

Comments on State of Maine Corporate Law Reform Initiative

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(Note: Hinkley is the author of the "Code for Corporate Citizenship" which has informed proposals in California, Minnesota and Maine to reform director' duties under state corporate law. See

http://forums.seib.org/corporation2020/documents/Resources/Hinkley_Interview.pdf.)

First, I want to point out that the main thrust of these objections has to do with how the Code will be enforced. These objections can be addressed, but doing so in a legislative committee hearing takes lots of time that usually is not available. The result is that legislation is drawn away from how corporate behavior needs to change (the 28 words), and instead gets focused on how the enforcement provisions will generate lawsuits and (as you say) "mess" with the system. This is essentially what happened in California and Minnesota.

In order to prevent this from happening in Maine, I suggest that we simply amend the Maine statute to put in the 28 words without the enforcement provisions (which provisions were included in a separate section of the draft bill I sent you). Without the enforcement section, the bill to amend the corporate law would simply amend directors' duties to provide that their duty to act in the best interests of the corporation could not come "at the expense of the environment, human rights, public health and safety, the dignity of employees and welfare of the communities in which the corporation operates."

Keeping the amendment to just the 28 words would focus the debate on how corporations should be expected to behave and not get into the issue of "what if they don't". Some (mostly people who have little knowledge of how a corporation works) will say that, without the enforcement provisions, the Code will be a toothless tiger. I think they are wrong, but even if I am wrong, passing the 28 words of the Code can't hurt and will still be a big step in the right direction. The enforcement provisions, if needed, can be passed later.

A lot of what corporations do today that damages the public interest, they do because the law does not prohibit them from doing it and their duty to shareholders prevents them from stopping (because stopping would involve write downs of corporate assets, reduced profits and the taking of otherwise avoidable risks). The argument goes like this. "Our job is to make money for shareholders without doing anything illegal. What we are doing is not illegal. Changing our behavior to be more socially responsible will cost money and involve additional risk. Why should we do it?"

Passing just the 28 words will go a long way towards eliminating that rationale for socially irresponsible behavior. It will also open the way for directors, officers, managers and employees to start considering more than just the bottom line. It will cause the 28 words of the Code to become as much a part of their job description as "helping the company make money" is now. This will

result in a significant overall improvement in corporate behavior. If it doesn't, then we can always go back to the legislature later with the enforcement provisions.

That is one alternative (drop the enforcement provisions, make the 28 words essentially voluntary and hope they stick). Another is to meet the objections raised in your message head on and try to get the Code passed with as much of the enforcement provisions intact as possible. This is no doubt the more difficult course.

If you decide to proceed in this manner, you should try to make it clear the legislature up front that the enforcement provisions contain significant safeguards to protect the economy as the new law comes into effect. The enforcement provisions do not become effective until 15 years after the date of enactment. The purpose of interposing such a long transmission period is to give companies sufficient time to find ways to change their behavior and to mitigate the costs that may be incurred. It may cause some companies to argue that 15 years is not enough time, but if that happens (and the debate shifts from "how much" we are going to allow companies to abuse the public interest to "when" we are going to require them to stop), we have won the most important part of the battle.

Another safeguard built into the enforcement provisions is the inclusion of an exemption for small business. This exemption limits application of the Code to only Maine's largest companies (companies with annual sales of over \$ 15 million). This exemption is in recognition of the fact that small companies do not have the capacity to harm the public interest the way large companies do. If experience teaches us otherwise (that small companies are doing substantial damage to the public interest after passage of the Code) we can always go back to the legislature later to reduce the size of companies able to take advantage of the exemption.

Another aspect of the small business exemption is that politically it should keep small business on our side. It will make it easier for them to compete against big business. It will also keep big business from using the argument (as they have been known to do in Maine) that the new law should not be enacted because of its detrimental effect on small business.

Although the existing enforcement provisions do not include this, if you wanted to, you could also condition enforcement (at the end of the 15 year transition period) on at least a majority (or some other amount, eg.75%) of other states also passing similar amendments to their corporate laws. Offering this provision would go a long ways to eliminating the argument (which you didn't raise but is sure to arise with the introduction of the enforcement provisions) that the Code will make Maine corporations (notice I did not say Maine businesses) uncompetitive with businesses incorporated in other states.

Viewed in this light, even the enforcement provisions that have been suggested are not too burdensome (they don't take effect for 15 years, they don't apply to small business). However, because the Code is framed in terms of open-ended fiduciary duties, it is different from most (but not all) other business regulation and (as long as the enforcement

provisions are attached) is bound to attract some of the criticism suggested in your email.

This criticism basically is that the language of the Code is not written with sufficient specificity so that businesses can clearly tell whether a planned course of corporate behavior is legal or illegal. There are a number of possible responses to this objection. This first is simply that this is not true.

The Code speaks in terms of absolutes. It says that companies shall not run their operations at the expense of five elements of the public interest. For example, with regard to the environment, it means no emission or discharge of toxic materials into the environment either as part of the manufacturing process or from the product that is created. Some people will find it incredible to even dream of such a goal, but that does not mean we should not set it for ourselves. Obviously, all the technology that will be necessary to make the conversion to business without pollution is not available today. However, this is the primary reason why the enforcement provisions include a 15-year transition period--to give business the time to develop it.

In this way, the Code sets a goal for business much like President Kennedy did for America's space program when he said that within 9 years it would land a man on the moon and bring him home safely. We can't get there today (neither could they), but we will never get there if we don't set the goal first.

Business tends to develop only the technology that is necessary for it to comply with existing law or to obtain a competitive advantage. Sometimes they are successful in winding back laws restricting their behavior through lobbying, campaign finance, moving jurisdictions and other means. This lowers the technology hurdle they must meet, taking us in the wrong direction.

We will never get to the goal of no pollution (and why shouldn't that be the goal) passing environmental laws that limit (actually sanction) pollution one chemical, one jurisdiction at a time. The Code sets an absolute goal. The enforcement provisions set a time frame for when it must be achieved. If the transition period is not sufficient, the debate should shift to "when" such a goal is achievable. Even if we only get this far, we will have made real progress.

The second response to opponents' objections that the language of the Code is not precise enough (and at least with respect to "the dignity of employees", I will concede that it is not very precise) is that its lack of precision is at the end of the spectrum where small injustices may arise. Even without the enforcement provisions, there should be no doubt in the minds of corporate directors, officers, managers and employees that much of the socially irresponsible corporate behavior (which heretofore has created great damage to the public interest) is no longer acceptable. The discharge of greenhouse gases and other dangerous pollutants into the environment, violations of human rights through the use of sweatshop conditions in the third world, the manufacture and sale of tobacco, paying less than a living wage and major employers within a community leaving the community in

the lurch in order to move operations to greener pastures in the third world are all examples of corporate behavior which is legal today, but clearly violate the 28 words of the Code.

As you know, there is a saying in the law that the law does not deal with trivialities. My belief is that, if the Code takes care of these big issues, then people will be a lot less prone to abuse its enforcement provisions and courts will be less willing to entertain lawsuits that deal with trivial matters. Again, on this I could be wrong. If so, and the enforcement provisions (when they come into play) cause a backlog in the courts or otherwise are found to be unduly impeding the operation of corporations, then changes to the enforcement provisions can be made to cut back the ability to bring frivolous lawsuits. In the meantime, we still will have eliminated much of the serious corporate abuse of the public interest that now occurs.

A third response to the objections raised in your email would be that provisions which encompass open ended obligations to behave in the public interest are not unprecedented in the law. Although the law more typically imposes obligations not to engage in specific types of anti-social behavior ("thou shalt not laws") (for example, discharging more than a certain number of parts per million of certain toxic substances in drinking water), there are many examples where the law, indeed even the constitution, imposes open ended obligations on certain parties designed to protect the public interest. These instances include the bill of rights and the fourteenth amendment to the constitution (which require federal and state governments to refrain from passing laws which violate, among other things, freedom of speech, freedom of religion and the right to due process and equal protection). There are also numerous provisions where the law recognizes that certain people because of their position vis-à-vis other people owe those other people a higher duty of care than is otherwise required under the law. Examples of this appear in trust law, the law with respect to guardians, and in an area with which I am most familiar, the securities laws (which impose open ended obligations on companies seeking to raise money in the securities markets for the benefit of the investing public).

All of these laws have open-ended obligations (obligations whose ultimate reach are not specifically defined) imposed for the benefit of people whom the government has decided cannot otherwise defend themselves. These laws do result in a certain amount of litigation over time as courts refine the meaning of the language in the constitution or the statute in question imposing the obligation (e.g., after 215 years we are still litigating provisions of the bill of rights and more than 70 years after the passage of the Securities Act we are still litigating what constitutes a misstatement or omission of a material fact in as prospectus), but such litigation does not bring down the system. Indeed, it strengthens it.

I say this because open-ended obligations tend to make the people upon whom they are imposed more cautious. Not knowing exactly where the boundary between legal and illegal is causes them to think twice before engaging in behavior that goes near it. In my business almost all companies try to err on the side of full disclosure in their securities offering documents. They not only want to be able to defend in a lawsuit, they want their

prospectuses drafted so that there is no question as to its accuracy and completeness. They know the consequences of becoming too aggressive. They want to avoid the risk not just that they might lose a lawsuit, but that they will have to defend one. The open ended obligations of the Securities Act has not eliminated securities fraud or litigation in America, but in terms of the total size of the markets and the amount of money being raised such fraud and litigation has been reduced to an almost infinitesimal level.

This is the goal of the Code, to make companies more cautious with their treatment of the public interest. Bright line tests in "thou shalt not" laws coupled with a duty of directors to pursue only the interests of the corporation's shareholders, has the opposite effect. Such tests usually sanction some harm to the public interest (e.g. environmental laws which sanction pollution up to a certain number of parts per billion) and the duty of directors encourages companies to be aggressive in taking advantage of the law to the full extent permitted.

I believe the Code's open-endedness will strengthen capitalism. It will put corporate personnel on notice that they have obligations to the public interest as well as their shareholders' private interest. By not drawing a bright line, these managers will recognize there is a risk in behaving in a way which a court may later interpret as violating the five elements of the public interest the Code protects. It will teach them that making money and protecting the public interest are no longer to be thought of as mutually exclusive. This is a good thing—not only for the public interest, but in the long run capitalism. It will cause capitalism to evolve to its next level, not destroy it. Moreover, phrasing the Code in more broad less specific terms will allow its interpretation to grow with the times (again, much as is the case with the bill of rights).

One final response to the objections raised in your email is that it is time we recognized that corporations aren't people. They are creatures whose existence is provided for by state law. They are the engine and most powerful actors in our economy. Because their actions are the collective actions of dozens, sometimes hundreds of people working to a single purpose backed by millions (and sometimes billions) of dollars of capital, they have the power to do more damage to the public interest in one afternoon than the average individual could do in a lifetime.

To govern corporations the same way we do people (with each jurisdiction passing separate "thou shalt not " laws for each specific offense to the public interest that may arise) will never work. It is easy for corporations to comply with these types of laws. But, because their language is very specific it is just as easy for corporations to evade them. Everything such laws do not make illegal, remains legal. The more specific the law, the easier it is for the corporation to get around it.

In addition, "thou shalt not" laws get passed jurisdiction by jurisdiction. A company does not even have to stop its anti-social behavior when such behavior is made illegal if it is willing to move its operations to a jurisdiction where the new law does not apply. Globalization has shown how easy it is for corporations to move their operations where the cost of regulation is the least. They use this power to threaten state and local

governments to extract corporate welfare and to reduce the impact of regulation on their business.

So, for all the talk about how existing "state and federal laws that [are] enacted, with great care and thought, that are designed to protect "the environment, human rights, the public health or safety, the [effect on] communities in which the corporation operates or the dignity [rights] of its employees," this system of governing corporate behavior is not working. In the age of globalization its inability to govern is becoming more and more obvious. Something new has to be tried. Imposing open-ended obligations on companies to protect the public interest is the only thing that will work.

Not only is there precedent for this in the law, but it also makes sense for corporations. President Bush has said, "In the long run there is no capitalism without conscience". The same could be said of the five elements of the public interest the Code seeks to protect. In addition, governing through the use of open ended obligations such as are suggested by the Code, could eventually open the way for the elimination of the many volumes of "thou shalt not" laws which are now on the books and the corporate sector complains about so incessantly.

Deregulation and self-regulation is what corporations say they want. They say the market will serve as a moderating force on corporate misbehavior. Most people know it won't. The Code, however, may be the first step on the path to a system of corporate self-regulation. Its enforcement provisions will ensure that corporations will be called to account for gross violations of the public interest.

This is a long message. To summarize, there are good responses to the objections that will be raised to the enforcement provisions. The question is, will the legislature take the time to have this important debate or will it consider a bill with the enforcement provisions all too hard and table it for another day (as was the case in California and Minnesota). I cannot judge that from here. The wisest course may be to put forth a bill that does not include the enforcement provisions and go with just the 28 words amending directors' duties. I leave it to you.