will scrutinize each quarterly report filed with the SEC. Short-term decisions may begin to rule at the expense of long-term planning and profitability which the familyowned business had enjoyed for many years. A company may find that it has lost the voting control and operating flexibility it exercised before going public. Management will need to deal with shareholder relations, public relations, public disclosures, periodic filings with the SEC, and reviews of stock activity. Add to that shareholder meetings, annual and quarterly reports, public relations efforts, and ongoing legal, accounting and auditing fees, all of which must be paid out of pocket. So an offering of less than \$25 to \$30 million becomes uneconomical.

Most major investment banking firms today prefer at least a \$50 million offering at a minimum price of \$10 a share before they will take on a company. Smaller offerings are more difficult to market, and after-market trading is often considered too volatile due to the reduced number of outstanding shares (also

called "float"). Underwriters want to see a minimum size to create sufficient interest within the investment community in order to attract a large syndicate and active aftermarket.

So if a company is large enough and profitable enough, it may benefit substantially from a well-planned public offering. But if it is an SME with steady revenues and profits, and happy to remain so, all of these costs and responsibilities will detract significantly from its historical orientation toward "conscious growth" over long-term horizons. It can find itself moving quickly away from its original purpose and mission, now driven by the demands of shareholders that expect larger profits and a more active trading regime.

Publicly Traded Exchanges

An exchange is typically any kind of marketplace for bringing together buyers and sellers. To become such a marketplace, an entity must either register as a national securities exchange, or find an exemption from

The assets of small firms are, by definition, sited in the community.

registration; for example, on the basis of limited transaction volume or, as recently seen, by becoming what is known as an alternative trading system, or an electronic communications network. Exchanges are tasked with self-regulation of their markets, including the consideration of the public interest when administering their markets, allocating reasonable fees in an equitable manner,

establishing rules designed to admit members fairly, designing listing standards, and monitoring its markets for misconduct. By controlling the listing standards process, investors are theoretically able to make informed judgments about whether to purchase a security of a company. The other way they may do this is through the exchange's self-regulatory function, which targets fraud and manipulation, and protects investors from such things as insider trading, front running, and trading ahead.

At the same time that the process for becoming public is increasingly tedious for small companies, we also have witnessed a parallel trend: every national stock exchange in the U.S. has departed from the 200-year-old, notfor-profit structure, to become a for-profit corporation, often going public just like the companies that are listed and traded on those exchanges. As not-for-profit entities, exchanges were not prohibited from making profits (as nonprofits are), but the profit was supposed to be incidental to its charter. Today, however, exchanges are caught up in the very same profit-driven, quarterly-earnings compulsion that dominates most every publicly traded company.

Thus the question arises, is the stock market an effective vehicle for distributing capital to all companies that truly need it? While the IPO market certainly delivers the funds that a company needs, the market itself has far surpassed its role as provider of liquidity. As William Greider observes:

Since 1970, stock turnover has risen from 15 percent a year to more than 50 percent. Even institutional investors, despite their supposedly long-term perspective, experience portfolio turnover of 40 percent annually. There is no argument that speculators provide a key function in the markets, but it would appear now that the market is mainly a house of speculation. And what does that mean for any connection back to the company and the original public offering? Very little.²

Public Offering Alternatives for Small and Medium Enterprises

In the move toward bigger companies, faster transactions, and more profits, even the "regional" national exchanges (such as those in San Francisco, Boston, Chicago and Philadelphia), by and large have rid themselves of what used to be termed the "local" listings. Up until recently, those local listings existed and traded side-by-side with the larger, more highly capitalized stocks. They were much less active and, as a result, those listings have now been mainly moved over to markets known commonly as OTC (derived from the term "over-the-counter," when one could only trade a small cap stock by going to a prescribed counter to make the transaction with a clerk).

The Over the Counter Bulletin Board (OTCBB) and the National Quotation Service Bureau (NQS, or more commonly known as the *Pink Sheets*) together make up the OTC market in the United States. These markets are quotation mediums, not stock exchanges. OTC securities are traded by a community of market makers who enter quotes and trade reports through a sophisticated, closed computer network.

The more we nurture and support local business, the more likely we will bring prosperity to all Americans.

Thus small companies, in particular those that could not meet a national exchange's listing requirements, do have opportunities to be listed and traded today. Some companies may even prefer to be listed in an OTC market due to less stringent disclosure rules. In addition, new opportunities for small companies are being rolled out. The London Stock Exchange's alternative investment market (AIM) is

now the favored destination for many growth companies. In the U.S., the over-the-counter market Pink Sheets just launched a new quoting and listings system for microcaps. NASDAQ as well as Goldman Sachs are planning similar marketplace structures that will allow accredited investors easier access to private company ownership. But even for those that can afford to, and have an interest in being either publicly traded or having easier access to accredited investor dollars, there are drawbacks to joining these markets.

For one, many if not most of these companies are interested in eventually being picked up by a national exchange, much like moving from the minor leagues to the major leagues in baseball. These markets attempt to mirror what happens in the larger markets, often resulting in the appearance of failure if a company stock does not mimic those larger market behaviors. Another problem with OTC or bulletin board status is that many of the major brokers have a policy against buying and selling OTC stocks. As a result, brokers are unable to offer stock in these companies to their clients, and the brokerage research departments then reduce or stop the analysis of them.

In addition, despite recent reforms that have been placed on OTC markets, there are still far too many instances of penny stock and micro cap fraud, since they are not as closely scrutinized by regulators. Low-priced, infrequently traded, and thinly capitalized securities also attract a large number of new and inexperienced investors, hoping to turn those pennies into dollars. And because of the lack of reliable, accurate, and timely information about the business operations of many of the lesser known OTC companies, dishonest brokers are provided the perfect conditions to prey upon the innocent, who mistakenly believe that, because it is a market, it must be regulated like all the others.

SMEs are clearly challenged—not only from the heavy cost burdens connected with the requirements of going public, but also from the limited fundraising and marketplace alternatives. From a free-market perspective, one would argue that if SMEs are too small to meet the regulatory and financial requirements, then they should not participate in the marketplace in the same way as large companies. If those small companies cannot garner sufficient interest and liquidity in a marketplace, then they will not be appropriate participants in a market that works only when volumes are high and trading interest is active.

But this simple conclusion does not take into account the importance and value that SMEs have to local economies, and it assumes that the ultimate end user, the individual investor, will always opt for only highly liquid stocks that offer the richest of rewards for the least amount of risk.

The Case for Investments in Local Economies

Why should we care about small local companies? Michael Shuman observes:

...[m]ost of us suspect—correctly it turns out—that local businesses in our community are more directly connected to our well-being. The assets of these small firms are, by definition, sited in the community and owned by people residing there. They almost exclusively hire neighbors. The benefits of their success and the fallout of their failure are experienced directly by residents.³

Local business actually constitutes the lion's share of the U.S. economy. The U.S. Small Business Administration (SBA) defines small business as firms having fewer than 500 employees, and these actually account for half of private-sector employment in the country and 44 percent of private payrolls. A more restrictive definition of small business—a firm with fewer than one hundred employees—still accounts for about a third of private employment and private payrolls. By either definition, more than 99 percent of all firms in the United States are small businesses.⁴

Put another way, footloose global businesses dominate our imagination, get showered with subsidies, and monopolize our capital markets, but actually occupy only about half of the economy. Firms with more than 500 employees constitute only about 0.3 percent of all firms. They supply fewer than half of all private jobs.

Shuman lays out the advantages of local ownership as promoting:

- 1) long-term wealth generators;
- 2) fewer destructive exits:
- 3) higher labor and environmental standards:
- 4) better chances of success; and
- 5) higher economic multipliers.⁵

He adds that:

[t]he Financial Markets Center, a financial research and education organization, has found that, compared to banks with far-flung portfolios, those that concentrate lending in a geographic region are typically twice as profitable and wind up with fewer bad loans. These factors point to the need for a new approach as to how we deal with local economies...The central argument here is that [locally-owned] businesses are the key to a community's economic future. The more we nurture and support [SMEs], the more likely we will bring prosperity to all Americans rich and poor, black and white, male and female, rural and urban, young and old. With greater prosperity for so many diverse groups, we also have a better

shot at solving hundreds of other knotty problems bedeviling our society.⁶

If the SME sector is to reach its full potential, major improvements in capital access for such enterprises must be established.

The Local Exchange

A promising new approach would be to develop a complementary approach to how a company, desirous of remaining small and local, might be provided with its own forum for raising capital. It would be an approach apart from the current traditional national exchange or OTC approach—one that provides for raising capital via a public offering, but is also supported by the government with a focus on the local, on responsibility, and on true transparency.

To achieve this, we must explore what a new kind of marketplace might look like. It should meet the spirit and letter of the regulatory frameworks designed by Congress. And it should explore the untapped opportunities that arise from the connection of individuals and local companies.

The idea for a local exchange began with the theory that to flourish, local economies need more than "Buy Local" campaigns. They need an easy way for residents of a community to invest in local businesses. The latter represents a return to what communities did for two centuries prior to twentieth century laws such as the 1934 Securities Exchange Act, which practically put an end to state-approved listing and trading of securities (in the name of protection of the public investor) and nationalized the process.

A local exchange would thrive where there are a sufficient number of small companies to populate it. Choice locations might include the San Francisco Bay area or portions of New England. The exchange would include small companies in various stages of their lifecycle—some in a moderate growth phase—and a few that may ultimately grow to a size where the classic IPO alternative becomes their best route. Many such companies seek to retain control and remain independent for the time being. They also may seek to preserve a loyal employee base and retain the values and practices unique to their community-based,

triple-bottom-line⁷ goals. Presumably, many of these companies are frustrated with the existing financing options, such as additional rounds of debt, private equity, VC's, bulletin boards, Pink Sheets, intrastate offerings, direct public offerings or traditional IPOs, and will find the idea of raising funds through an alternative IPO within their local community intriguing.

Examples of the profiles of such companies include:

- A closely held \$10 million organic food business with owners facing retirement and in need of some liquidity.
- A \$30 million family-owned winery in need of expansion capital that is leery of the financing alternatives they have researched.
- A growing regional \$2 million biofuels operation that is receiving offers from private equity firms but not interested in losing decisionmaking control.
- A \$50 million real estate brokerage company based upon a sustainable model that pours funds back into its community and now is interested in bringing this model to other cities, but is unhappy with the existing funding alternatives.

To serve these kinds of companies, a local exchange could be designed to function like a traditional exchange—or possibly as an autonomous facility of an existing Self Regulatory Organization that regulates exchanges⁸—while utilizing existing operative systems, networks and back-end clearing/depository functions of the existing exchange. Ideally, an existing exchange would decide that it is in its best interests to support this concept, and perhaps enjoy additional economic benefits that result from the creation of multiple, networked capital market communities.

Business owners could sell minority stakes to local residents (primarily non-accredited investors) who are devoted customers, who share their vision, or who want to support local businesses. The local exchange would not restrict the ability of investors outside the community also to participate in the offering if the company met the appropriate exemptions allowing for offerings in all states (i.e., blue sky exemptions), but the marketing focus would remain local. Also, if the company was not large enough for the applicable exchange exemption that alleviates the blue sky work, the local exchange will obtain the blue sky exemption only in that state, which also significantly limits outside investor interest.

The local exchange would offer a range of products, including dividend-producing index funds for varying sizes of companies, sectorspecific types of companies (e.g., the food and energy sectors of a local economy) that might be traded as an Exchange Traded Fund, or perhaps a real estate instrument designed to offer ownership and dividends while assuring the conservation of the land as an alternative to selling it to developers. When appropriate, companies that are too small to be included in anything but a fund consisting of a group of similarly sized companies conceivably could grow over time and become eligible to be individually listed. All of these structures would be available for secondary market trading.

Because of the significant accounting, audit, and disclosure requirements that any company faces when going public, there would be a need to provide local exchange companies with assistance. Approaches include using service providers with a significantly reduced cost structure via scaled services, and partnering with others to develop services, such as a complete software package for small company accounting, audit, and reporting/disclosure. This could be done in conjunction with parallel efforts to work with the SEC to create modified standards for small companies. Efforts are underway now to try to relax some of the Sarbanes-Oxley reporting and control standards that burden small companies but, until such changes become a reality, a local exchange would find ways to provide the necessary support to companies.

In addition to helping meet the traditional financial reporting requirements, a local exchange would partner with others to develop responsible business reporting standards for social, environmental, and governance

practices. Local exchange-listed companies would be encouraged to adopt amendments to their articles of incorporation that take into account stakeholder as well as shareholder interests.

These additional surveys, reporting systems, and changes to incorporate stakeholder interest will provide significant filters to screen out companies not meeting social responsibility standards. They also could lead to some interesting data outputs that could become standard reporting information.

A parallel structure to a local exchange would be a Local Exchange Online (LEO), which would provide an online network for likeminded businesses to exchange information. Areas of sharing might include banking, best practices, resources, co-investment, memberbased loyalty cards, and alternative businessto-business trade currencies.⁹

Because this concept involves public investors and small companies—a combination that has had its share of problems in the past—the highest priority in this endeavor must be to reduce risks to the investors, companies, and the exchange. This can happen most effectively by the introduction of standards that go beyond today's typical financial listing criteria—standards that focus on the elements identifying a responsible company. The

Local exchanges could partner with others to develop responsible social reporting standards.

incorporation of additional listing standards focused on environmental, social, and governmental behaviors will be one of the most effective ways both to filter companies and to monitor how they behave. As mentioned earlier, the investment data that are produced out of this should be compelling.

This concept is close, but not yet ready for implementation. In addition to further exploration of the logistics of implementation, we must

tackle larger questions such as defining the term "local." Shuman offers some general guidance when he writes:

[a] business can only be considered locally owned if those who control it live in that community. That could mean...that residing in the community are more than half of a firm's...shareholders... The truth is that these details matter enormously when it comes to the local multiplier.¹⁰

For companies listed on a local exchange, liquidity will likely be low and exits lengthy at times. Expectations for finding the next hot mover will need to be eliminated. Companies expecting the hockey-stick growth pattern will not be appropriate for such an exchange. We are, instead, talking about the loyal, local employer that intends to remain loyal to its values and keep its customers primarily local, and that expects modest but steady returns. We are also talking about individual investors who will be content with putting a small portion of their funds into local, long-term investments with the expectation of modest gains.

This model cannot be sustainable if it relies only on revenues produced from transaction fees, nor should the trading be active. It behooves us to look at the entire network of companies, investors, and intermediaries that understand the importance of this model, and find alternative models of support. Networks often are successful in generating revenues when the participants understand the value received and remain active. This model should look beyond the traditional trading and data revenues that an exchange obtains, and should consider this a community: from the scaleable services and early-stage debt financings all the way to new business-to-business and consumer-to-business opportunities this community might generate.

Conclusion

The role of an exchange was once a pivotal part of how local individuals supported local business, until that structure began to migrate toward a national, then multinational model, supporting a profit-driven mission for the sole benefit of shareholders. But local communities still exist, and they could still benefit greatly from a local exchange. What is necessary is a sustainable business model that allows for that structure to survive.

The concept may appear to be the antithesis to our experience with markets over the last few decades, and it is meant to be. However, many are beginning to understand the compelling need to find local solutions to sustain local economies. For every effort to double down on the dollars in search of the next pile of returns, there are other equal and opposite efforts to regain a slow, sane connectivity to business and community. If there are enough individuals willing to back that up with just a portion of their investment dollars, being local could become a sustainable model and secure its rightful place as a key component of capital markets, helping to build prosperous enterprises and communities for the long term.

FOOTNOTES

¹ John Maynard Keynes, *General Theory of Employment*, *Interest and Money*. Amherst: Prometheus Books, 1997.

² William Greider, *The Soul of Capitalism*. New York: Simon & Schuster, 2003, p.200.

³ Michael Shuman, *The Small Mart Revolution*. San Francisco: Berrett-Koehler Publishers, 2007, p.9.

⁴ This number is higher than total household energy expenditures because it includes non-household efficiency savings and transportation efficiency savings that show up elsewhere in consumer expenditures.

⁵ Shuman 2007, op. cit., p.46-49.

⁶ Tom Schlesinger, *Nationwise Banking: An Analysis of the Treasury Proposal*, monograph (Southern Finance Project, Philamont, VA, March 1991). The Southern Finance Project has since changed its name to the Financial Markets Center (www.fmcenter.org).

⁷ Companies that generate (1) healthy profits, while also striving to be (2) socially and (3) ecologically responsible.

⁸ Self Regulatory Organization as defined by the 1934 Securities Exchange Act—basically meaning that the Local Exchange would be a facility of an existing national exchange.

⁹ Credit for this concept belongs to Kiefer Katovich, Stanford University.

10 Shuman 2007, op. cit., p.41.

Revisiting Corporate Charters

Reviving chartering as an instrument for corporate accountability and public policy

BY CHARLES CRAY

Exactly what is a corporation? There are many ways to answer that question—from the prevailing legal view that corporations are a "nexus of contracts" to the more whimsical observations of Buckminster Fuller (who defined corporations as "socioeconomic ploys") and Ambrose Bierce (a corporation is "an ingenious device for obtaining profit without individual responsibility"). From a public policy perspective, the precise answer is that corporations are creations of the law. They come into existence through the legal process of incorporation, also known as chartering.

The chartering system in the U.S. has been in disrepair and disuse as a means of corporate accountability since the end of the 19th century.

Though little used today, chartering has the potential to be one of the best ways to hold corporations directly accountable to the public interest. Chartering is an important but neglected tool of industrial policy-making. With global warming and other forms of environmental damage demanding rapid action, the time is ripe to examine how this powerful policy tool might be used to refocus economic activity to better serve a variety of public objectives.

Until the late 19th century, state governments used corporate charters to shape economic behavior, requiring corporations to meet certain public obligations in exchange for the privileges conferred through incorporation.² In the first 100 years of the Republic, citizens and legislators used the chartering process to shape the nation's economy by placing limits on capitalization, debt, land-holdings and sometimes even profits. Strict rules limited the issuance of stock, clarified shareholder rights, and determined record-keeping procedures. States limited charters to a set number of years, forcing their review and renewal.³

Today, as the U.S. Government Accountability Office stated in a report to Congress, "Most states do not [even] require ownership information at the time a company is formed."4 While at one time charters could be obtained only for projects in the public interest, today corporations can be chartered for any purpose. That was demonstrated recently when activists incorporated "License to Kill, Inc." in the state of Virginia. As described in their application, the stated purpose of the company was "the manufacture and marketing of tobacco products in a way that each year kills over 400,000 Americans and 4.5 million other persons worldwide." The state commission incorporated the company without hesitation. The majority of large U.S. corporations are incorporated in the state of Delaware, which requires very limited information when a company is formed. Indeed, the laxity of the process raises concerns about the ease with which companies may be used for illicit purposes by foreign citizens, including terrorist activities.

The chartering system in the U.S. has been in disrepair and disuse as a means of corporate accountability since the end of the 19th century. But every generation since then has entertained proposals for modernizing the corporate chartering system.

During the trust-busting era, President Theodore Roosevelt concluded that "the citizens of the United States must control the mighty commercial forces which they themselves called into being," proposing that federal chartering be introduced to control the big trusts of his day.

Proposals for federal corporate charter laws were included in the 1904 Democratic Platform, the 1908 Republican Platform, and the 1912 Democratic Platform. Between 1915 and 1932, at least eight bills related to federal chartering were introduced in Congress. In the 1930s, populist Senator Joseph O'Mahoney of Wyoming promoted the idea of "National Charters for National Business." In his statement to the Temporary National Economic Committee (TNEC) at its closing session on March 11, 1941, O'Mahoney suggested that to ensure business responsibility, it is necessary to have "a national charter system for all national corporations." His effort to control corporate power through federal chartering was derailed by the gathering storm surrounding World War II, and the TNEC that O'Mahoney convened to ask tough questions about corporate excesses was largely forgotten.6

In 1976, Ralph Nader and co-authors Mark Green and Joel Seligman revived the proposal to overhaul the corporate chartering system in *Taming the Giant Corporation*, a sweeping examination of federal chartering proposals, concluding that federal charters should be required for corporations capitalized above a certain size (e.g., \$250 million in annual sales plus 10,000 or more employees).

All of these proposals acknowledged a central fact that remains with us today: the inability of existing systems of regulation and law to hold giant corporations accountable. If chartering were to be taken up again as a tool of public policy, there are three possible approaches it could take, focused on single companies, all companies, or specific industries. Public policy could:

- Create government charters of individual companies for specific public purposes, as has been done with mortgage giant Fannie Mae, and Amtrak, the railroad corporation.
- 2) Broadly redefine charters at the state or federal level to reinforce the public purpose of every corporation.
- Create industry-specific charters as a way to prevent harm to the public good from companies in industries such as defense, tobacco, or energy.

Government Chartering of Individual Companies

Congress has issued charters since 1791, most of them after the start of the 20th century. The chartering power has been used to create a variety of corporate entities, including banks, venture capital funds, commercial corporations and more.⁷

Two notable federally chartered corporations are mortgage lenders Freddie Mac and Fannie Mae, created by an act of Congress to operate in the Department of Housing and Urban Development for the public purpose of increasing homeownership.⁸ During the Depression, Franklin Roosevelt used a federal charter in 1938 to create Fannie Mae as a public policy tool to compensate for inadequate private mortgage lending. The company initially was financed with Treasury funds, which over time were retired through sales of common stock until the company became entirely privately held, though still under Congressional control. Today it is a publicly traded company with over \$48 billion in revenues, which purchases mortgages from banks in the secondary market, providing much of the glue holding together the U.S. housing market. The nation largely has Fannie Mae (and partner Freddie Mac) to thank for the 30-year mortgage, which is rare in other nations, and for many years of low mortgage rates.

The power of the firm's government oversight framework could be seen in the company's 2004 governance crisis. When the company was caught managing earnings and was required to restate financials, an investigation by its federal overseer—the Office of Federal Housing Enterprise Oversight (OFHEO)—led Fannie Mae's board to reshape the company. The board replaced the CEO and other top executives and revamped accounting and risk management systems. A subsequent independent review found there had been "a dramatic shift in the 'tone at the top'," from arrogance to accountability. New CEO Daniel Mudd pledged to rebuild the company to again be "worthy of our public purpose—to serve affordable housing."

During the subprime mortgage meltdown of 2007, Fannie Mae was seen by investors as offering safe haven, because by policy it did not purchase mortgages with the most abusive

features, insulating it against the crisis to a greater extent than traditional mortgage companies. In summer 2007, there was a clamor in Congress and on Wall Street to raise the legal limits on Fannie Mae's mortgage portfolio, so it could purchase more loans and thus help relieve the crisis. It is a powerful example of how a company chartered in the public interest can—over the long run— better serve investors, customers, and the public than companies focused solely on short-term profit maximization.

Chartering could be used to reinforce the public purpose of every corporation, or to provide additional forms of accountability.

The National Railroad Passenger Corporation (Amtrak) is another federally chartered corporation, established under the Rail Passenger Service Act of 1970 to preserve intercity passenger rail service. All of Amtrak's preferred stock is owned by the federal government, and its board of directors is appointed by the president, subject to confirmation by the Senate.

Fannie Mae and Amtrak are but two examples of

charters where specific public obligations or goals have been embedded directly into the mission of a corporation. As examples they suggest a strategy that could be taken much further.

Over the course of the 20th century, Congress chartered a number of other corporations, primarily in response to different national crises, including the two World Wars, and the Great Depression. As such, each Congressionally chartered corporation was fashioned for a particular purpose. ⁹ Quasi-governmental corporations such as the Tennessee Valley Authority were thought to be better suited to handle certain commercial-like activities (e.g., selling electrical power) than either the publicly traded limited liability corporation or typical government agencies.

The ability of the federal government to alter a single corporation's charter also could be used in cases where a company is bailed out by taxpayers, as Chrysler was in the past. Any

company enjoying government largesse in this way should be held to a higher standard on issues such as executive compensation and governance. The process established under the SEC's enforcement proceeding against WorldCom took this approach, although it was modest in the reforms imposed on the company. Richard C. Breeden, a courtappointed corporate monitor, issued 78 recommendations to address explicit abuses that were instrumental in the company's collapse, including a "maximum wage" for the new CEO (which can be exceeded only by a vote of shareholders), limits on severance packages, and certain shareholder rights. 10 Alterations and amendments to a corporate charter similarly could be used with other corporations as a way to remedy serious crimes and recidivist behavior.

Reinforcing the Public Purpose of Every Corporation Through Chartering

Going beyond individual companies, a uniform higher standard of chartering might be established for all companies. As the U.S. Department of Justice Law Enforcement Assistance Administration suggested in 1979:

"The size and the complex interrelationships of large corporations make it extremely onerous for government agencies to exercise any effective social control... Corporate chartering alone would not in itself necessarily offer a solution to all corporate law violations: it would offer simply a better situation for accountability. The provisions of the charter would still have to be enforced by government agencies. Yet, the more uniform framework of a federal charter might offer greater coordination than is now provided by the SEC, the FTC, and other agencies that try independently to regulate illegal activities and secure disclosure, often without adequate legal weapons." 11

In the broadest approach, chartering could be used to reinforce the public purpose of every corporation, or to provide for additional means of accountability that the current systems of regulation are incapable of providing. Individual states or the federal government might craft charters that included provisions such as these:

- Limits on size and/or cross-sector ownership structures that are inherently anti-competitive.
- Restrictions on the corporation's ownership of other corporations, especially where there is no apparent purpose other than to escape potential liability.
- Restrictions on joint ventures and other instruments used to circumvent antitrust and other laws
- Corporate governance rules regarding board composition (e.g., director independence, representation of stakeholder groups such as employees and public directors), committee structures, stakeholder consultation, and other duties.
- The appointment of a public interesttrustee to serve as part of the daily management structure.
- Federal, state or local government stock ownership structures.
- Tiered liability structures that hold management accountable (e.g., multivariable liability for insiders or certain classes of stock associated with greater voting power or other forms of controlling interest).
- Rules regarding shareholder rights.

 These might, for example, provide for shareholder access to proxy nomination, or require that shareholder resolutions become binding on management.
- Rules on record-keeping and social reporting, especially when it comes to information not captured by general corporate disclosure laws, for which there is a compelling argument for public access.
- Restrictions on debt, land holdings, and so forth.

In the early days of the American republic, these and other features were established regularly by state legislatures when they granted new charters of incorporation. In centuries past, state legislatures and municipalities also forced the periodic review and renewal of corporate charters by limiting their duration, forcing them to expire unless they were renewed. Often, this led to contentious battles in the legislature over the policies associated with the company involved.

This process of "sunset and review" is a powerful aspect of the chartering approach that could be revived as a way to keep corporations accountable to the public good and democratize corporate oversight. Any reform of the chartering system might require corporations to declare their contribution to the public interest. A review of the corporation's compliance with this declaration would be required for the charter's renewal. The process should provide opportunities for the public and other interested stakeholders to present evidence and arguments for canceling or altering the corporation's charter in ways that improve its ability to serve the public in the future.

The potential politicization of these review and renewal processes raises one caveat: any consideration of federal charters by Congress should carefully consider whether the authority for renewal is best delegated to a specific department responsible for regulating the company's activities, a special corporations commission, or a committee of Congress itself. Each of these options would have certain advantages and disadvantages when it comes to upholding the public interest. If the aim is to remove the process a step from politics, the best route would be to establish a new corporations commission.

Whatever process is used, it should offer multiple opportunities for public intervention. These might, for example, be modeled after the processes of electric utility commissions. In the best of those processes, powergenerating companies apply to the commission for permission to raise rates, public hearings are held, professionals are employed to advocate for the public good, and individual citizens have the right to be heard.

Although corporate charters should be subject to periodic review and renewal, citizens also could have the right to challenge a corporation at any time, for actions that significantly exceed the terms established by its charter. This might, for example, be established by restoring the *Ultra Vires* doctrine—the notion

that a corporation has a legitimate sphere of activity which it may not exceed. When it does so, it is deemed to be legally out of bounds. 12

The chartering instrument is part of a broader public policy framework that strives for increased accountability and service to the public interest. In certain sectors of the economy, therefore, the issue will not simply be what features might be required of a corporation, but what is the best kind of institution to be used. An under-used but promising group of company charters cooperatives, employee-owned, trust-owned, and other "for-benefit" rather than for-profit company models—collectively have been termed a "fourth sector." These companies combine profit with social mission in ways that take them beyond the other three sectors of business, nonprofits, and government. Fourth-sector companies might be more appropriate for certain areas of the economy. Utility companies, for example, might be seen as inherently serving the public interest and so best subject to local or public ownership. It is important that local or state governments have some authority over the corporations that provide essential services within their jurisdiction (e.g. some forms of transportation, electricity, water, garbage, etc.).

Creating Industry-Specific Charters

Rather than attempting a major overhaul of the corporate chartering system immediately, policy- makers might first take up the neglected tool of chartering to address problems in specific industries where the case for public intervention is more obvious. Charters could be used in one or more specific industries of critical importance, such as public health, natural security, energy, and transportation.

The characteristics of any industrial sector where a new approach to chartering might emerge include:

• Industries that rely principally upon public and natural resources or the commons (essential services such as water, the broadcast media, extractive industries) where the assumption is that such resources should be managed equitably and with respect for the interests of future generations.

- Industries that serve the national interest (e.g., weapons manufacturers and other contractors whose primary income is derived from federal defense, intelligence and/or homeland security contracts).
- Industries with a key role in national security debates and perceived emergencies (e.g., energy and transportation).
- Industries that provide an inherently public function (e.g., auditing firms).
- Industries that are critical to achieving public health goals (e.g., HMOs, insurance, tobacco).
- Industries where an epidemic of corporate crime requires aggressive action.
- Industries in which unfair market power is relatively easy to exercise.

We might better understand how charters could serve as a useful public policy instrument by examining certain economic sectors that fit some of these criteria, including tobacco, the defense contracting industry, and auditing firms.

Example # 1: The Tobacco Industry and Public Health

Toward the end of his memoir, *A Question of Intent*, ¹³ David Kessler, the head of the Food and Drug Administration from 1990 to 1997, concludes that regulating the tobacco industry in the traditional sense would not adequately achieve national public health objectives:

"My understanding of the industry's power finally forced me to see that, in the long term, the solution to the smoking problem rests with the bottom line, prohibiting the tobacco companies from continuing to profit from the sale of a deadly, addictive drug. These profits are inevitably used to promote that same addictive product and to generate more sales. If public health is to be the centerpiece of tobacco control—if our goal is to halt this manmade epidemic—the tobacco industry, as currently configured, needs to be dismantled [T]he industry cannot be left to peacefully reap billions of dollars in profits"

Instead of regulating the industry, Kessler proposed that tobacco companies be required to spin off from their corporate parents, and that—if tobacco were not to be banned outright—Congress "charter a tightly regulated corporation, one from which no one profits, to take over manufacturing and sales."

Kessler's solution to the tobacco problem is a bold public health policy proposal along the lines proposed here: through Congressional action, the public once again exercises its prerogative to control the corporations its laws have created. In this case, those corporations whose business mission is in direct conflict with public health are not simply regulated; they are forbidden to continue to conduct business as usual. Tobacco has been recognized as a public-health threat for some time. The Centers for Disease Control and Prevention estimates that in addition to causing 440,000 premature deaths each year, smoking costs the nation \$167 billion a year in health care costs and lost productivity—well over seven dollars for each pack of cigarettes purchased by consumers.14

Kessler's tobacco proposal reminds us that our ability to control corporations comes from a powerful starting point: we create corporations and endow them with rights and privileges for one ultimate purpose—to serve the public good. Upon this basic framework, much follows.

A similar approach to Kessler's proposal also might be used to control other industries with inherently dangerous technologies. The chemical industry, for example, is at the center of the spread of certain persistent toxic pollutants (e.g., dioxin, PCBs, pesticides, ozone-depleting chemicals, etc.) recognized to cause a wide range of serious human health and environmental effects—the vast majority of them based on the production, use, and disposal of one particular class of chemicals: organochlorines.¹⁵ Various organizations including the American Public Health Association, the U.S./Canadian International Joint Commission on the Great Lakes, and numerous environmental groups, have called for a planned phase-out of the industrial production and use of chlorine-based chemicals—a class that includes 11,000

individual chemicals. In 1994, the Environmental Protection Agency (EPA) proposed to study the viability of a national strategy to "prohibit, substitute, or reduce" the use of chlorine in four key industrial sectors (PVC, solvents, pulp bleaching, and water treatment), but a powerful response from the Chlorine Chemistry Council defeated the EPA's proposal.¹⁶

Since then, evidence of the global impacts of chlorine-based chemicals led to the Stockholm Convention on Persistent Organic Pollutants, which recognizes the global threat from dioxins and other chemicals produced throughout the production, use, and disposal of chlorine-based chemicals. In addition, homeland security experts have raised national security concerns about the terrorist threat of chlorine transportation and storage near populated areas around the country. 17 The manufacture of chlorine—and other chemicals—could be banned until proven safe, with a specific timeline for the termination of corporate charters used as one of many possible enforcement mechanisms.

Example # 2: Global Warming, National Security, and Transportation

In 2003, the Pentagon issued a hair-raising report describing the potentially imminent and colossal national security threat posed by climate change. ¹⁸ Meanwhile, scientists such as NASA's James Hansen have warned that we have less than ten years to take decisive action to avert a climate catastrophe. ¹⁹

One of the main obstacles to taking such action has been the political influence of large oil and coal companies, and the intransigence of associated industries that might reduce the nation's dependence on fossil fuels, especially the auto industry.²⁰

Any significant effort to confront the obstacles to addressing global warming should consider a massive restructuring of the nation's energy and transportation industries, using the tool of chartering.

Congress has entertained the idea before. In 1974, the Senate Committee on the Judiciary Subcommittee on Antitrust and Monopoly held hearings on The Industrial Reorganization Act, where a detailed proposal for restructuring the automobile, truck, bus, and rail industries concluded that "as a result of their monopolistic structure the Big Three automakers have acted in a manner detrimental to the public interest. ...demonstrat[ing] that in the absence of vigorous competition, the automakers were naturally inclined to build oversized, high-profit cars which were energy-inefficient, unreliable, costly, unsafe and destructive to the environment."²¹

Like Kessler's, this proposal placed an emphasis on restructuring the industry rather than attempting to alter its unsatisfactory performance through regulation. Instead, "if Congress prefers competition to monopoly, public or private," it was encouraged "to reverse its emphasis on regulation and take action to restructure these industries," while taking action to shift the emphasis of transportation from highway to rail transport: "Reorganizing the Big Three motor vehicle manufacturers cannot by itself bring us balanced and efficient transportation; rather it is an essential first step in this direction."

Example # 3: National Security and the Defense Industry

"The Big Defense Firms Are Really Public Firms and Should be Nationalized." This was the title of a feature article published by John Kenneth Galbraith in the New York Times Magazine in 1969. 22 It is hard to imagine an industrial sector better suited for federal chartering than the nation's defense and security contracting firms. As Galbraith suggested, the existence of these firms is predicated upon federal policy goals, with the largest receiving major income streams through federal contracts. The nature of these firms raises public-policy issues, such as how much profit should be allowed when the sole or major revenue source is the public purse. Excessive profits in this situation could be considered a form of private taxation. An example of limiting profits in the public interest can be found in the electric utility sector, where utility commissions were created on the premise of regulatory control of a monopoly industry.

Lockheed Martin, the Pentagon's number one primary contractor, received \$21.9 billion in 2003 from the Pentagon out of its total revenues of \$32 billion.²³ Yet, Lockheed and

other big national defense corporations are chartered under state law, where they demonstrate the same weaknesses of state control as other corporations.

When for-profit firms are allowed to influence defense policies from which they directly benefit, national security policy is determined for private benefit rather than public benefit. Examples of private contractors defining the government's defense policy are rampant. In the recent case of Halliburton in Iraq, for example, Bunnatine Greenhouse, the senior contracting specialist with the Army Corps of Engineers, blew the whistle on Halliburton's involvement in the contracting process: "I can unequivocally state that the abuse related to contracts awarded to KBR represents the most blatant and improper contract abuse I have witnessed during the [twenty year] course of my professional career [in government contracting]," she testified.

The problem is systemic and extends far beyond Halliburton. The growth of private military firms and corporate intelligence contractors in the past decade has created additional profit-making pressures on national security policymaking processes.²⁴

Homeland security, post-disaster contracting, and intelligence contracting are the fastest-growing areas of government contracting. Outsourcing and contract procurement of government goods and services has grown rapidly in recent years, reaching a new high of \$412 billion in 2006. More than half of federal procurement spending (\$207 billion) in 2006 was awarded through no-bid and limited-competition contracts. The federal government spends over 40 cents of every discretionary dollar on contracts with private companies. ²⁵

The result is a steady stream of abusive contracting practices and a potentially dangerous distortion of American national security objectives. A *New York Times* reporter described the relationship between the government and the nation's largest corporations this way: "Lockheed has become more than just the biggest corporate cog in what Dwight D. Eisenhower called the military-industrial complex. It is increasingly putting its stamp on the nation's military policies, too." ²⁶

In his *Times* article, John Kenneth Galbraith wrote: "By no known definition of private enterprise can these specialized firms or subsidiaries be classified as private corporations." He noted that much of the fixed capital of defense firms is owned by the government, and that these firms effectively were protected from competition. There is no market between the firm and the government; instead, members of two public bureaucracies work out agreements for supplying weapons and other war technologies.

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"The process of converting the defense firms from de facto to de jure public enterprises would not be especially complicated," Galbraith suggested. outlining a strategy for doing so: if a company or subsidiary exceeded a certain size and degree of specialization in the weapons business, its common stock would be valued at market rates well antedating the takeover, and the stock and the debt would be assumed by the Treasury in exchange for government bonds. Stockholders thus would

be protected from any loss resulting from the conversion of these firms. As was done with Fannie Mae, the process ultimately might involve a conversion back to publicly traded stock ownership, with Congressional oversight retained in perpetuity through a federal charter. Thus, government funds in the long run would be freed up again.

Bringing defense and other companies into the framework of a government charter could be a way to reduce their impetus for aggressive lobbying and campaign contributions. The government-issued charter could explicitly ban such activities outright. This would change the industry from a master to a servant of foreign-policy objectives. Like Fannie Mae, the firms could continue to operate as profit-making entities, but their performance would be judged not only by quarterly earnings but by service to the national interest.

Example # 4: Auditing

The accounting industry's failure to adequately serve the public interest is well known, in the wake of Enron and other recent corporate scandals, where auditors authorized deceptive financial reports.²⁷ The Sarbanes-Oxley Act of 2002 provided for strong penalties for financial fraud, and eliminated certain conflicts of interest created by the consulting work that accounting firms conducted for their audit clients. But the law was imperfect in a number of ways. For example, it exempted tax consulting. "Tax work requires you to be an advocate for the client," suggested an industry observer who was critical of the loophole. "That is not compatible with audit work."28

Columbia University Law School Professor John Coffee suggests that independent auditors serve as gatekeepers for corporations whose assertions about their own financial health are inherently suspect.²⁹ Yet, given the financial rewards for complacency built into the system, it is difficult to imagine how public confidence can be restored unless auditing functions are established in a completely independent body accountable to the public.

New accounting scandals are a virtual certainty. For example, the FBI predicted in 2004 that "major white collar crime will impact the U.S. economy over the next five years." In its latest strategic plan it reported investigating over 189 major corporate frauds, eighteen of which involved losses exceeding \$1 billion.³⁰ Yet, after Arthur Andersen descended into bankruptcy in the wake of its initial prosecution and conviction (later overturned by the Supreme Court on a technicality), regulators have felt constrained to sanction the Big Four. No one wants to cause another of these big firms (who audit 97 percent of all large public companies in America) to collapse, because that could cause paralysis in the financial markets. By 2005, the Big Four accounting firms already faced an estimated \$50 billion in outstanding claims, and were having problems getting insurance, particularly against unpredictable catastrophic risk.31

The industry has acknowledged its perilous position by proposing a legislative limit on auditors' liability. An alternative—which

would not force taxpayers to bear the industry's risk without any benefits—would be to place the auditing function in the public domain. Former Reagan-era SEC commissioner Bevis Longstreth recently suggested that the SEC should be put in charge of auditing America's public companies, in much the same way government bank examiners audit banks.³² This kind of approach to financial auditing problems was included in legislation introduced in early 2002, before Andersen collapsed and Sarbanes-Oxley was completed. That bill would have created a Federal Bureau of Audits responsible for auditing all publicly traded corporations.³³

"Americans rely on the FBI to protect them from criminals and terrorists, the FBA (Federal Bureau of Audits) [would] protect American stockholders from the silent crimes committed by corporate criminals," the sponsor, Rep. Dennis Kucinich (D-OH), suggested. "The Enron scandal suggests we need cops who carry calculators instead of firearms!"

Given the precarious state of the accounting industry, a conservative case can be made that chartering a federal auditor is necessary to protect the country's free-market system. We must recognize that accounting fraud has calamitous consequences, not only for the firms involved, but also for millions of people who depend on the performance of the market for their retirement security. In this respect, confidence in corporate financial reporting can be considered a question of national security.

The Way Forward

There is enormous potential in new forms of corporate chartering as a powerful instrument of industrial policymaking. For such proposals to gain traction, however, there would need to be a major shift in the political climate, so that corporations and their ideological allies are no longer able to forestall significant reform. This might come about through widespread citizen protest against corporate power, leading to considerable reform of the legislative and regulatory system itself, perhaps through measures such as the adoption of public funding of elections. That also be encouraged by more widespread adoption of fourth-sector charters by

community-friendly, for-benefit corporations, or by the increasing use of company-specific charters as a tool for combating corporate malfeasance, as was done with WorldCom. These kinds of new charters might create public comfort with the notion of alternative charters, showing how they are compatible with business success. Further, climate change might serve as an impetus for reforming the charters of energy or auto companies, creating new models that are widely perceived as beneficial.

There are many possible developments that might create the conditions under which chartering in the public interest could again be taken up as a more widely used policy tool. What is critical in the meanwhile is to recognize the power of this neglected concept, and to begin to imagine—in visionary yet practical ways—how corporate chartering can serve as a powerful instrument for harnessing the power of corporations to serve the public good.

FOOTNOTES

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⁴ See GAO-06-376, "Company Formations: Minimal Ownership Information is Collected and Available," April 2006.

⁵ See GAO-01-120, "Suspicious Banking Activities: Possible Money Laundering by U.S. Corporations Formed for Russian Entities," October 2000.

⁶ See Nader, Green and Seligman, *Taming the Giant Corporation*, p. 68.

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Transforming Corporate Reporting

Envisioning a new reporting framework that serves multiple stakeholders

BY ALAN WILLIS

Imagine that in the coming decade a new corporate reporting regime emerges that embodies Corporation 20/20's Principles of Corporate Design (hereafter "the Principles"). The new regime reflects the spirit of transparency and accountability in Principle 5: "Corporations shall be governed in a manner that is participatory, transparent, ethical, and accountable." At the same time, its content captures the essence of the remaining principles—that corporations have a duty to serve the public good, to consider the interests of many stakeholders, to distribute wealth equitably, to operate sustainably, and to respect human rights.

In this new world of reporting, all public companies (and non-listed ones above a

Imagine if
corporate
reporting
contained a
statement of how
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those who helped
create it.

certain size) issue periodic reports, available to all stakeholders. The historical shareholder-focused regime has been replaced by one that recognizes the broad array of stakeholders with legitimate claims on the performance of the corporation. Such reporting provides a broad array of economic, social, environmental and governance information, both quantitative and qualitativeinformation that is complete and reliable enough for judgments to be made by readers, not only about the

creation and distribution of wealth, but also about the extent to which the company adheres to all the Principles in its governance policies and practices.

Further, imagine that to account for how owners' invested money has been deployed, the report to all stakeholders would include financial statements, probably not unlike those we are familiar with today, but with an additional component—a statement of how wealth has been distributed to those who helped create it. Independent auditors' reports would accompany all these reports, providing assurance that they may be relied upon as fairly presenting what is reported.

Is this bold vision within the realm of plausibility? What would we need to do to make it reality? These larger questions lead to more precise queries, such as:

- To whom would companies be expected to report and why?
- What are likely to be the information needs of various stakeholder groups?
- Is there a need for mandatory reporting regimes, or would voluntary reporting suffice? What legislative, regulatory and standards-setting mechanisms and institutions are needed?
- What issues would need to be addressed to enable a successful transformation from the current system to the future desired model? What actors would need to be engaged?
- Are there other models from which we can learn?

What is the Objective of Corporate Reporting?

First, let's consider corporate reporting in its traditional function; namely, to inform shareholders about how successful their company has been in generating value and financial returns, and to enable them to assess its prospects for generating future value and returns.

Corporate reporting by public companies in stock markets informs the decision making of both existing and potential investors. Federal regulation of stock markets and disclosures by those who raise capital is intended to protect the interests of investors who have to rely upon the information provided by public companies. But federal regulation of stock markets and corporate reporting by public companies does not address corporate reporting requirements for private companies or other forms of business enterprise, nor the rights of shareholders of such entities to obtain financial information, appoint directors, call meetings, submit resolutions and so forth.

A more progressive objective for corporate reporting would be not just to inform the decisions of investors in publicly traded companies in capital markets, but also to enable all stakeholders—whether or not shareholders—to assess the extent to which the company has discharged its accountabilities in alignment with the Corporation 20/20 Design Principles, and to make decisions or take action accordingly. Corporate reporting can therefore function as a key enabling element of all accountability relationships between a company and its stakeholders, not just its currently defined stewardship accountability to shareholders. For example, the new-style corporate reporting would provide relevant, reliable information that various stakeholders could use in deciding whether they need to take issue with the company about something of concern to them and, if so, what action might be most appropriate. The information would provide a starting point for meaningful dialogue.

In the case of shareholders, there is a clear accountability vested in boards of directors and management for satisfactory stewardship of invested funds and a legally enshrined expectation that the directors will act in the best interests of the company—whose shareholders are often in the best position to enforce that duty. But even shareholders may have accountability expectations beyond just wealth creation in their own interests. In a Corporation 20/20 world, shareholders presumably would expect a company to fulfill the six Principles and would, in common with other stakeholders, hold the company and its governing body accountable. Shareholders as well as other stakeholders would therefore have broader expectations about the purpose and nature of corporate reporting.

For the purposes of corporate design, it is important to recognize that today's corporate reporting model is fundamentally oriented toward investors. The reporting and disclosure rules of the Security and Exchange Commission (SEC), the related accounting and auditing standards, and the stock exchange listing requirements are all designed from this point of view. So any proposals for redesigning corporate reporting—changing its purpose and nature to meet stakeholder expectations in a Corporation 20/20 context—must, to be realistic, flow from a reasonable understanding of the current model and the processes and institutions that shape it.

It is important to understand the anatomy and physiology of the present mode, how it evolved, and how well it works. There is extensive evidence that corporate reporting today does not even fully satisfy the information needs of investors. Corporate reporting today certainly fails to meet the needs and expectations of many other stakeholders.

Later in this paper we will consider the broad characteristics of a possible blueprint for a more satisfactory reporting model and how we might get from now to then, from here to there.

A Brief History of Corporate Reporting

Corporate reporting in the Anglo-American tradition has evolved from being a 19th century statutory accountability mechanism, whereby once a year the directors and management of a company were required to present a set of financial statements to the shareholders, so that the shareholders might assess the stewardship of the funds they had invested in the company. Shareholders needed to be in a position to assess the acceptability of the return earned by management on the funds invested. They needed to be satisfied that dividends were paid out of earnings, not capital, and so on. Depending on the company law of the chartering jurisdiction, various recourse rights and actions were available to discontented shareholders.

In the years leading up to the stock market collapse and the Great Depression in the first part of the 20th century, public companies multiplied in number and grew enormously, while shareholders too increased greatly in

number, becoming much more diverse and detached from their former management oversight role. Meanwhile, corporate reporting practices became less and less regular and reliable. Investors knew less and less about the companies in which they held stock. Management and boards became less and less accountable to shareholders.

The creation of the federal SEC and introduction of the 1933 and 1934 acts caused fundamental changes in corporate reporting. New requirements, requiring reporting to shareholders by public companies and filing of corporate disclosures with the SEC in prescribed forms, were introduced and enforced. Financial statements now were to be presented in accordance with accounting standards set by a professional accounting body, and an independent audit of the financial statements was to be carried out by certified public accountants in accordance with professional standards—features we take for granted today.

Since the 1930s to the present day, corporate reporting to investors in capital markets in the

U.S. has been shaped by the 1933 and 1934 securities acts and the SEC, using regulation of corporate disclosure as a primary means of protecting the investors who trade in such markets. This model—however well we may think it serves its intended purpose—was not designed on principles of accountability, stewardship, director's duties, and shareholders' rights. These were matters constitutionally left in the realm of state corporation law.

Recognizing the fundamental purpose of today's corporate reporting model clearly is important if we want to consider transforming it to serve multiple stakeholders as envisioned by the Principles. Some parts of today's model, possibly with modifications, may continue to be useful but, as we shall see, much of it may be inadequate.

Corporate Reporting Today

Figure 1 is a simplified depiction of today's corporate reporting model:

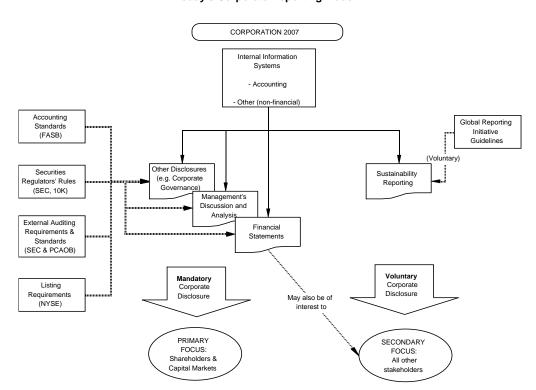


Fig. 1
Today's Corporate Reporting Model

At the top of the diagram we have the company, let's say Corporation 2007, and at the bottom we have two broad classes of interested parties—first, the shareholders and other actors in capital markets, including potential shareholders. Of secondary importance are the many other categories of stakeholders.

Shareholders and capital markets primarily want information to assess past performance and future prospects in creating financial equity and cash flows that translate into returns to investors over time (short term and long term). Other stakeholders—debt providers, employees, and labor organizations, suppliers, customers, communities, and governments—seek information for a wide variety of reasons linked to the nature of their stakes in the company: economic, social, environmental or other.

Any informed dialogue about the future of corporate reporting must be based on a realistic appreciation of how to effect system

The availability of financial information is essential to enable all investors to make informed investment decisions on a level playing field.

changes. For example, witness the Investor Network on Climate Risk and CERES trying to persuade the SEC to enforce its existing MD&A requirements to cause better disclosures about climate change impacts on companies' future prospects, and their strategies to address such impacts—a good example of understanding the existing system and knowing who to target for desired change.

The existing corporate reporting model evolved in a piecemeal fashion over time,

originating with the company law concept that shareholders are entitled to receive periodic (annual) financial statements, and continuing with the 1933 and 1934 federal securities legislation to ensure, among other things, fair and timely financial disclosures to participants in stock markets.

Today's public company corporate reporting model reflects a series of remedies to problems in reporting to shareholders, and has been constrained by tensions between securities law and state law about the responsibilities of directors to shareholders. The model is not the result of holistic, fundamental thinking about the role of the corporation in society and its concomitant accountability and transparency obligations to all stakeholders. It is probably more useful, therefore, first to envision afresh what tomorrow's reporting model should look like and then to work out how best to effect a transformation from the status quo.

Statutory Obligation to Report to Shareholders

The obligation for all limited liability companies, private and listed (or public),² to provide audited financial statements to their *existing* shareholders customarily is entrenched in the corporation law of the state³ in which the company obtains its charter. The substance of such obligations, including what is to be reported, varies among the jurisdictions, as do:

- a) the extent of monitoring by the incorporating jurisdiction, and
- b) the nature of remedies available to shareholders.

In other words, we can expect to (and do) find differences between how U.S. state corporation laws, Canadian corporate law (federal and provincial) and UK company law address corporate financial reporting obligations to shareholders.

There are no obligations under corporate laws in the U.S., Canada or the UK for companies to report to other stakeholders or interested parties.⁴ The underlying principle for reporting to shareholders is that since (in theory) they appoint the board of directors, the shareholders are entitled to receive information from the board. This enables the shareholders to make informed assessments about the directors' performance, and to introduce resolutions or make other decisions, such as voting for election of directors.

Public Company Reporting

When companies have issued equity (shares) or debt (bonds) to the public, their financial reporting obligations as issuers are, in the U.S., entrenched in securities laws and regulations. Securities regulators not only set the specific disclosure rules called for under the securities acts and other statutes (e.g., Sarbanes Oxley Act, 2002), but also monitor companies'

filings and enforce the disclosure requirements. Further, stock exchanges, such as the New York Stock Exchange, from time to time introduce listing requirements that call for practices and additional related disclosures regarding, for example, aspects of corporate governance.

The securities laws and regulations administered in the U.S. by the SEC aim to protect the interests of all participants trading in capital markets. Regulatory filings of required disclosures are the primary vehicle for ensuring that all capital market players have equal, timely access to reliable information. Theory has it that the availability of reliable information is essential to enable all investors to make informed investment decisions on a level playing field. Financial information has long been considered the lifeblood of efficient capital markets.⁵

Financial Reporting Components

The exact form and content of financial reporting varies between jurisdictions within North America, and between North America and the UK and the rest of Europe and other countries around the world. What has emerged in North America (U.S. and Canada) as the core financial reporting package for public companies is a combination of the following:

- a) the company's financial statements (including the notes thereto), together with
- b) an accompanying supplementary disclosure called Management's Discussion and Analysis (MD&A).

In the U.S. the form 10K, of which the financial statements and MD&A are perhaps the most important components, is the principal annual disclosure package that companies must compile and file. Prescribed corporate governance disclosures, including executive compensation information, are other elements of the 10K package.

Financial statements for all companies, large and small, private and public, are prepared and presented in accordance with accounting standards that have evolved over many decades and are issued by independent standards-setting bodies. The securities regulators in both the U.S. and Canada recognize these independent accounting

standards-setting bodies (Financial Accounting Standards Board [FASB] in the U.S.) as being the authorized developers of standards. These standards often are referred to as Generally Accepted Accounting Principles, or GAAP for short. Financial statements basically focus on past transactions and have limited predictive value, although the notes that form part of financial statements may include information about expected or reasonably likely future events and commitments.

The MD&A is intended to provide to investors two types of information "through the eyes of management":

- a) additional explanation and historical analysis of what is presented in the financial statements, also providing a business context that can assist investors in understanding the information provided in the financial statements, and
- b) additional information, whether historical or forward-looking, to help investors assess the company's future prospects. For example, known risks, trends and uncertainties or other factors known or likely to affect future performance are to be reported in the MD&A. The securities regulators in the U.S. (SEC) prescribe the rules for what is to be disclosed in the MD&A, and monitor and enforce compliance therewith.⁶

The SEC requires companies to prepare and file an MD&A, and prescribes its purpose, nature and content. Securities regulators in Canada have similar requirements. Unfortunately, in both countries it has long been evident that what companies in fact provide in their MD&As often falls short of what was originally intended; namely, meaningful contextual insights into past performance and future prospects, especially about business matters that the financial statements alone do not (and are not designed to) reveal.

The combined package of audited financial statements and MD&A, together with other disclosures about corporate governance matters such as appointment and compensation of directors, constitutes the 10K. Quarterly, interim versions of these disclosures are also required.

The form and content of these public company disclosures are prescribed through the various pronouncements of the SEC, PCAOB⁷, FASB and stock exchanges, notably the NYSE. The SEC oversees both the FASB and the PCAOB as well as the various stock exchanges.

Reporting to Other Stakeholders

Corporation 2007, our hypothetical organization, is under no obligation to report to any other class of stakeholders (other than government filings of various types, such as under various environment, health, safety and labor laws and regulations, or for taxation and statistical data collection purposes).

Over the last two decades, there has been an increasing trend for mainly larger companies to issue voluntary reports about environmental and social performance.⁸ Except for a few short-lived initiatives, there originally was no framework, far less standards, for such reporting other than what was called for by CERES. The emergence of the Global Reporting Initiative (GRI) in 1997, and the development and uptake of its 2000, 2002, and 2006 ("G3") sustainability reporting guidelines, now represents de facto a voluntary global reporting standard for social and environmental reporting, used by hundreds of companies worldwide. These guidelines call for reporting on the economic, environmental and social aspects and impacts of a company's activities, products, and services, as well as relevant governance and management policies and systems, and key stakeholder relationships, pertinent to understanding and assessing the effectiveness of its stated sustainable development policies.

Sustainability reporting and the role of the GRI Guidelines as the main vehicle for voluntary corporate disclosure to other stakeholders is depicted on the right of Figure 1. Figure 1 also acknowledges that some of these other stakeholders (e.g., employees, labor organizations, suppliers, lenders, and communities) will be interested in financial reporting, and in a few selected elements of financial statements that are also called for in the GRI Guidelines.

Companies are under no obligation to provide their financial statements directly to other stakeholders but, since public companies' financial reporting is contained within mandatory SEC filings, such information is available freely to the general public.

Today's Model, Tomorrow's Principles

It becomes readily apparent that today's corporate reporting model is inadequate for a company's expected disclosures to stakeholders in a Corporation 20/20 world. The information presently required to be reported to shareholders and capital markets, even if considered adequate for that context, hardly informs a broader assessment of the company's sustainability or its conformity with the societal expectations embedded in the six Principles. And there is currently no requirement for companies to issue a sustainability report of any kind.

Equipped with the preceding overview, let us ask whether today's reporting model would provide the information needed for stakeholders of any type to answer satisfactorily the following questions:⁹

- 1. Is the company functioning in a way that is consistent with harnessing private interests to serve the public interest?
- 2. Is the company accruing fair returns for shareholders, but not at the expense of the legitimate interests of other stakeholders?
- 3. Is the company operating sustainably, meeting the needs of the present generation without compromising the ability of future generations to meet their needs?
- 4. Is the company distributing wealth equitably among those who contribute to its creation?
- 5. Is the company governed in a manner that is participatory, transparent, ethical, and accountable?
- 6. Is the company infringing on the right of natural persons to govern themselves, or infringing on other universal human rights?

The combination of laws, regulatory agencies, accounting standards, disclosure rules, and auditing arrangements we have today are probably incapable of producing much of the corporate reporting package necessary to meet the expectations and needs of stakeholders in a

society and economy where companies are expected to function according to the Principles.

If we conclude that today's reporting model is inadequate for these fundamental societal accountability purposes, then the justification for transformational change in corporate reporting becomes urgent.

Longer-term investors are likely to recognize that their own future return on financial investment will be influenced by the extent to which the company is striving to fulfill the spirit of the Principles. Such enlightened investors then may be willing to collaborate with other interested parties to redesign and implement corporate reporting appropriate in a Corporation 20/20 economy and society.

Pathway to Transformation

Recall the scenario sketched out at the beginning of this paper:

In this new world of reporting, the shareholder-focused regime has been replaced by one that recognizes the broad array of stakeholders with legitimate claims on the performance of the corporation. Such reporting provides a broad array of economic, social, environmental, and governance information— complete and reliable enough for judgments to be made not only about the creation and distribution of wealth, but also about the extent to which the company adheres to all the Principles of Corporate Design.

Further, imagine that these reports are supplemented by financial statements, not unlike those of today, but with an additional component— a statement of how wealth has been distributed to those who helped create it.

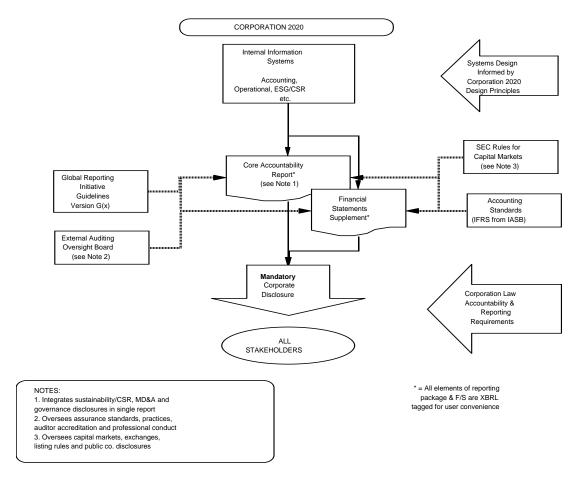
This is just an example of what a nextgeneration reporting model could look like, in terms of what is reported and to whom. It will be a creative and exciting task for a multistakeholder group to reach consensus on what such a reporting package should look like and then figure out how to make it happen.

Even when consensus is reached about the design of a new, appropriate corporate reporting package, it will be necessary to see how other features of the model, as a

connected system, will need to be re-designed or created anew.

Figure 2 depicts a possible future corporate reporting model that captures the above design features:

Fig. 2
Future Corporate Reporting Model



Consider the key features and assumptions reflected in Figure 2, while highlighting key challenges of transforming the extant reporting regime.

1. Mandatory corporate disclosure is available to all stakeholders, comprising a core accountability report supplemented by financial statements. In the future, this reporting will be called for under corporation law—whether at state or federal level—that embodies the Principles, including the concept of accountability to all stakeholders for various matters, and the requirement for appropriate periodic reporting to them all on how these accountabilities have been fulfilled.

This reporting will be required for all publicly traded companies and also for private ones above a certain size threshold, e.g., 500 employees or \$50 million in turnover. The application of the reporting model to smaller private companies may need to be modified as necessary for reasons of scale, resources, cost, etc.

2. The core accountability report integrates the types of information currently reported (to some extent) in various, disparate sources. These include:

Management Discussion and Analysis (MD&A) filings, sustainability or CSR reports, governance disclosure filings, and other periodic reports to shareholders and other stakeholders. Its purpose is to communicate to stakeholders in such a way that they can assess the corporation's adherence to the Principles.

The form and content of the core accountability report will be driven by a future version of the internationally recognized, widely adopted, Global Reporting Initiative (GRI) Guidelines, the use of which will have been prescribed in corporation law and, for public companies, by SEC rules—at least with respect to those disclosures in the core report that, like today's MD&A, are deemed necessary for investor decision-making purposes.

- 3. The core accountability package may contain some financial performance highlights and summary information deemed relevant to more stakeholders than just shareholders. There will be a continuing need for a financial reporting component that measures and discloses how the company has performed as a steward of its shareholders' investments. The form and content of the financial statements provided as a supplement to the core accountability report will be shaped by internationally accepted accounting standards (IFRS), which the SEC and FASB are likely to adopt in due course. Accounting standards- setters will need to be more mindful than at present of the broader societal context within which financial reporting occurs. The statement of wealth distribution, relevant to all stakeholders, will be a new component of the financial statements, for which new international (or, failing that, domestic) accounting standards will have been developed by an appropriate body.
- 4. All items of disclosure within the core accountability report and financial statements will be available in electronic format and be tagged using XBRL. This will facilitate its access and use by specific stakeholder categories, such as investors and analysts, or human rights or environmental groups, who have a special interest in specific parts of the overall reporting package. The SEC already is moving fast towards implementing the XBRL tagging of all filings.
- 5. The regime will provide assurance for the entire reporting package. Addressing assurance about the core accountability report and the financial statements component will necessitate establishing a public oversight board. This new body must be broader in mandate and representation than the PCAOB established under the Sarbanes-Oxley Act with regard to auditing the financial statements and internal controls of public companies.

Requirements regarding assurance and auditing of corporate reporting will be embedded in corporate law in the interests of all stakeholders, as well as in SEC requirements for the benefit of investors in

- capital markets. There will be a need for all components of the reporting package to be subject to appropriate independent assurance processes to ensure reliability, completeness and balance, i.e., freedom from management bias. This will call for extension of conventional financial auditing concepts, standards, and methods to new types of information, utilizing multi-disciplinary teams.
- 6. The design of the internal information systems of a company needs to **harmonize with the Principles.** This is the case in order to be able to produce the core accountability report and financial statements that are informed at an overall level by the Principles, as well as the provisions of the GRI Guidelines and accounting standards. Suitable internal systems will also be needed in order that management and governing bodies may obtain the information they need internally to ensure the company is constantly striving to fulfill the expectations and accountabilities imposed on it by (transformed) corporation law, as well as to meet its external reporting obligations.

Each of the features discussed above is a complex area in terms of transforming reporting, and all are linked in various ways as a connected system. Adjustment or transformation of one feature depends in most cases on changes in others. The necessary changes involve not just technical adjustments to standards and rules, but involve consensus building to address structural, legal, crossjurisdictional, and even constitutional impediments to progress. But there are already encouraging examples, best exemplified by GRI, of progress being made on what at one time might have seemed an impossibly ambitious path of change.

In short, the new corporate reporting model is forward looking and embraces the "value" concepts of multiple stakeholders, whereas the existing model, at best, is short on meaningful insights about value creation, and focuses unduly on the interests of investors. In view of the origins of the existing model, further piecemeal adjustments to it are doomed to

inadequacy. Fundamental reconceptualization and transformation are called for.

Is it plausible to imagine that in the coming decade a new corporate regime will emerge that embodies stakeholder-centered reporting? The answer is yes. Indeed, the markings of an emerging consensus in support of transformative change are already discernable. Such change holds the promise of moving reporting from the narrow domain serving the interests of a few to a vehicle for contributing to the broader public good.

Appendix A – Relevant Initiatives and Models to Consider

There are several current reporting initiatives and papers relevant to consideration of future external corporate reporting obligations and practices, and therefore potentially useful to study. Among these are:

A. Driven primarily by investor interests and their information needs:

- ICGN (International Corporate Governance Network)
- UNEP PRI (United Nations Principles for Responsible Investment)
- INCR (Investor Network for Climate Risk)
- EAI (Enhanced Analytics Initiative)
- CFA Institute
- Marathon Club

B. Driven by accounting bodies, primarily to address investor needs:

- IASB MC (International Accounting Standards Board project and discussion paper on Management Commentary)
- VMRC (Value Measurement & Reporting Collaborative)
- EBR (Enhanced Business Reporting)
 Initiative
- Report Leadership (PwC, CIMA et al.)

C. Driven primarily by broader-based constituencies to address stakeholder accountability and transparency needs, including but not limited to investors' needs:

- GRI (Global Reporting Initiative)
- Conference Board (U.S.)
- Tomorrow's Company (UK)

FOOTNOTES

www.corporation2020.org.

⁴ There have been examples in other countries, however, such as Denmark, where company law was amended to call for companies to report externally on environmental matters. In France there are mandatory requirements for corporate reporting on environmental and social matters. ⁵ The UK and Canada have somewhat different legal and regulatory mechanisms and systems for establishing, overseeing and enforcing requirements for company disclosure to shareholders and capital markets, the Canadian system being more similar to the U.S. system than the UK's.

⁶ In the UK, financial statements are accompanied by a directors' report and, for public companies, a "business review" by the directors is required, somewhat comparable to the MD&A in content. For over a decade in the UK, there also has been voluntary reporting by some public companies of what was termed the "Operating and Financial Review," which went further than the "business review" and was more directly comparable to a North American style MD&A. The form and content of the business review have recently been amended in the context of UK company law reform and EU requirements.

⁷ Public Company Accounting Oversight Board.

⁸ See, for example, International Corporate Governance Network, Consultation Paper on Non-Financial Business Reporting, June 27, 2007; Enhanced Analytics Initiative, (http://www.mercerhr.com/referencecontent.jhtml?idContent=1167975) Marathon Club, www.themarathonclub.org. UNEP FI Principles for Responsible Investment, (http://www.unpri.org/) International Accounting Standards Board, (http://www.iasb.org/Home.htm) Discussion Paper on Management Commentary; (Available at:

 $\frac{http://www.iasb.org/NR/rdonlyres/0FE78C14-8AF9-}{4CFB-A764-}$

40B1A08E0DF5/0/DPManagementCommentary.pdf)

Allen L. White, *The Quiet Revolution in Business Reporting*, CERES, 2006,

 $\underline{http://www.ceres.org/pub/docs/ceres_sloan_paper.pdf}.$

⁹ Principles of Corporate Redesign at www.corporation2020.org.

² In the U.S. and Canada, a company becomes a public company by virtue of registering and offering to the public an issue of equity or debt (bonds), regardless of being listed on any particular stock exchange.

³ In the UK, companies are chartered at the national level under the Companies Act: in Canada, at either the national level under the federal Canada Business Corporations Act or at the provincial level under a province's corporations act.

The Emergence of New Corporate Forms

The need for alternative corporate designs integrating financial and social missions

BY SUSAN H. MAC CORMAC
WITH ASSISTANCE FROM JONATHAN GLASS AND JULIE COOKE

Many believe that the prevailing corporate form focuses on maximizing profit for stockholders at the expense of other stakeholders—specifically employees, the community in which it operates, and the natural environment. Even corporations that strive to integrate corporate social responsibility (CSR) into operations face constraints on their ability to pursue deep social responsibility, primarily as a result of the fiduciary obligations of their boards of directors. Federal or state governments offer one possible solution through legislation to create a new corporate which would embed social purpose into the DNA of future corporations. This new form could be structured as either a for-profit charity, a socially conscious corporation, or some

One possible solution is to create a new corporate form that embeds social purpose into the DNA of future corporations.

combination of both. Such hybrid models have both strengths and weaknesses. This paper will suggest which models hold the greatest promise for acceptance by business, investors, lawyers, civil society, and government.

Understanding the Problem

During the semi-finals of the Global Social Venture Competition (GSVC), a student-led business plan

contest sponsored by the Haas School of Business at Berkeley, a panel of judges reviewed 14 business plans for social venture organizations, defined as entities that generate profits and feature a social or environmental return on investment. The high caliber of the business plans was impressive, with the nascent entrepreneurs articulating how to address a variety of social problems—the electricity needs of developing countries, nutritious school lunches, or an alternative cash crop to combat poverty in Sub-Sahara Africa. However, the entrants clearly were constrained by the rigid legal structures which framed their business models: for-profit corporations or tax-exempt organizations.

The inadequacy of this rigid line—dividing for-profit vs. nonprofit—has been recognized by two different movements gaining momentum in the last decade. For-profits are beginning to pursue social missions like nonprofits, and nonprofits are taking on profitable subsidiaries much like for-profits.

The emergence of these two movements raises questions about the adequacy of existing corporate forms. Are there significant limitations to for-profit and nonprofit models that prevent organizations from successfully blending profit making with social mission?

The business plans submitted to the GSVC demonstrate that social and environmental values can be incorporated successfully into for-profit corporations without changing a firm's legal structure. There are several reasons for this. First, there is a compelling business case for the adoption of CSR principles. Second, the business judgment rule covering the behavior of boards can, in some cases, promote both stockholder profitability and social and environmental values. Third, there are investors drawn to businesses that provide a social or environmental return.

However, because the CSR movement is relatively recent, it remains an open question as to whether these reasons are sufficiently compelling to overcome the problems inherent in the current legal forms. Unfortunately, it is likely that because for-profit companies only have one stakeholder to whom management and the board owe a fiduciary duty—the stockholder—the existing for-profit corporate form may preclude more fundamental change.

On the other side of the dividing line we see the "social enterprise" movement, where selected nonprofits are increasingly incorporating market drivers into their business models. Many types of organizations, from medical centers to trade organizations, are finding ways to generate revenue from socially beneficial offerings within the tax-exempt structure. In some cases, like Underwriters Laboratories, the government has enacted legislation to expand the scope of an exempt purpose to maintain the entity's tax-exempt status. Other non-profits, like Pacific Community Ventures, have established wholly-owned, for-profit subsidiaries that generate non-exempt revenues and allocate a portion of the profits to the nonprofit parent.

Corporate Social Responsibility initiatives are not likely to stimulate change fast enough to address the major issues facing us today.

However, social enterprises are hobbled by many legal constraints, including a seemingly arbitrary designation by the IRS of what is considered tax-exempt revenue, and the labyrinth of legal rules that regulate their activities. In addition, nonprofits are required to articulate a fairly narrow public purpose in their articles, and in states such as California, they are not permitted to change this purpose without attorney general approval. They

also lack access to financial markets, relying instead on philanthropy. And without stakeholders who have an ownership interest, they lack effective incentives to achieve the efficiency necessary to compete and create change on a broader scale.

Unfortunately, the CSR and social enterprise movements are not likely to stimulate change in business fast enough to address the plethora of environmental and social issues facing us today. How can we address the problems inherent in the existing corporate forms? This analysis will look at a variety of approaches.*

Part I: Expansion of Existing Corporate Forms

The for-profit corporation is primarily defined by its relationship with its stockholders. Unlike banks and other creditors, stockholders typically have no right to be repaid for their investment and are, instead, *residual* claimants, entitled to whatever value is left after creditors have been repaid. The primacy of the stockholder derives from the theory that only residual claimants have an appropriate incentive to maximize the total value of the corporation, because other stakeholders are motivated only to satisfy their fixed claims. Fiduciary duties of care, loyalty, and obedience are designed to safeguard against loss of stockholder value. The relationship between the corporate entrepreneur and the supplier of capital serves as the engine that drives the for-profit corporation in its existing form. Significantly, these two constituents also generate the impulse for changes in corporate forms.

CSR Policies Within the Current Legal Framework

CSR initiatives are a good place to begin examining the shortcomings of the existing corporate structure. It has been comparatively easier for start-up companies with a social mission to attract investors, because these companies do not already have an established stockholder base. Companies such as Revolution Foods and World of Good focus not only on stockholder value but on providing healthy and organic lunches for low-income school children, or selling ethically sourced housewares and accessories.

It has been more difficult for large, publicly traded corporations to incorporate CSR principles deep into the fabric of their operations. The easiest case occurs when CSR initiatives are profit-generating or provide clear cost savings. As the March 22, 2007 issue of *FORTUNE* magazine gushes, the business case for CSR can be compelling, because CSR products can outperform existing products and build goodwill with customers and employees.²

As a matter of corporate law doctrine, managers have discretion to adopt CSR initiatives even when they cannot be cast as a means of maximizing stockholder returns over the long run.³

*Many of the companies mentioned in this article are clients of Morrison & Foerster. All information provided is public and/or has been included with their permission.

Managers have broad discretion in their duty to act in the best interests of the corporation.

Only in liquidation events (where the company is on the brink of sale or dissolution) are the best interests of the corporation equivalent to immediate stockholder profit maximization. Unfortunately, boards of directors and management of many corporations have not welcomed this expanded view of the traditional business judgment rule.

Although there are many opportunities for CSR, actual accomplishments have thus far not made high-impact change. There are many reasons for this, which vary by type and size of

There are insufficient metrics for measuring social and environmental returns, leaving investors to focus on stock price.

corporation. For small, socially oriented companies, access to capital markets can be limited for social enterprises that embrace a "double, triple or quadruple bottom-line" philosophy, which might be perceived as offering lower returns. There are insufficient metrics for measuring social and environmental returns, leaving investors to focus on stock price. And as companies grow and need more capital, the corporate

focus on CSR may fade unless the entrepreneur and later-stage funders can agree on possible trade-offs between profitability and social or environmental mission.

For public companies, the threat from stockholders may arise less from litigation and more from a takeover by a private equity fund or hedge fund determined to wring more profits out of the enterprise. In addition, the increasing prevalence of stock options in executive pay packages means management has little incentive to pursue CSR initiatives unless they immediately enhance profitability. Also, the shortened tenure of CEOs and the ever-present threat of dismissal means the pressures run in a single direction, toward greater profitability, not toward greater social responsibility.

Given these constraints, CSR policies by themselves are unlikely to trigger the systematic and widespread changes that society needs, within the short time horizon that we have.

Shareholder Activism

One existing tool stockholders have to encourage social and environmental change is the shareholder resolution, included in the company's proxy statement. Public companies communicate with their stockholders annually via proxy statements, which identify management's slate of candidates for the board and seek stockholder consent on proposed corporate actions, such as mergers. Simply submitting a stockholder proposal may begin a dialogue with a corporation to achieve improvements. For example, the Hershey Company, in response to a stockholder proposal from Walden Asset Management, agreed to create a broad-based supplier code of conduct focused on child labor in the cocoa industry. Satisfied with the results, Walden withdrew its proposal.5

Other proposals result in conflict with management. For example, stockholders of International Paper were given the opportunity at the May 2006 annual meeting to consider a proposal that the board prepare a report to asses the feasibility of increasing the use of post-consumer recycled fiber and adopting Forest Stewardship Certification.

Management opposed the proposal.⁶

While in many cases a powerful tool, shareholder resolutions are limited in their effectiveness by the fact that the SEC can give management the power to exclude stockholder proposals from proxy statements. Among other things, the proposal may be excluded if it relates to what is considered ordinary business, a category often cast in an over-broad way. Going directly to shareholders, outside the proxy statement, is prohibitively expensive. For these reasons, the shareholder resolution mechanism is unlikely to achieve significant CSR improvements.

Alternatives Offered by Private Equity/Venture Capital Firms

Another force for change is the emerging class of funders that value the CSR mission of corporations and are willing to invest accordingly. These include: (1) "angel investors" who invest early on; (2) venture capitalists or private equity firms that invest during the interim phases of corporate growth; and (3) large institutional stockholders, willing

to hold shares in large public companies with appreciable CSR accomplishments.

In this spectrum, some for-profit investment institutions operate in parallel to charitable grant-making institutions. These institutions (e.g., the Bay Area Equity Fund, an affiliate of JP Morgan/Chase and the Omidyar Network) exist because they believe that investments can make money *and* promote social and environmental objectives, or because they find traditional philanthropic grant-making less effective for certain kinds of endeavors.

If these kinds of investors wish to incorporate social elements into their investing agreements, they have a great deal of freedom to do so. Importantly, funders typically will demand the contractual power to eject or sideline an ineffectual chief executive. Other contractual elements that the double-bottomline funder and the entrepreneur may consider are:

- a) charter agreements that the board of directors will include members with CSRindustry specific expertise;
- b) rights for the investor to sell its investment to the corporation if the corporation strays from its CSR mission;
- voting provisions that require the funder's consent for the corporation to change its strategy;
- d) tools that aid the board in resisting takeovers by financial buyers;
- e) requirements that the corporation report its performance on specified CSR criteria; and
- f) bylaw provisions committing the corporation to maintain membership in a CSR standards organization, procure inputs only through responsible channels, or make corporate donations to CSR nonprofits.⁸

Though theoretically possible, such contractual agreements remain relatively uncommon. Off-the-shelf corporate provisions remain the norm. The difficulty and unfamiliarity of negotiating investing agreements on a case-by-case basis represents a significant hurdle to using this route to effect substantial change.

Stimulating Economically Sustainable Nonprofit Organizations

While for-profits struggle to incorporate social mission in effective ways, nonprofits face the opposite problem. They struggle to incorporate profit-making within the nonprofit framework. There are various ways they are doing so.

Nonprofits Generating Revenue Without Structural Change

Many nonprofits today creatively and successfully generate revenue or seek funding without altering their tax-exempt structures, using a variety of methods. For example, Underwriters Laboratories (UL) generates a good portion of its revenue through fees received from a safety certification process. Others, such as Business for Social Responsibility (BSR), generate revenue from membership fees, conference fees, and a store that sells books and other materials on CSR.

In addition to these successful revenue-generating models, companies can utilize program-related investments (PRIs). A PRI permits foundations to support a charitable activity by making a financial investment—such as a loan, loan guarantee, or equity investment—which generates a potential return on capital. While this is a useful cross-over tool—from the charitable to the profitmaking side of the line—in practice it is limited because, to qualify as a PRI, an investment must meet stringent tests, including these:

- It must further the charitable purpose of the nonprofit making the PRI.
- It must significantly further the foundation's tax-exempt activities.
- It normally would not be made by a fiduciary because the risk/return profile does not meet the "standard prudent investor" criterion.
- It can result in substantial income or appreciation as long as obtaining that income or appreciation is not the goal of the foundation making the investment.

Although available and rather flexible, PRIs are generally not utilized as a tool for social benefit purposes for a number of reasons:

- 1. A targeted vehicle has not been created specifically to receive and use PRIs.
- 2. There is no method of marketing PRIs so that smaller and less-sophisticated foundations, trusts and investors can invest in a small portion of a specific PRI
- 3. The PRI requires documentation similar to the documentation necessary for a market-rate business investment, increasing legal and other expenses.¹¹

In addition to these limits on the use of PRIs. there are other significant limitations on nonprofits that wish to behave more like forprofit firms. Tax-exempt organizations whether public charities or private foundations—face strict rules on how donors may make contributions and obtain tax deductions, which often limits flexibility in receiving funds. Both public charities and private foundations are subject to rules regulating self-dealing transactions. In addition, both public charities and private foundations may not engage in business activities that are substantially unrelated to their charitable purpose, because doing so means risking their tax exemption. Also, income from insubstantial unrelated business activities is taxable at corporate rates.

Although nominally tax-exempt, private foundations pay a 1 percent or 2 percent tax on their annual income and must distribute at least 5 percent of the fair market value of their assets annually, or face a penalty tax. The investments of public charities are constrained by legal requirements with respect to management of charitable assets, and foundations are further subject to strict percentage restrictions on ownership of corporate stock (and thus may not have a corporate subsidiary). Foundations also must pay a penalty tax on certain investments, such as high-risk investments, that are deemed to jeopardize their assets or charitable purpose.

Given all these constraints, nonprofits lack the flexibility of for-profit operations and, as a result, are not able to compete as effectively in the marketplace.

Nonprofits Establishing Hybrid Structures

To get around some limitations, an increasing number of nonprofits are establishing hybrid structures, which can take various forms:

- A nonprofit can establish a wholly-owned for-profit subsidiary.
- A nonprofit can make a minority investment in, or establish a contractual relationship with, a forprofit.
- A nonprofit can enter into a joint venture (typically in the form of a limited liability company) with a for-profit.

In each case, the nonprofit spins off its forprofit affiliate and receives direct benefit from it in the form of investment returns, donations, or services. The social entrepreneur may consider a hybrid form, for a wide range of reasons.

First, certain types of income that the nonprofit generates may not be tax-exempt, and too much of such revenue could put 501(c)(3) status in jeopardy.

Second, the social entrepreneur may want to change his or her business model. For instance, Drive Neutral is a 501(c)(3) nonprofit that allows consumers to neutralize their carbon emissions through large-scale sustainable projects, and it generates income through tax-exempt donations or purchases of carbon-offsets. It is considering changing its business model by forming a for-profit subsidiary that provides consulting and other services. ¹²

Third, the social entrepreneur may realize that he or she can attract un-tapped for-profit funding sources by establishing a hybrid organization. The for-profit affiliate can sell stock to investors, can provide dividends (if the nonprofit is a stockholder), and can make donations and provide services to the nonprofit. However, there is risk in the long run if the original investors sell to new stockholders who do not embrace the social mission.

Finally, 501(c)(3) organizations that are structured as public charities may look to hybrid models in the wake of the Gates

Foundation grants. The size of the grants will require that many recipients register as private foundations as opposed to public charities, and the management of these tax-exempt entities may not have the resources, or the desire, to comply with the rigorous IRS foundation rules.

Hybrid structures give social entrepreneurs the flexibility to attract funding from private, forprofit sources, without jeopardizing the parent's charitable status.

Like social entrepreneurs, double-bottom-line investors may choose a hybrid structure for similar reasons, where they want the flexibility to make under-market or market-rate investments in for-profit entities with a social or environmental mission. Two prominent examples here are Pacific Community Ventures (PCV) and Omidyar Network. PCV is a 501(c)(3) nonprofit organization, that "helps companies [in California] in traditionally overlooked areas to gain access to capital, business advice, and critical business resources that will accelerate company growth."13 To expand its scope, PCV formed Pacific Community Ventures Investment Partners, a for-profit entity.14

There are certain advantages to the hybrid structure. It gives social entrepreneurs the flexibility to attract funding from private, forprofit sources. ¹⁵ And if implemented properly, creating a for-profit arm eliminates the risk of jeopardizing the nonprofit parent's charitable status. ¹⁶ It also can insulate the nonprofit from liabilities related to the for-profit's activities. ¹⁷ Perhaps most importantly, the profits, donations, or services from the for-profit affiliate or subsidiary can help alleviate the dependence of a nonprofit on the whims of philanthropists and foundations.

While there are many benefits to a hybrid structure, there are also constraints. Hybrid entities require additional resources, including fees for attorneys and other advisors to create and operate two distinct entities. The hybrid structure also may raise public relations issues (i.e., that the nonprofit's charitable reputation is tarnished by profits). In addition, any income from rents, royalties, or interest that flows to the nonprofit will result in Unrelated

Business Taxable Income (or UBTI), if the nonprofit owns more than 50 percent of a subsidiary for-profit.²⁰ Finally, upon the dissolution of the subsidiary, the transfer of any appreciated assets to the nonprofit parent will constitute a sale of the assets, which is taxable at the subsidiary level.²¹

New Fund-raising Techniques by Nonprofits

A recent development in nonprofit fundraising is the use of private placement services from seasoned veterans. The Non-Profit Finance Fund (NFF)—a 501(c)(3) which provides financial analysis and unsecured, non-equity financing for nonprofits—recently launched NFF Capital Partners, a for-profit subsidiary. ²² It offers private placement services for nonprofits and social enterprises seeking equity funding. ²³

Another example is the for-profit Calvert Group of socially responsible mutual funds, which operates a nonprofit subsidiary, the Calvert Social Investment Foundation. This foundation offers to investors the unique Calvert Community Investment Note, which permits individuals to make low-risk loans at rates between 0 and 3 percent, with the funds invested in a professionally managed loan fund. The funds are used to make affordable loans to over 200 nonprofits and social enterprises, such as FINCA International, a microcredit organization operating in 60 countries, or Peoples' Self-Help Housing, a leading nonprofit developer.

Experimentation With New Corporate Forms

While all these examples show the latent flexibility available under current law, they also point up the limitations inherent in the existing legal framework, where the law leads business people and investors to envision a rigid dividing line between for-profit activities and social mission. To address the limitations of current legal forms, a myriad of new legislation or new proposals for company designs have been suggested recently. In the for-profit arena, these include amending charter requirements and creating new forms of social enterprise corporations. In the nonprofit community, these include new corporate forms, designations, and laws affecting tax-exempt entities.

Novel Proposals in the For-Profit Arena

Changing Charter Requirements

State laws which establish charter requirements for corporations have been and may be further updated to strike a new balance between society and corporations. One proposal is that states impose caps on corporate returns to stockholders. While the cap could be structured in many ways, one idea proposes that equity holders hold timelimited rights in their shares, much as patents

A new community of companies branded as B Corporations—beneficial to society—would help lower costs in attracting investors and customers.

and copyrights are limited in time rather than perpetual.²⁴ Shann Turnbull has suggested limiting stockholding rights to 20 years, a period during which stockholders would insist on receiving dividends, since they would no longer have equity in the retained earnings. Stakeholders—such as employees and the community in which the company operates, among others—would become the residual claimants. Management still would be required to operate the company efficiently because, in order to finance new projects, management would need to attract new investment capital as opposed to relying

on retained earnings. Under the proposed scheme, corporations that adopted this form would enjoy a reduced level of corporate tax, which would boost dividends and compensate for the lost equity. One possible downside is that projects with long development horizons would have difficulty attracting funds using this corporate design. That would make this design inappropriate for corporations that engage heavily in research and development, such as the pharmaceutical industry, where the period during which investors are entitled to dividends may not coincide with the profitable period under patents. In addition, fewer investors may be willing to purchase stock in which there is no chance of a long-term return, making them less valuable than traditional shares of stock. Another issue with changing the charter requirements in one state is that corporations may then elect to incorporate in a different state.

In addition to creating new mandatory charter requirements, some are recommending the establishment of new voluntary charter arrangements. One idea offered by Jay Coen Gilbert of B-Lab is to create a corporate charter under existing law that would be available for adoption by social ventures.²⁵ The concept is to create a community of companies branded as B Corporationscorporations beneficial to society—which would help attract both investors and customers. The brand would simplify investors' diligence on a corporation's CSR commitment and negotiation of operating principles, thus lowering the transaction costs of capital formation. In return for these benefits, companies would be required to incorporate stakeholder governance provisions into their legal framework, and to clear a hurdle of social and environmental performance standards.

On the plus side, a package of workable corporate design documents could significantly reduce the costs of establishing a socially responsible company and negotiating terms of investment. A similar arrangement is found with the National Venture Capital Association, which offers model forms for venture finance documents, commonly used by lawyers. If the brand sponsor keeps tabs on its community of B Corporations, it could develop experience with the issues that arise and help managers find solutions to common difficulties.

However, there are limits to the branded charter and B Corporation. To the extent that the branded charter prohibits activities that other corporations may engage in, or requires express commitments where other entities have informal relationships, the branded charter form could be less flexible. This could be a disadvantage if it prevents entrepreneurs from choosing the most efficient solution to a problem or requires more complex negotiations with stakeholders to execute strategies. In markets where the branded charter firm competes with other firms, it could be fatal.

Another alternative—as was explored earlier in this paper—is for individual corporations to negotiate socially responsible charter provisions with their funders. For example, a corporation may write a bylaw requiring the corporation to buy only fair-trade goods, or to

maintain membership with a standards body that certifies compliance with environmental or social standards.

A Minnesota
proposal would
allow corporations
to use the letters
"SRC," for
Socially
Responsible
Corporation, after
their name.

There are many problems with all of the custom charters described above, whether they be voluntary or mandatory, and therefore we do not believe that they should be adopted by for-profit corporations. First, there is no guarantee that the provisions of the charter of a state will be upheld in other states, given the prevalence of long-arm statutes (as in California). For example, if a company incorporates in Oregon but does business in California and includes provisions in its charter that limit fiduciary

duties to stockholders, such charter may not be upheld by California courts.

In addition, there is a danger that unique features could later conflict in ways that are not appreciated at the time of adoption, and, as with the B Corporation, such features could become a competitive disadvantage. B Corporations or companies with custom charters will likely have more restricted access to traditional capital markets, given the restrictions in operations that could affect profitability. The operational elements embedded in the custom charter could become obsolete over time (e.g., if a standards body is captured by the lowest common denominator) or become a point of contention (e.g., fairtrade may mean different things to different corporate constituents). Further, it is possible that the custom elements will not generate the desired outcomes. For example, reserving board seats for stakeholders does not ensure their opinions will be heeded. Apart from the prospect of future problems, custom features also increase the costs of negotiations at the outset of the corporation's existence.

Minnesota Socially Responsible Corporation²⁶

Another proposed approach is to legislate into existence a new voluntary corporate form, which the Minnesota State Legislature

proposed in 2006. Under H.F. No. 4161 (introduced in the 2005-2006 session) and S.F. No. 1153 (introduced in the 2007-2008 session), the Minnesota State Legislature introduced the Minnesota Responsible Business Corporation Act. ²⁷ Under the act, a corporation would have the ability to designate itself as a Socially Responsible Corporation, using the letters "SRC" after its corporate name rather than the standard letters "Inc." The aim of the legislation is to create a design that integrates a dual focus on both financial success and social responsibility. ²⁸

The legislation includes the following features:

- (a) In determining the best interests of the corporation, directors and officers *must* consider (in no particular order of importance), the interests of the corporation's stockholders, employees, customers and creditors; the "public interest". and the long-term as well as short-term interests of the corporation and its stakeholders. 30
- (b) Employees will elect 20 percent of the board of directors, and an additional 20 percent of seats will be reserved for public interest directors (who are also required to balance the interests of all stakeholders).
- (c) If publicly traded, corporations will be required to issue an annual "Public Interest Report" along with their annual report.
- (d) The board is required to provide opportunities for stakeholders to provide advisory input at regular stakeholder meetings and through a web site or email listserve.
- (e) The corporation is required to train its officers, directors, and employees regarding the special duties to stakeholders.
- (f) To prevent courts from overriding the legislation, the law explicitly carves out the application of the common law of agency, under which the officers and directors are required to act almost solely in the interests of the stockholders by maximizing the corporation's profits.³¹

There appear to be more benefits to this form than the others discussed above. First, it provides input from non-traditional stakeholders to allow the board to be better informed when making its decisions. It also gives employees and the public interest a voice at management level. Further, like the B Corporation, the corporation has the opportunity to brand itself as a CSR entity to attract customers and possibly investors. Finally, it may protect directors from stockholder lawsuits when directors satisfy their stakeholder duties, and it may protect against frivolous stakeholders' suits (through the balancing of interests requirements).³²

Despite its benefits, this voluntary approach is fraught with many of the same issues as the adoption of custom charters. Companies that chose the new form may face a lack of flexibility, possible conflicts with future business plans, and more limited access to capital markets. Also, an external regulation (even one that is voluntary) may require greater ongoing enforcement costs.³³ Finally, it is unclear whether the new design would be recognized and provide protection against shareholder litigation if the company were to conduct significant operations in other states.

International Efforts

Across the pond, the British government created a voluntary legal structure in 2005 to bridge the gap between the for-profit and nonprofit worlds, the Community Interest Company (CIC).³⁴

A CIC is a limited liability company that is designed for use by those who want to conduct a business for the community benefit, and not purely for private financial advantage.³⁵ Features of the CIC include:

- a) requirements to pass a "community interest test" and operate under an "asset lock," which ensures that the CIC is established for community purposes and that the assets and profits are used to meet such purposes;
- b) requirements to file an annual report to detail payments to directors, dividends paid on shares, interest paid on loans, and how the CIC has included the involvement of stakeholders in its activities; and
- c) unlike charities, CICs do not enjoy tax- exempt status.³⁶

The benefits of this new corporate form include branding awareness, flexibility in commercial activities (e.g., some CICs can pay dividends to individual stockholders, subject to a cap), lower legal costs from adopting a standardized form, and more limited

regulation. The major constraints include the lack of beneficial tax treatment, the rigidity of the structure, the more limited access to capital markets, and the focus on expansion of the nonprofit as opposed to the for-profit market segment. ³⁷

Low Profit Limited Liability Company (L³C)

Straddling the line between the for-profit and nonprofit worlds is yet another proposed solution: the Low Profit Limited Liability Company (L^3C). L^3C , tagged as "the for profit with a nonprofit soul," would act in a way that furthers its mission, like a nonprofit, as opposed to maximizing stockholder value. In addition, this new form will purportedly operate "with the simplicity and clarity of thought of a for profit."38 The reasons behind the development of the L³C are the creation of an easy vehicle (i.e., L³C itself) and a stable, reputable market for PRIs (through highly regarded securities brokers), to alleviate the constraints on the use of PRIs discussed above.³⁹ A foundation may transfer money into the L³C using a PRI, then later sell its stake to another foundation or donor and recycle its profits from the PRI into another PRI project.⁴⁰ The profits that the L³C generates can be used for its own programs and to pay dividends to its investors.

The L³C model has three main advantages:

- a) No new legislation would be needed (as the LLC is recognized in all 50 states, and PRIs are already incorporated into the tax code).⁴²
- b) The L³C will arguably increase the use of the PRI vehicle, offering an additional fundraising tool to foundations and charitable trusts.
- c) It offers a brand to the PRI, which may also help increase its effectiveness and employment.

The structure also has limitations. PRIs are still restricted investment tools. They can be used for certain types of investment—low-cost or affordable housing or loans, museums, downtown redevelopments, educational projects, research and the like—but not others. Further, based on the views expressed by foundations about the current use of PRIs, building the L³C brand may be a difficult, long, and costly process.

Novel Proposals in the Nonprofit Arena

Changes to the nonprofit form are motivated by a desire to encourage self-sustaining charitable enterprises, and by a philosophical view that the for-profit form attracts better entrepreneurs.

One proposal is to create for-profit charities, which would be distinguished by several characteristics: permitting managers to keep a portion of profits, allowing donors to deduct contributions from income taxes, and exempting the corporation's income from taxation. The entrepreneur's income and share of earnings would presumably still be taxed at the individual level. Proponents of this proposal say that as long as the government offers tax subsidies to any corporation, entrepreneurs who engage in charitable activities should be subsidized regardless of the corporate form they choose (e.g., consumers could deduct from their taxes the additional cost attributable to fair trade beans when buying coffee at Starbucks). 43 The argument is that for-profit entrepreneurs have a greater incentive toward efficiency, because they can keep the savings. But this assumes that nonprofit entrepreneurs enjoy fundraising and are indifferent to the trade-off between raising more money and spending less.

The problem with this proposal is that with a for-profit company, the distinction between charitable and noncharitable purposes may be a hard line to draw, particularly given the prevalence of green-washing (actions which provide a positive public relations spin but have little real impact). Another risk of this plan is that it could serve as a justification for abolishing the tax privilege of nonprofits.

Yet another proposal is to permit an IRS certification for organizations—either for-profit or nonprofit—that operate in a businesslike manner and have a charitable mission. Capital could flow from both market sources and foundations, and the investment could be structured as a loan, grant, equity investment, or PRI. The rules governing the taxability of revenue generated by the organization do not change. This proposal aims to strike a compromise to satisfy funders, whose investment decisions are influenced by their tax implications, as well as entrepreneurs, who would like access to the broadest possible group of investors.

Preferred Pathways

In this time of ferment, there are many proposals being floated and experiments underway today. As yet, it is unclear whether any of the proposals can create large-scale change quickly.

On the nonprofit side, the various types of hybrids do work. Incorporating more for-profit business principles into *certain types* of revenue-generating nonprofit models will serve the nonprofit community well. Yet nonprofits on the whole remain a very small percentage of the overall economy and will never have the power to effect widespread change.

On the for-profit side, the problems inherent in new voluntary or mandatory charters, or the B Corporation, could frustrate their effectiveness. Proposed new forms—incorporating profit- making with social mission—may work for small-scale for-profits with a strong social mission. Yet the "legacy problem" represents one of the great challenges of retaining a social mission over time. Many socially oriented for-profits find that their social mission is dependent on founders' fervor, and when founders retire or sell, their social legacy is often lost as more traditional owners and managers take over.

None of the proposed forms or legislation will serve as a viable option for the multinational corporations that are the most powerful forces in the world today. New hybrids and social enterprises likely will be used primarily to expand the nonprofit community.

The operations of larger, for-profit corporations can be transformed significantly by the adoption of CSR principles. In addition, we must be optimistic that boards and management (with court approval and guidance) will exercise their business judgment in expansive ways that embrace the concerns of stakeholders, broadening company mission beyond a sole focus on return on investment for stockholders. However, there are two fundamental issues with sole reliance on the existing corporate tools. First, the process will take too much time. The current fiduciary duties have evolved through legislation and judicial activism over the past 100 years. Now, there is a need for quick action to align corporate purpose and practices

with social and environmental issues. Second, given that CSR has only recently been embraced fully by certain large multinational corporations, it is too early to tell if an increased emphasis on employees, community, and the environment can serve to change the *fundamental* way a corporation operates – primarily because the stockholder remains the sole *legally recognized* stakeholder.

What changes do we recommend that may serve to effect the greatest transformation of the corporation most quickly?

First, instead of relying on modifications of charters or the creation of hybrids, legislation should create new fiduciary duties—covering both public and private corporations—that favor employees, the community, and the natural environment. The legislation must be federal or adopted in all 50 states (if there is no federal preemption), although one or two states could serve as pilots for the new regime. The largest obstacle will be creating a means for the board and management to weigh the different and often diverging interests of stakeholders effectively when making decisions. To ensure accountability, the legislation must include clear metrics to measure the impact of the corporate actions on various stakeholders. One proposal is the analytic hierarchy process developed by Thomas Saaty, 44 which would create a matrix decision-making tool to help in balancing financial and non-financial stakeholder interests

Second, we recommend government action to increase corporate disclosure and accountability on environmental issues. Universal disclosure requirements should be adopted by the world stock exchanges, with NASDAQ, NYSE, AIM, and the Tokyo Stock Exchange taking the lead. The effect of a corporation's actions on all stakeholders including the local and world community, employees, and the natural environment clearly should be included in the definition of "materiality." Stockholders would then be able to evaluate such factors, the expanded impact would be understood more widely, and connections between social impact and longterm profitability would become more clear. Enforcement would be critical. Corporations would need to face real and substantial penalties for failure to disclose according to the new guidelines. Fortunately, such a

disclosure framework already is being developed through the Global Reporting Initiative sustainability reporting guidelines.

Third, it's vital to recognize that redesigned corporate forms are not the only route to creating corporate responsibility, particularly when quick change is needed. Also needed are new government regulations, particularly to address environmental degradation and climate change. Governments should regulate the environmental impact of all economic actors (including government and quasigovernmental entities), not just private corporations. And they should impose a uniform burden on all companies operating in the U.S., to minimize the likelihood that firms will re-incorporate off-shore to avoid compliance. (We recognize the extra-territorial extension of U.S. laws will not be well received on the international stage and will face enforcement complexities.)

The challenges presented by the inadequacies of current corporate legal forms can and must be solved, for the 21st century will require corporate forms that incorporate a responsibility to a wide range of stakeholders, not just to stockholders alone. There is a clear case to be made for the creation of new corporate forms, yet the complete answer to the puzzle is not yet fully in hand. Many promising alternatives are already in play, as this analysis has shown. The ferment of existing experimentation needs to continue, as new ways of thinking about innovative corporate designs continue to evolve. ■

FOOTNOTES

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- ⁷ See 17 C.F.R. § 240.14a-8 (Exchange Act Rule 14a-8). ⁸ For example, the for-profit corporation Give Something Back provides in its bylaws that all profits will be donated. See Eve Kushner, "The Greater Good: East Bay Companies live by the triple bottom line: profits, the planet and people," The Monthly (December 2006) (available at http://www.themonthly.com/feature12-06.html).
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- ¹⁶ Wexler, supra at 243.
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- ¹⁹ Strom, supra note 28.
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- Shann Turnbull, "The Case for Introducing Stakeholder Corporations," available at
- http://ssrn.com/abstract=436400.
- ²⁵ Coen's proposal is described in Billiterri article, supra note 22.
- ²⁶ We have learned of a proposal introduced in North Carolina to create new socially responsibility corporations, but have yet to locate any relevant information.
- Marjorie Kelly, Creating a Voluntary Legal Design for the Responsible Corporation: Minnesota Responsible Business Corporation Act, Citizens for Corporate Responsibility, Minneapolis; MN Bill S.F. No. 1153. ²⁸ Supra note 47.
- ²⁹ Under MN Bill S.F. No. 1153, "public interest" is defined as "the general public well-being of present and future generations including, but not limited to, the economy, natural environment, public health, public safety, human rights, educational and other human development opportunities, and the general well-being of the local, state, national, or world community."
- ³⁰ Also, under MN Bill S.F. No. 1153, a "stakeholder" is defined as "(1) a shareholder; (2) an employee; (3) a customer; (4) a supplier; or (5) a creditor."
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- ³² Kelly, supra note 47.
- 33 Kent Greenfield, From Metaphor to Reality in Corporate Law, Stanford Agora: an Online Journal of Legal Perspectives, Volume 2, Issue 1, at 67.
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An Action Agenda for Corporate Redesign

Creating a roadmap for stakeholder action

BY DEBORAH DOANE

Some men see things as they are and ask 'why'?
Others dream of things that never were and ask 'why not'? — George Bernard Shaw

In 1789, William Wilberforce, a British politician, first articulated a public policy vision for the abolition of slavery. In his monumental address to the British House of Commons, he stated that he sought nothing less than the total abolition of the abhorrent practice, which, at the time, continued to play a vital role in the British economy. Wilberforce was both passionate and measured in his address. He refused to accuse the Liverpool ship merchants of causing harm but, instead,

Our society is more entrenched in the status quo than ever before—no coherent vision yet exists for corporate transformation.

rose above the personal to simply describe the wretched conditions in which the slaves were transported from Africa, to Britain, to the U.S. It took a further 18 years before the first act was passed that would start to bring an end to slavery throughout the British Empire.

The year 2007 marks the 200th anniversary of this defining moment in history—one in which political acceptance of human rights over economic

rights ultimately prevailed. Today's corporations are not the equivalent of history's slave traders; many bring great prosperity to people throughout the world. But many corporate actions are unsustainable for a world in which poverty prevails and our natural resources are becoming scarce.

The Corporation 20/20 initiative aims to define a coherent vision of a renewed corporation that would help create a more equitable and sustainable future. While the corporate institution is now an integral part of the global economy, its design is not cast in stone. Taking a leaf from Wilberforce's book: with courage and tenacity, eighteen years is not a long time to achieve our vision in practice.

How do we move from articulation of the vision to achieving measurable change? This will require action on many fronts: companies, consumers, markets, and media. Each of these stakeholders has a vital role to play.

This paper sketches a possible action agenda to build a cohesive social movement among these different sectors, outlining possible tasks that different groups could take up.

Part I: From Vision to Social Movement

Vision without action is merely a dream, action without vision just passes the time, vision with action can change the world. — Joel Barker

In the 1950s, a series of discrete events—a political judgment, boycotts and other acts of civil defiance—gave rise to one of the most profound political movements of our time, the American Civil Rights movement. A key role was played by Martin Luther King's "I have a dream" speech of 1963, which coalesced the movement into a more effective political force that would pass the 1964 Civil Rights Act the following year.

No such coherent, defining vision yet exists for corporate transformation. While many engage in various actions for incremental change—corporate social reporting, social investing, Fair Trade, to name just a few—none of these have yet created a defining political movement with a discrete vision, and critical mass with which to achieve that vision.

One reason might be that we have yet really to think of ourselves as activists. We are certainly not at ease with such a phrase, unless it's offered within the confines of acceptable social norms, such as "shareholder activism." Most are unwilling to chain themselves to fences, be arrested, or embark on demonstrations beyond a comfortable forest sit-in on a summer's afternoon.

We practice philanthropy to good causes, invest in SRI funds, or join environmental groups, but none of these routes has revolutionized capitalism as we know it. Our society is still held within the vice grip of a system that has failed to tackle the defining issues of our time, from climate change to global inequality. Indeed, we are more entrenched in the status quo than ever before.

Corporate social responsibility (CSR) managers dabble with the odd supply chain management system to enforce codes of conduct—finding, after 10 years, that little has really progressed. An oil company espousing high environmental values issues a report showing its CO₂ emissions will continue to climb. We lull ourselves into thinking we are doing our best, assuming somehow that our disparate actions add up to a cohesive whole. In fact, none of our actions measure up to the type of transformative power exhibited by successful social movements of the past.

While largely defiant forms of civil disobedience may not be what we need, it is nonetheless critical that we begin to think of ourselves as a *social movement*. And we can look to other social movements for signposts. Research shows that social change historically requires three key factors: political opportunity; organizational capacity, and framing ability. Taking each one of these in turn, what can we do to create the type of transformative movement engendered by civil rights, anti-apartheid, or women's suffrage?

Creating Political Opportunity

Creating political opportunity can be either a passive or active affair. In some cases, there may be legislative opportunities on which we can piggyback our concerns. The CORE coalition in the UK, for example, took advantage of a review of Company Law and a government-backed bill to overhaul a 50-year-

old system as a platform to launch a campaign to broaden directors' social and environmental responsibilities. But these opportunities are few and far between.

Creating political opportunity is more often about responding to a crisis, such as the Enron and Worldcom scandals; or about proactively creating political space in which to achieve change, as women's suffrage did, or Al Gore did with climate change.

Let's assume that our social movement falls within the last category: opening up political space in which to achieve change (though our preparedness to respond to crises along the way should not be discounted). One starting point is to agree on a commonly shared vision and turn this into an operationalized platform to be used in different spheres of influence: political, market, and individual. Initial tasks might include the following:

- Agreeing upon Corporation 20/20 vision and principles. These higher-level principles could help to provide a focus and bring together diverse stakeholders. *Public agreement* of the vision and principles must engender a wide range of support at the outset, across sectors. This, in effect, becomes our platform for the movement.
- Identify policy outcomes based on each of the principles. This will establish our goals and define our broad roadmap. If we are effectively to open up political space, initial proponents must all, effectively, sing from the same song sheet. While businesses may prefer market-led approaches to change, some might accept the need for policy changes, such as ending political contributions. The role of policy might be to set the right incentives, such as pricing out bad behavior; leveling the playing field; and protecting the public interest.
- **Develop the evidence base.** Why is the status quo insufficient? What hard evidence can be brought to bear? What is already working in practice that is transferable? Case studies or single media stories of the new values-led market will help build the broader base of support. *Convergence of the evidence* provides a key lever for change.

- Broaden agreement of the vision and platform. Starting with a coalition of diverse stakeholders, each actor plays a role in *advocating and articulating the evidence*, using tools such as education, campaigning, lobbying and partnership building, to open up the political space. One method, for example, would be to organize a traveling commission.
- Identify existing political opportunities. Development of an initial *map to identify key opportunities* in coming years can enable us to launch more widely. Opportunities might include: regulatory reform, international events such as the UN Global Compact Summit, accounting rules changes at the International Accounting Standards Board, and so on. How do we capitalize on what is out there?

Strengthening Organizational Capacity

We may agree on a vision and agenda, but how do individual actions become a movement for change? It is not enough for us to beaver away in our different spaces and sectors. We need to create stronger organizational capacity that makes us more than the sum of our parts. Most importantly, it means ensuring we have a) the resources to persist through ups and downs; and b) mechanisms to fertilize cross-communication between the different change-agents.

Key actions that can strengthen our organizational capacity as a movement include:

- Mapping key stakeholders. We have a vague picture of the types of categories of stakeholders that will introduce change; however, a more systemic understanding of who the change-agents will be can help to strengthen our capacity. Each stakeholder group has a particular role to play, be it identifying discontent with the system, pioneering new business models, or lobbying political leaders for change.
- Achieving incremental victories. Campaigns for change in the initial phase of start-up often have masses of energy at their disposal, but frequently die down—the campaign in the U.S. for health reform, for example.

Supporting the movement will require accepting incremental victories and ensuring our *tenacity and maintenance of that movement* to move forward and drive growth. This comes in the form of financial resources, but also resources in-kind. To create the corporation of the future, we must be in it for the long haul. The international campaign for debt relief (Jubilee 2000) achieved change over a 6-year public campaigning period, but preceding this success was almost 20 years of concerted action on the part of civil society and other key players along the way. Churches, governments, and funding bodies were critical.

Framing

Conversations about corporate re-design and corporate responsibility are often blurred because of the lack of a clear framework. The dialogue generally inspires polarized viewpoints and entrenched positions, from anti-corporatists, to staunch supporters of free markets. NGOs, for one, consistently talk about whether or not to use the phrase "corporate accountability" versus "corporate responsibility." More controversially in the south, this is often translated as "dismantling the power of corporations."

As a result, those in the media and public spheres have a hard time describing the debate and latching onto possible solutions—is it really a corporate versus anti-corporate debate? Is it about the global economic system, or simply about corporate governance? The response is, more often than not, to move on and not deal with the root cause.

But there are beacons of hope and inspiration. In the past few years, as climate change has crept up the public agenda, it was originally unclear if this was an anti-capitalist plot designed to undermine the American way of life, or about genuine scientific evidence showing threats to us all. More recently, however, the issue has come to occupy a more common frame of understanding. After a series of severe natural disasters, such as Hurricane Katrina in 2005, climate change was more often referred to as "global warming" and the situation became a "climate crisis," in the words of Al Gore when he spoke at the 2007 Oscar ceremonies. The story now has a clear narrative.

This is what George Lakoff describes as "framing." Framing is about language and how we tell our story in order to shift people's perceptions and move, ultimately, their actions.

Framing, in part, means adopting the right language to narrate the movement as a whole—something that can be used by all stakeholders to *achieve legitimization of the vision* overall. Writes Marjorie Kelly, "through careful cultivation of new frames, we can rewrite the deep conceptual maps of the world that hold in place the current corporate design—opening a space where the public can embrace the task of redesigning the corporation."

The first thing we must do as a movement is thus seek to frame the debate in such a way as to change the narrative, and inspire positive, collective action. Illustrations of this are shown in the following table:

Part II: Action Plan for a Movement

Taking from another historical lesson, when the anti-apartheid movement finally built steam, there were actors from all walks of life contributing to overturn the South African regime, long before governments sought to exert their economic influence through trade embargoes on the country. Some were working inside business, ensuring that they actively employed black South Africans; outside the country, students and others organized a wide-scale boycott campaign, while the finance sector exerted significant pressure over investment into the country (pressured, in part, from the boycott itself).

To achieve our vision, we need insiders and outsiders; good cops and bad cops alike. As long as we are all using the same *end* message; that is, the Corporation 20/20 principles and policy platform, a diverse set of actions can, and must, persist to create the tension needed to effect change. The following discussion provides one key action that each stakeholder group should take on, as their specific role in building the corporate transformation movement.

Table 1: Illustrations of Collective Action

Current Frame	Transformative Frame	The Message	
The Individual	Community	Corporations would be seen as semi-public entities—not as "private property" that benefit a few individuals.	
Private Property	Common Good	The common welfare is more than the sum of the individual parts.	
Amoral	Moral	Corporations are living systems, part of the larger living systems of communities and the earth. Basic human and environmental values, such as human rights and biodiversity, should underpin our economy and our corporations.	
Sacrifice	Benefit	It's not about giving something up but about creating a safe and fair future for us all. Investing in labor or environmental protection is not a cost, but an asset.	
Money/ Economic Growth	Well-being	Focus on money and economic growth leads to a capital bias. Companies provide jobs and services that we need, and add to our collective well-being. Economic growth is an adjunct to that. The two are not necessarily commensurate.	

Large Businesses—Support Open Stakeholder-based Governance

In the last 5 to 10 years, we have seen a surge in the numbers of companies who have issued social reports that have involved some level of stakeholder engagement. The Global Reporting Initiative reports that there are 1,500 companies, worldwide, who have adopted such an approach. Thus, "stakeholder dialogue" has now become a part of the common lexicon for most leading companies.

But the challenge is to give such engagement more substantial meaning. Stakeholders frequently report that their concerns about such dialogues are one-way; and in the worst instances, that they are little more than public relations exercises. Companies who wish to take up the challenge must move from a loose form of dialogue to a more transformative measure which would see stakeholders engaged in the actual governance of companies. Inclusive stakeholder governance reflecting several of the Corporation 20/20 principles offers an ambitious target for

leading companies to aim for within the next 5 years.

Large companies have the unique capacity to advance this goal. Stakeholder governance offers a range of approaches. One is including a stakeholder position on the board of directors, to reflect the public interest.

By thoughtfully articulating our ideas, we can frame the argument for corporate redesign in a way that motivates peoples' actions.

Another approach is to establish stakeholder councils, representing different stakeholder groups—suppliers, consumers, employees—and enable them to work in conjunction with corporate boards. More boldly, directors could create incentive systems for reaching social and environmental targets.

ACTION: Innovate and adopt new forms of inclusive stakeholder management systems that embed the Corporation 20/20 principles into corporate governance.

Small-to-Medium Business—Demonstrate New Corporate Design

The Fair Trade model demonstrates how commercial success can be matched with strong socially based values. In the UK, Fair Trade coffee now captures almost 30 percent of the ground coffee market; in Switzerland, Fair Trade bananas represent a staggering 50 percent of the market. Fair Trade companies often include producer groups in company ownership and governance, and pay higher prices to producers than the market rate.

Other innovative corporate designs include cooperative models, employee-ownership schemes, and not-for profit companies, to name just a few. And new forms are yet to be created. Entrepreneurial companies could take

a leaf from the information technology sector and create their own form of disruptive innovation—inventing corporate forms that integrate social and financial mission in powerful new ways.

ACTION: Invent and demonstrate new corporate forms that integrate social and environmental mission with financial outcomes.

Investors—Tackle Short-termism

Short-termism, widely derided in business circles today, can be considered useful shorthand for the profit-maximizing focus of companies, because research consistently shows that in the long run, stockholder and stakeholder interests converge. Among those speaking out against short-termism are former Citigroup CEO John Reed, former Medtronic CEO Bill George, former Continental Airlines CEO Gordon Bethune, and DuPont ethics vice president Marjorie Doyle. Among the groups working on solutions to short-termism are the Aspen Institute, the Business Roundtable Institute for Corporate Ethics, the Conference Board, and the UN Global Compact.

The investment community holds the levers to shift financial markets to think more long term. And there is no shortage of ideas. In 2003, the Universities Superannuation Scheme in the UK ran a competition titled, "Investing in the long-term as if it really mattered." Eighty-eight participants offered suggestions, ranging from looking at new types of asset classes to altering the wider incentive system of fund managers. Still another approach would be to have higher capital gains taxes on short-term trades.

Tackling CEO pay could also prove a linchpin to this effort. As long as 60 percent of CEO compensation comes from stock options, meaning they are paid primarily for a rising stock price, executives will continue to focus the organization on the short term. Incorporating social and environmental performance metrics into CEO pay could go a long way toward changing corporations' fundamental orientation toward the long term.

ACTION: Stigmatize short-termism and develop a new set of rules for long-term

investment that incorporate social and environmental concerns.

Civil Society—Campaign for Policy Reform

Civil society fills a range of roles on this agenda—from helping to set higher standards, to raising public awareness. The most important role it can play, however, is to lead campaigns for reform. Between 2004 and 2006, the Corporate Responsibility coalition (CORE) and Trade Justice Movements in the UK successfully brought together 130 NGOs representing 7 million people to campaign for changes to UK Company Law. During the campaign, 100,000 people wrote to Government Ministers and officials in support of amendments that ultimately would place a responsibility on UK Companies to have an explicit regard to their social and environmental impacts. It was this wider voice that raised the issue to the front pages of the media, and to the level of national debate, in Parliament and elsewhere.

When civil society presents a unified voice, it is difficult for the political process to ignore.

As a testament to the success of this approach, a wider coalition called the European Coalition for Corporate Justice now brings together 15 similar groups across Europe to raise the bar at the European level, while seeking to harmonize policy campaigns at the national level. This noise can help to stimulate the movement as a whole.

Outside of corporate campaigns, this approach has been successfully adopted elsewhere. Prior to the millennium, the Jubilee 2000 campaign took a complex and hidden issue—debt relief—and built a campaign that would see several countries finally receiving international debt relief through national governments and the World Bank. When civil society presents a unified voice, it is far more difficult for the political process to ignore.

The challenge for this sector, nonetheless, will be to tie the divergent threads together, aligning single-issue campaigns, boycott targets, and partnership initiatives with the wider call for systems reform. Significantly, civil society's role is not to mediate different voices, but to define our aspirations. In doing so, it must keep the bar high, rather than negotiating a compromised approach to appease different voices.

ACTION: Coalesce national and global civil society around campaigns for policy reform on corporate law, reflecting the Corp20/20 principles.

Government—Charter Reform and Beyond

When we look toward our common agenda and what we must work on as a movement, the signs point toward public policy that impacts on companies directly. Two clear areas for policy intervention include transparency and corporate charters (known as Articles of Incorporation; or Company Law in other western countries).

In the U.S., the government could mandate social and environmental reporting. The European Union already has a level of mandatory environment and employee-based reporting, and some member states have gone further. When social and environmental reporting has the same status as financial reporting, it will go a long way toward redefining company success.

The government also has a role in creating new kinds of charters, like that of Fannie Mae, the company chartered by the federal government to provide mortgage financing, which in the recent debt crisis proved a safe haven for investors because of its higher standards. A similar kind of company might be created to further employee ownership, for example.

More fundamentally, the government might recharter law-breaking companies rather than put them out of business, as it did with Arthur Andersen—using deferred prosecution arrangements as a way to inject new social and environmental standards that will prevent profit-seeking excess. Similarly, to tackle global warming and resource depletion, companies in extractive industries might be rechartered with new environmental standards integrated into their core design.

ACTION: Introduce new policies, such as social and environmental disclosure and charter reform that guide corporate transformation.

Media—Reporting the Vision

In April 2006, a headline appeared in the *Financial Times*, "Headlines Burned for Lack of Hurricanes." The headline represents the epitome of how media myopically focuses its business reporting on finance rather than values. While reporting on CSR stories has become increasingly common in mainstream media, reporting according to raw financial indicators still persists and continues to be the norm. The nightly news typically leaves off with a quick reminder of indicators such as the Dow Jones Industrial Average, the FTSE Index, or the Tokyo Nikkei. And such indicators often reflect the mood of a nation—if it's up, so are we, and vice versa.

Media acts as the gatekeeper, shaping what is perceived to be important to society. When broadcast journalist Mika Brzezinski refused to report on Paris Hilton's jail departure as a leading story, she reflected a more pressing agenda—how can the media be used to relate the critical information that has a genuine impact on our society? In this vein, we must be aware that narrowly based financial reporting misses the wider links between corporate behavior, the environment, and our social well-being. The media, seemingly a passive actor, has lagged behind other sectors in looking at its social responsibility. On the transformative agenda, it has an opportunity to create new lenses through which we see the world. This could mean anything from reporting on corporate indices that reflect the public interest (in effect stronger barometers for what should be valued in society), to ensuring business-based reporting comes from all stakeholder perspectives, not just the angle of finance.

ACTION: Create new reporting tools for the media, such as indices and scorecards, to move reporting beyond financial values to incorporate broader social and environmental values.

Conclusion

In recent decades, activists have been effective at articulating a general malaise with the status quo of corporate-led capitalism. In response, a small minority have chosen to become ethical consumers and ethical investors, and businesses have chosen to adopt corporate social responsibility initiatives. But these are a drop in the ocean, compared to the task at hand.

Thus far, we have failed to translate our actions into the type of *activism* that will transform the wider system. We have only advanced to stage one of a three-stage process of social change: 1) acknowledging the problem, 2) articulating the solution, and 3) getting wider buy-in for action.

The Corporation 20/20 project brings us closer to stage two. We need to step up the game and come to a common transformative agenda, creating a more coherent social movement for policy change.

Our action agenda for change will not be an easy one—it will certainly face set-backs—but ultimately it can succeed. Two centuries ago this year, the first step was taken to end slavery in the British Empire. The corporate phenomenon is much younger. The first Companies Act, exported as a model around the world, was only passed in 1862, and recent models of the corporation and its interrelationship with global financial markets have really only manifested themselves in the last 30 years.

We are not seeking slow, evolutionary change in the corporate institution. Its inherent failures are far too urgent. But neither do we need violent revolution. What we needs is vision, the courage to speak out, and a coherent action agenda. Corporate re-design is an achievable vision—not only in our lifetimes, but within the foreseeable future.

Author and Editor Biographies

MARGARET BLAIR

Margaret Blair is an economist who focuses on management law. She joined the Vanderbilt faculty in 2004 as part of the team supporting the Law and Business program, which the law school offers in conjunction with the Owen Graduate School of Business at Vanderbilt. Blair moved to Vanderbilt Law School from Georgetown University Law Center, where she became a visiting professor in 1996 and served as a Sloan Visiting Professor, teaching Corporations and Corporate Finance, and as Research Director for the Sloan-GULC Project on Business Institutions, from 2000 through June 2004. She has also been a Senior Fellow in the Economic Studies Program at the Brookings Institution, where she wrote about corporate governance and the role of human capital in corporations. Her current research focuses on three areas: team production and the legal structure of business organizations, trust as a mechanism of governance in business firms, and the culture of boards of directors, and her articles and commentaries have appeared in numerous professional journals and essay collections, including *Restoring Trust in American Business*, a collection of essays and commentaries published by the American Academy of Arts and Sciences in 2005. She currently serves on the board of directors of Sonic Corp. Blair holds a B.A. from the University of Oklahoma and an M.A., M.Phil. and PhD. in economics from Yale University.

CHARLES CRAY

Charlie Cray is the director of the Center for Corporate Policy (www.corporatepolicy.org), a Washington, DC-based non-profit which researches and advocates for specific policies that advance corporate accountability. He is the former director of the campaign for corporate reform at Citizen Works, and a former editor of *Multinational Monitor* magazine. Cray is a contributor to the Strategic Corporate Initiative, a year-long investigative collaboration that published its findings in September. He is also co-author of *The People's Business: Controlling Corporations and Restoring Democracy* (Berrett-Koehler, 2004) and frequently writes for the Huffington Post, TomPaine.com, and other publications. A native Chicagoan, he worked for Greenpeace from 1988 to 1999, and graduated from Amherst College in 1983.

DEBORAH DOANE

Deborah Doane is a campaigner and writer on corporate responsibility. For the past 15 years, she has worked with NGOs, think-tanks and the private sector on ethical trading, human rights and sustainable development issues. She was Director of the CORE Coalition of over 130 environment, human rights and development NGOs, which campaigned for and achieved changes to UK Company Law to improve accountability for corporate social and environmental impacts between 2003 and 2007. Previously Doane was a Programme Director of Transforming Markets at the New Economics Foundation in London, and Head of the Humanitarian Ombudsman Project, based in London and Geneva. Currently Doane is Head of Sustainable Consumption at WWF-UK. She is a frequent guest lecturer, including at the London School of Economics and London Business School and has contributed to the *Guardian* and *Independent* newspapers, BBC Newsnight and BBCRadio4. Recent articles have included "The Myth of CSR" published in the Stanford Graduate School of Business' *Social Innovation Review* (www.ssireview.com); and "Can Globalisation be Fixed?" in the *Financial Times Handbook of Management*.

KENT GREENFIELD

Kent Greenfield is Professor of Law and Law Fund Research Scholar at Boston College Law School, where he teaches and writes in the areas of business law and constitutional law. He is the author of the book *The Failure of Corporate Law*, published in 2007 by University of Chicago Press. He has been called "the leading figure" and "the most creative thinker" in the progressive, stakeholder school of corporate law scholarship. Greenfield has lectured in 25 states, in six countries, and at 60 institutions. Greenfield was named B.C. Law Teacher of the Year for 2003-04, a recognition bestowed by the Law Students Association on vote of the entire student body and has been a Law Fund Research Scholar, a recognition of his scholarly contributions, since 2003. Greenfield also consults with litigators on issues of corporate accountability. He was instrumental in developing the theory of the case brought against Unocal Corporation for alleged human rights violations committed by the company in Burma. Before joining the faculty in 1995, Greenfield served as a law clerk to Justice David H. Souter, of the United States Supreme Court, and worked at the law firm of Covington & Burling. Greenfield is a graduate of the University of Chicago Law School and of Brown University.

JOHN KATOVICH

John Katovich has been in-house and external counsel to companies in the Bay Area and East Coast for the last 20 years and, before that, practiced law in his hometown of Chicago. In the mid-80s, he became the General Counsel for the Pacific Stock Exchange after several years as both a trader and regulator, and in the late 90s, left to become ExecutiveVice President and General Counsel for two software-trading companies, OptiMark Technologies and ePIT Systems. In 2001, John started Katovich & Associates, which provides general, licensing and regulatory counsel to technology, software and trading companies in the Bay Area. John also consults with emerging markets on market and regulatory practices, is a member of Business Alliance for Local Living Economies, and is a director on several boards. John graduated from the University of Illinois in 1976 and Southern Illinois Law School in 1979, and has extensive teaching experience as an Adjunct Professor in business law, capital markets, trading and market regulation at the Presidio School of Management MBA Program, Alliant International University, UC Berkeley, and as an Instructor for INSEAD, Fontainebleau, France. He is a licensed attorney in California and Illinois, and serves as an arbitrator for NASD. He also attended the Harvard Business School Executive Negotiation Program. John lives in Oakland, CA with his wife and two children.

MARJORIE KELLY

Marjorie Kelly is a Senior Associate at Tellus Institute and co-founder of Corporation 20/20, a project to create the vision and chart the course for the future corporation. Kelly was also co-founder and editor of *Business Ethics*, a national magazine on corporate social responsibility she launched in 1987, read by opinion leaders in business, academia, and social investing. It is known for its annual listing of the "100 Best Corporate Citizens," a ranking of Russell 1000 firms on how well they serve a variety of stakeholders. She is author of the book *The Divine Right of Capital*, published by Berrett-Koehler in 2001, which offers an analysis of the design of the corporate form, and explores ideas for creating a more democratically responsible corporate design. *Library Journal* named it one of the best business books of the year. The book has been translated into three languages, and is used in numerous college classrooms. Kelly's writings have appeared in publications such as the *Harvard Business Review*, *Utne Reader*, *Chief Executive*, *Tikkun*, *E Magazine*, *YES! Magazine*, *San Francisco Chronicle*, *Minneapolis Star-Tribune*, and *St. Louis Post-Dispatch*. Kelly has been a member of the Steering Committee of the Strategic Corporate Initiative sponsored by Corporate Ethics International, and the Advisory Board for Citizens for Corporate Responsibility in Minnesota, as well as serving on advisory

boards for the International Institute for Corporate Governance and Accountability at George Washington University Law School, the Capital Ownership Group, and the Citizen Works Corporate Reform Commission. Kelly holds a Master's in Magazine Journalism from the University of Missouri.

DAVID C. KORTEN

David Korten is an author and leader in the global resistance against corporate globalization. He is probably best known as the author of the book *When Corporations Rule the World*. His most recent book is *The Great Turning: From Empire to Earth Community*, which places corporate globalization within the context of 5,000 years of "Empire," used as a generic term for organizing human relationships by dominator hierarchy. Korten argues that the human system has now reached the limits of domination that social and environmental systems will tolerate. To secure its future, the human species must turn away from the dominator way of Empire to the partnership way of Earth Community, as defined by the principles of the Earth Charter. Korten received an M.B.A. and Ph.D. from the Stanford University Graduate School of Business. He served in the Vietnam War as a captain in the United States Air Force.

STEVEN D. LYDENBERG

Steven Lydenberg is Chief Investment Officer of Domini Social Investments and Vice President of the Domini Funds. He has been active in social research since 1975. Lydenberg was a founder of KLD Research & Analytics, Inc. and served as its research director from 1990 to 2001. From 1987 to 1989, he was an associate with Franklin Research and Development Corporation (now known as Trillium Asset Management). For 12 years he worked with the Council on Economic Priorities, ultimately as director of corporate accountability research. Lydenberg has written numerous publications on issues of corporate social responsibility. He currently serves on the advisory board for CANICCOR and the governing board of the Caux Round Table, and he has served as honorary chair of the board of directors of the Sustainable Investment Research International (SiRi) Group. He is a member of the Boston Security Analysts Society. Lydenberg holds a B.A. in English from Columbia College and an M.F.A. in theater arts from Cornell University, and holds the Chartered Financial Analyst designation.

SUSAN MAC CORMAC

Susan Mac Cormac is a Partner in the Corporate Group of Morrison & Foerster's San Francisco office. She currently serves as a co-chair of the Venture Capital/Emerging Companies Group and the Cleantech Group for the firm worldwide. She has extensive experience representing start-up to late-stage private companies primarily in the sustainable space. She provides corporate and finance advice in connection with mergers, acquisitions, asset purchases and sales, reorganizations, joint ventures, and equity and debt financings. She regularly advises boards of private and public companies, special committees, and CEOs on corporate governance and corporate social responsibility issues. Mac Cormac also represents non-profit corporations involved with Sustainability and CSR, providing advice to their boards on fiduciary issues, conflicts of interest, and other corporate matters. Further, Mac Cormac represents both general partners and limited partners in connection with venture fund formation and investment in other funds and portfolio companies. Mac Cormac has recently been appointed to the Northern California Advisory Board of the Nonprofit Finance Fund. Further, she has served as a judge for the semi-finals of the Berkeley Social Venture Competition. Mac Cormac is admitted to practice in both California and New York.

LYNN A. STOUT

Lynn Stout is the Paul Hastings Professor of Corporate and Securities Law at UCLA, where she specializes in corporate governance, securities regulation and law and economics. Stout, who publishes

extensively and lectures widely, is a national figure in these fields. She is the Principal Investigator for the UCLA-Sloan Foundation Research Program on Business Organizations, and sits on the Board of Trustees for the Eaton Vance family of mutual funds and the Board of Directors of the American Law and Economics Association. She is past Chair of the American Association of Law Schools (AALS) Section on Law and Economics, and past Chair of the AALS Section on Business Associations. Stout has authored a casebook series on law and economics as well as numerous articles on corporate governance, the theory of the corporation, stock markets, finance theory, and economic and behavioral analysis of law. Before joining UCLA, Stout was Professor of Law at the Georgetown University Law Center and Director of the Georgetown-Sloan Project on Business Institutions. She also has taught at Harvard Law School, NYU Law School and the George Washington University National Law Center, and served as a Guest Scholar at the Brookings Institution in Washington, DC.

MICHAEL THOMAS

Mike Thomas was educated at the University of Parana in Curitiba, Brazil, Miami University in Oxford Ohio, The American Institute for Foreign Trade in Arizona, Central Michigan University, and The University of Southern California. His professional career has spanned from Asia to South and Central America, Wall Street and Washington DC. Following his undergraduate degree in International Studies, he served on the Eastern Test Range supporting the Kennedy Space Center and the Apollo moon launch program. His success in this assignment led to his selection by the Department of Defense to write the Operations Plan for the repatriation of POWs from North and South Vietnam, Laos and China. His military career culminated on the Third Floor E Ring as the Executive Officer for the Assistant Secretary of Defense for Manpower. Thomas's business career included key assignments with several prestigious firms including Hoechst do Brasil, Air Products and Chemicals, Exxon Corporation, America's first bank The Bank of New York, BankAmerica Corporation, and from 1987 to his retirement in 2005, Granite Construction Company. Each of these positions contributed to his deepening understanding of the power of collaboration, the role of compelling purpose in driving employee engagement, and the critical nature of Stakeholder management in the success and evolution of corporations. Thomas is particularly proud of Granite's development and selection as one of the 100 Best Companies to Work For in America his last four years at Granite, and its frequent selection as one of America's Most Admired Com, Thomas spends much of his time presenting to groups including The Best Place To Work Institute annual conference, The Construction Industry Roundtable, the Josephson Institute for Ethics Business Roundtable, the Association For General Contractors Executive Development Program, the National Center for Construction Education and Research, the InterClass Companies Conferences, and Corporation 20/20.

BILL VELTROP

Bill Veltrop is a leading "architect of generative change" in the fields of organization design, learning and change. A pioneer in organic learning community approaches to leadership development, he has designed and led numerous generative leadership learning expeditions. Veltrop's professional background includes over 30 years of innovative organization design and large-scale change implementation experience in the United States, Canada, Europe and the Far East, both as an internal and an external consultant. As an external consultant Veltrop has worked with Clorox, Imperial Oil Ltd., Corning, James River, Esso Singapore, Gulf Resources Canada, Shell Resources Canada, PetroCanada, TransAlta Utilities Canada, MW Kellogg, Honeywell, Exxon Exploration And Production, Chemelex, Pepperdine MSOD Program, Hewlett Packard, Chevron Research and Development, Meta Group Executive Council, Xerox, 3Com, The Covey Leadership Center, Granite Construction Co., Cabrillo Community College, and MindLeaders. In 1990, Bill founded The International Center for Organization Design, a network of leading-edge change champions committed to supporting global business transformation. In 1998, he and his wife Marilyn co-founded

Pathfinders, offering guidance to individuals and organizations in evolving "from where they are . . . to who they are." More recently Veltrop has developed www.TheInfiniteGames.org, a website intended to provide pragmatic support to those leaders and practitioners committed to on-going transformation at all levels of system—individual, organizational, community and global.. He is a co-founder of the Monterey Institute for Social Architecture (MISA), a circle of pioneering practitioners committed to supporting such a transformational shift.

ALLEN L. WHITE

Allen White is Vice President and Senior Fellow, Tellus Institute, Boston, USA, and directs the institute's Program on Corporate Redesign. In1997, he co-founded the Global Reporting Initiative (GRI) and served as CEO until 2002. In 2004, he co-founded and is Director of Corporation 20/20, an initiative focused on designing future corporations to embed social purpose at their core. He has advised multilaterals, foundations, corporations, and NGOs on corporate responsibility strategy and policy. White has held faculty and research positions at the University of Connecticut, Clark University and Battelle Laboratories, and is a former Fulbright Scholar in Peru and Peace Corps staff and volunteer in Nicaragua. White has served on advisory groups and committees of the International Corporate Governance Network, Civic Capital (an SRI fund), Instituto Ethos (Brazil), and the Institute for Responsible Investment, Boston College Center for Corporate Citizenship. In 2006, he was elected Chair of GAN-NET, a non-profit dedicated to capacity-building of global action network organizations working on global issues such as trade, environment, corruption and employment. Since 2005, White has served as Senior Advisor to Business for Social Responsibility. He has published and spoken widely on corporate responsibility, accountability and governance.

ALAN WILLIS

Alan Willis is an independent consultant in business performance measurement and reporting to meet the information needs of capital markets and other interested parties. This work addresses the evolving responsibilities of boards of directors and management for transparency, sustainability and accountability to shareholders and other stakeholders. He chaired the advisory panel for the 2003 research study by the Canadian Institute of Chartered Accountants (CICA) on the business value created by stakeholder relationships. From 1997 to 2002, he represented the CICA on the Steering Committee and working groups of the Global Reporting Initiative. More recently he has authored papers for Canada's National Round Table on the Environment & the Economy regarding capital markets and sustainability as well as their earlier work on eco-efficiency indicators. He is a member of the Sustainability Experts Advisory Panel of the International Federation of Accountants, the advisory council of Innovest Strategic Value Advisors, and the Non-Financial Business Reporting Committee of the International Corporate Governance Network. He is currently working on CICA projects on risk disclosures in the MD&A, the applicability of cybernetics and systems theory to entity-wide controls, and "20 Questions for Boards of Directors to ask about CSR." He chaired a panel at Globe 2006 on "Realizing the Social Sustainability Dividend," featuring executives from US companies Intel and Interface, and Canada's Encana. Willis is a Chartered Accountant and Canadian citizen; he lives with his wife, Mary, in the Toronto area. Mississauga, Ontario.

