

Draft # 2 with Dan Greenwood comments: Proposed Hawaii Stakeholder Governance (SG) Corporation

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(This is a preliminary draft. However, before I spend more time refining specific provisions I would like some feedback about whether you wish to pursue these concepts, and your thoughts about conceptual revisions. I can provide a more polished looking version, on COG electronic letterhead, when my assistants return after Christmas. This does not include the draft Fair Exchange legislation which will follow soon. – Deb Olson)

I. Background

The rationale for the following provisions come from the Corporation 2020 principles, my experience creating participative employee owned companies and my research and writing.¹

A. Currently corporations (find Hawaii statutory citation) are:

- 1) Operated primarily for the benefit of shareholders;
- 2) All directors must be elected by all shareholders,
- 3) Voting on the basis of share ownership, usually one per share if the shares have any voting rights;
- 4) Generally provide no voice or investment compensation to other stakeholders.

B. The guiding principles of a Stakeholder Governance (SG) Corporation are that:

Comment [DG1]: Assuming Hawaii law follows standard US law, it is not the case that corporations are legally bound to operate in the interests of shareholders alone. The usual statement of the doctrine of loyalty is "in the interests of the corporation" or "in the interests of the corporation and its shareholders". It is important not to minimize the flexibility that standard corporations already have.

Comment [dgo2]: I am concerned that we are having some difficulty agreeing on definitions of the words we're using. Dan, I appreciate your comments and your expertise in corporate law. I would like your help. However, we need to come up with a consistent agreed upon vocabulary for this discussion. As an employee ownership attorney, I agree that workers make a huge investment in companies, but they are not generally considered "investors" in the normal use of that term. Please help me create some defined terms for this discussion. What term do you suggest to deal with the shareholder primary problem that we are all addressing? To me, "equity investors" are initial shareholders who actually inject risk capital into the company. Bondholders are "secured creditors". Workers provide "sweat equity". I don't have a term for people who buy shares on the secondary market, although they are generally called "shareholders" along with the primary equity investors. In this legislation we should use terms with the most commonly accepted meaning to the extent we can. Since we are creating something new we must create the vocabulary to make the debate clear and comprehensible.

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¹ These include an article to be published in the Winter 2006 *Cornell Journal of Law and Public Policy*, "Fair Exchange: Providing citizens with equity managed by a community trust, in return for government subsidies or tax breaks to businesses" (See <http://www.capitalownership.org/lib/OlsonFairExchangePaper.pdf>) and previous publications including: "Union Experiences with Worker Ownership" 1982 *Wis. LR* 729; "Keeping Jobs and Capital at Home" 1984 *Nova Law Journal* 583; "Employee Ownership and Economic Development" 1987 *NYU Review of Law & Social Change*; "Unions and Employee Ownership", *ESOP Handbook* (Probus, 1989); "Unions and Fair Market Value: An Argument for a Safe Harbor for Negotiated ESOPs", 1992 *Journal of Employee Ownership Law & Finance* 135; "ESOPs for People, Not for Wall Street," 1993 *Journal of Employee Ownership Law and Finance* 5; "Development, Growth & Experience of ESOPs and Democratic Employee Buyouts" speech at International Conference on Democratic Employee Ownership, Dublin, Ireland, October, 1993; "Giving Employee Owners a Real Voice as Stockholders: Legislative Proposals to the Dunlop Commission", 1994 *Journal of Employee Ownership Law & Finance*; "The Employee Buyout Feasibility Study", *Leveraged ESOPs and Employee Buyouts*, NCEO 1997 (updated 2004), "The Feasibility Study for an Employee Led Buyout" Winter 1998, *Journal of Employee Ownership Law & Finance*; Summary of "Capital Ownership Group Industrial Homestead Policy Proposals" *Business Ethics* September 2000 and *Accountability*, December 2000; Chap. 17 "Labor Unions", *ESOP Answer Book*, Panel Publishers, July 2000. See also materials on my web site www.esoplw.com.

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- 1) It acknowledges that its wealth is created by a number of stakeholders, including: investors, entrepreneurs, employees, creators of intellectual property, communities hosting the facilities; and natural resources from the biosphere;
- 2) Traditional business enterprise law has required that company directors be elected exclusively by one investor role, the shareholders;
- 3) In a global economy a state needs to consider the needs of all these stakeholders when granting a business a corporate charter, access to its law enforcement and court system and other protections of state law;
- 4) Hawaii proposes a model statute for voluntary creation of SG Companies including
 - a. Economic incentives for using this new business structure;
 - b. Not imposing burdens that would undermine the efficiency or marketplace competitiveness of SG Companies;
 - c. Methods for companies to experiment with the new SG arrangements without making irrevocable commitments.

C. This document outlines several legislative options:

- 1) A law permitting any company to have “**Community Fiduciary Rules**”: This law permits a company to create a board of directors comprised of stakeholder representatives who may be chosen by, and owe primary responsibility to, specific constituencies in addition to the stockholders. It permits its corporate charter to provide that directors are acting as proper corporate fiduciaries when they consider the impact of corporate decisions on employees, communities and the environment as well as shareholders. It provides that fiduciary liability is owed to the specific named constituencies, but is not expanded to other unnamed claimants. This model need not receive any special financial incentives from the State.
- 2) A law creating a **Stakeholder Governance (SG) Company**: defines stakeholders; enumerates their rights to participate in an SG Company; provides a method for the State to determine if such standards are being met; and provides economic benefits to companies that meet these standards. An SG Company should be allowed to utilize the C, S or LLC corporate formats if it can do so and also meet the SG requirements.
- 3) A law creating a **Shared Ownership (SO) Company**: that provides 15% of the tax incentives provided to a full SG Company where at least 30% of its highest class of voting and dividend paying stock is owned by Qualified SG stakeholders or a voting trust controlled by said SG stakeholders. An SO company could get (on a sliding scale) up to 50% of the SG Company tax benefits if it became 100% owned by Qualified SG Stakeholders. SO company securities would be subject to independent valuation meeting the standards of IRS Rev. Proc. 59-60 and the ERISA 29 U.S.C. § 1108 (e) definition of “adequate consideration”. Unlike an SG company, and SO company need not have all the stakeholder governance provisions, it is simply sharing ownership with Qualified SG stakeholders. So, for example, a company with a 30% ESOP could meet these requirements without creating an SG governance structure.

II. Outline of a Model SG Company Act (“SG Act”)

A. SG Company Stakeholders Defined: Stakeholders are those who contribute to the wealth created by a business, including those who merely absorb costs involved in creating that wealth. They are defined as:

Comment [DG3]: Here too: ALL corporate wealth is created by all stakeholders, and shareholders – most of whom by stock in the secondary market and therefore contribute nothing directly to the corporation – and hardly among the more important contributors except at very specific and unusual moments in the corporation’s history.

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Comment [dgo4]: See comments above about creation of consistent vocabulary.

Comment [DG5]: As originally written, (2) was incorrect. No version of corporate law of which I am aware requires that companies be run in the interest of “investors”. Even the most shareholder-centered decision of the modern era, Revlon, classified bondholders, who are clearly investors, with all non-shareholder stakeholders. And long term employees are clearly investors.

Comment [DG6]:

Comment [dgo7]: Same comment as above. Lets define our vocabulary for this discussion.

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Comment [DG8]: If I were a corporate planner, I’d immediately seize on a corporate form that allowed me to have unenforceable fiduciary duties to gazillions of constituencies, especially if I didn’t have to give any of them any power. That is a terrific route to increasing the already largely unrevievable autonomy of the board. If that is not the goal, it is essential that stakeholders be given EITHER rights to elect board members, OR rights to sue for breach of duty OR both. I would not recommend rights to sue alone: if courts treat it seriously, it will make it impossible for boards to act (since every act will be a breach of duty to someone) and if they don’t, which is far more likely, it simply accentuates the status quo of unrevievable autonomy combined with excessive shareholder influence.

Comment [dgo9]: Your point is good. However, if we create open-ended liability to gazillions of constituencies no one will agree to create an SG company. This proposal aims to provide practical incentives, and limit the complexi... [1]

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- 1) Capital/ resource investors
- 2) Employees and contractors who generate/ enable products, services or sales and all types of business skill (entrepreneurs, marketing, sales and management). Employee stakeholderhood may not be weighted in favor of “highly compensated employees” (HCEs). The HCE provision could fashion rules based on ERISA’s penalties for plans that provide excessive benefits to highly compensated employees.
- 3) Intellectual capital & innovation providers
- 4) Infrastructure providers and representatives of the effluent neighborhood (facility site local governments)
- 5) Biosphere – environmental impact beyond immediate effluent neighborhood

B. SG Corporate Structure and Charter

- 1) The various stakeholder interests in an SG Company should coincide but may, at times, conflict. An SG Company provides means to efficiently govern the enterprise and work out these issues. This legislation allows a range of corporate governance structures to accommodate different businesses and definitions of constituencies within its framework.
- 2) An SG Company shall have a board of directors including representatives of its stakeholder constituencies selected by those constituencies through a democratic process wherever practical. The SG Review Board shall provide model bylaws outlining such democratic processes, but will accept any other company created selection process they deem to serve the purposes of the SG Act.
- 3) SG stakeholder constituencies *shall include* at least providers of:
 - i. capital (financial, real estate and intellectual);
 - ii. labor (skilled and unskilled);
 - iii. community infrastructure and receipt of effluent.
- 4) An SG Company may configure the above-mentioned constituencies to provide more precise stakeholder representation (such as separate representatives for union and management employees or financial and intellectual property investors, etc.) Where a single person resides in more than one constituency s/he may have a voice in each relevant constituency.
- 5) SG stakeholder constituencies *may include* other constituencies provided these are so determined by the Board of Directors and approved by the Hawaii Corporations and Securities Bureau SG Review Board.
- 6) An SG Company’s Charter shall provide stakeholder representation on its board of directors and allocate its stock based on its **Declaration of Stake Allocation (DSA)**. Its DSA shall describe the basis on which it determines the proportion of stock and governance allocated to each designated constituency. A DSA should allocate stock and governance based on a projection of the amount of company wealth attributable to each constituency; and should provide a basis for recalibrating DSA as the respective impacts of each constituency on the company’s wealth changes over time. The SG Review Board shall provide model DSA language. But an SG Company shall be permitted to provide its own DSA, provide it complies with the intent of the SG Act as determined by the SG Review Board.
- 7) The impact of any business on the biosphere, beyond its immediate environs, is very difficult to measure. Therefore, the biosphere’s interests are represented in this law by means of environmental tax incentives rather than specific board representation.
- 8) Obtaining an SG Charter
 - i. In order to enable experimentation with SG structures, any SG Company chartered before December 31, 2010, (hereinafter referred to as an “Early SG”) shall have the following privileges during that period:

Comment [DG10]: This places a large amount of discretion in a reviewing agency, making the functionality of the scheme dependent on the funding and competence of the agency. Is there a strong reason to bar private innovation within some minimum statutory standards?

Comment [dgo11]: Again, I was trying to leave room for innovation without giving companies opportunities to scam the system (based on experience with the recent SubS ESOP benefits.) During a trial period the review work could probably be done by a committee created of people from the existing state labor, securities and environmental agencies. After the experimental period, the legislature would have to decide whether or not to fund agency oversight or not.

Comment [DG12]: This is impossible. All wealth is produced by labor, as Marx pointed out, and all wealth is produced by capital, as Friedman contends. Allocations are meanin

Comment [dgo13]: This is only impossible on the theoretical level. Practically it could be done fairly easily by determining the actual return on the various investments made by the various parties. It is a matter of creating proper metrics. Shann Tumbull has proposed some of this methodology. Companies are constantly analyzing their costs of capital, labor, and depreciation in [3]

Comment [DG14]: This suggests that board representation is restricted to STOCKHOLDERS presumably voting on the basis on one share one vote, and that the innovation is that stock will be [4]

Comment [dgo15]: Again, this is a problem of vocabulary, not substance. I have created boards of directors that represent different constituencies. If we can come up with some medium of [5]

Comment [DG16]: Couldn't some board member(s) be specifically directed to take these interests into account? Even though only precatory and unlikely to be enforceable, it would have import [6]

Comment [dgo17]: The general design of the SG law allows the entrepreneur to find appropriate representatives of the 3 main constituencies. It is not easy to fin [7]

Comment [dgo18]:

Comment [dgo19]:

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- ii. Upon filing an application for an SG corporate charter, an Early SG may begin to operate as a normal business and shall have a one-year grace period to organize its stakeholder board and fulfill its other SG requirements, and shall be eligible during that year for all SG Company Tax Incentives.
 - iii. At the end of its first year of operation, an Early SG shall file a special SG Annual Report with the Hawaiian Corporation and Securities Bureau SG Review Board. Said SG Annual Report shall outline the stakeholder governance and structure and share allocation adopted in its DSA and any other special SG required disclosures.
 - iv. The SG Review Board shall decide whether the Early SG Company complies with the intent of the SG Act and is thus eligible to continue receiving SG tax benefits. If the Board finds any deficiencies, it shall provide the company a specific list of compliance requirements that, if fulfilled within 60 days, will entitle it to retain SG status.
 - v. Once a company has received its initial SG status compliance approval from the SG Review Board, it shall file regular corporate annual reports. However, every 5 years it shall file a special SG annual report and have its SG status re-examined by the SG Review Board. An SG Company that has obtained compliance approval from the SG Review Board shall be called a "Qualified SG Company." In addition, during the non-SG Review years, any qualified Stakeholder, may petition for a special SG Review Board examination of the Company's SG compliance.
- 9) Board members elected by stakeholder constituencies (other than shareholders) have a fiduciary duty to serve the best interest of the corporation and all its stakeholders to the extent that it does not contravene the best interests of their constituency. They must use their best efforts to run the corporation to serve the best interests of all the stakeholder constituencies, but shall hold the interest of their stakeholder constituency as their primary responsibility. SG Company board members' fiduciary liability is owed to the specific named constituencies, but is not expanded to other unnamed claimants.

C. Appointment and Powers of SG Review Board

The Hawaii Secretaries of Commerce, Labor and Environmental Protection shall each nominate 3 potential nominees for the SG Review Board. The Governor, with the advice and consent of the Hawaii Senate, shall appoint one nominee from each of these three sectors to the SG Review Board to serve for a period of 5 years. The SG Review Board shall interpret the SG Act and oversee the SG Company qualification process, creating the necessary forms, rules and procedures to enable and ensure true stakeholder representation and ownership in companies that receive Qualified SG status. *(This author can provide examples of potential DSA guidelines and democratic stakeholder constituency election processes upon request.)*

D. SG Corporate Tax Incentives –

One hundred percent (100%) of the following tax incentives shall be available at to any Qualified SG Company or Early SG Company. A Qualified SO Company may obtain (on a sliding scale based on ownership percentage) up to 50% of these benefits.

Comment [DG20]: Oddly, this might FORCE shareholder elected board members to put share interests ahead of corporate interests, which is a step backward from current law, which only permits that.

Comment [dgo21]: Please suggest some better language. I was trying to strike a balance by requiring all of them to serve the best interests of all stakeholders and the corporation, while allowing them to negotiate with one another. In reality, under the current standard, I believe money investors generally look out primarily for their own interests. When employees get board seats the attorneys terrify them with the concept of board fiduciary duty. The outcome is that the money investors are able to look out for their own interests, while mouthing the right words, and silencing the worker board members.

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Comment [DG22]: current law, which only permits that. If this is meant to create a cause of action for stakeholders, it isn't enough. Standard rules are likely to deny standing to everyone but shares. I'd replace with something like: "Named stakeholder constituencies may bring a direct action or a derivative action in the name of the corporation (as appropriate) against directors elected by that constituency for breach of fiduciary duty to that stakeholder constituency, but not on behalf of other constituencies." Note, though that this leaves some confusing questions unanswered—for example, in a standard derivative action, recovery goes to the corporation. Will the same be true here? If so, just as in the standard derivative action, there is no assurance that the named constituency will actually benefit from the recovery.

Comment [dgo23]: Dan and Kent, I could really use some help with this part.

Comment [DG24]: Wow. These are seriously generous. Better be really careful that the form actually has significant benefits!

Comment [dgo25]: I agree. The law could be passed on an experimental basis and only guarantee the benefits during the term of the experiment to give the legislature and agencies time to figure this out.

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- 1) CO2 Credits – any profits made by an SG Company that sells CO2 credits shall not be subject to any Hawaii taxes, including but not limited to corporate income tax.
- 2) Any SG Company that builds, or leases a LEED certified structure, shall pay no more than 50% of the assessed real estate taxes on that structure and the real estate on which it stands, to any government body in the State of Hawaii.
- 3) Any SG Company that includes on its board of directors at least one representative from a jurisdiction in which it has a business facility, shall pay no more than 50% of the assessed real estate taxes for any real estate owned or leased in that jurisdiction.
- 4) Any SG Company that provides for at least 1/3 of the seats on its board of directors to be filled by non-HCE employee-elected or collective bargaining unit elected representatives; shall pay no more than 75% of the unemployment compensation taxes normally assessed a similarly situated non-SG business and no more than 85% of its normally assessed worker's compensation taxes.
- 5) An SG Company may, with the consent of any jurisdiction in Hawaii, pay up to 25% of its taxes to that jurisdiction in SG Company securities, provided that there is an independent valuation of those securities meeting the standards of IRS Rev. Proc. 59-60 and the ERISA definition of "adequate consideration".
- 6) An SG Company that: a) makes a physical product and b) demonstrates to the satisfaction of the Hawaii EPA that it takes full responsibility for its products' life-cycle by reclaiming to nature its post consumer waste; c) is eligible for a tax credit against its Hawaii income taxes. The tax credit is equal to 50% of the reclamation cost certified by the Hawaii EPA.

E. SG Company Special Contractor Status

Qualified SG Companies shall receive preference in bidding on government contracts in Hawaii, as SG Companies are determined to be as Hawaii Community Investors.

F. Qualified SG Company Stakeholder Rights

- 1) SG Company Stakeholders have the right to vote on all shareholder issues, including voting for the board of directors (although voting on some of these director seats may be limited to specific stakeholder constituencies).
- 2) Voting of SG or SO stock shall be on the basis of (a) one participant, one vote or (b) one share, one vote.
- 3) SG or SO company stock appraisals are made available to SG constituents upon request for copying cost.

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Your point is good. However, if we create open-ended liability to gazillions of constituencies no one will agree to create and SG company. This proposal aims to provide practical incentives, and limit the complexity. That is why we've initially defined only 3 constituencies. Do you have a suggestion for altering the language?

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This is only impossible on the theoretical level. Practically it could be done fairly easily by determining the actual return on the various investments made by the various parties. It is a matter of creating proper metrics. Shann Turnbull has proposed some of this methodology. Companies are constantly analyzing their costs of capital, labor, and depreciation in a given product, plant, product line, etc. There is no reason such cost accounting methods could not be applied to stock allocation. I know this is true based on my experience in negotiating the present value of labor sacrifices provided in exchange for stock in collective bargaining.

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This suggests that board representation is restricted to STOCKHOLDERS presumably voting on the basis on one share one vote, and that the innovation is that stock will be held by stakeholders. If so, that replicates the problems of the current system (in which much stock is held by stakeholders in any event). In particular, it is likely that courts, markets and directors will view stockholding as a role and ignore the real interests of the full human beings behind the stock: it is hard to think of it being "in the stockholders interest" to reduce stockholder returns in favor of employee returns, even if they are largely the same people and good policy encourages giving the returns to labor rather than stock ownership.

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Again, this is a problem of vocabulary, not substance. I have created boards of directors that represent different constituencies. If we can come up with some medium other than stock to calculate, count and distribute the stakes amongst the stakeholders, that is great. I still call them "stock" because I am used to doing this on behalf of "employee stockholders". They actually don't own the stock. Rather it is owned by a trust for their benefit. In this outline I did not want to get into such detail. I could provide a model DSA for the agency to use based on work I've done for clients.

Page 3: [6] Comment [DG16] greenwoodd 1/4/2006 3:59:00 PM

Couldn't some board member(s) be specifically directed to take these interests into account? Even though only precatory and unlikely to be enforceable, it would have important educational purposes – it might encourage companies to use their discretion this way and it clearly would eliminate the common argument that the company's first responsibility is to profits, not the biosphere.

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The general design of the SG law allows the entrepreneur to find appropriate representatives of the 3 main constituencies. It is not easy to find an appropriate biosphere representative. I came up with the biosphere being represented by very specific tax credits after discussion with some environmental engineering students and potential SG company founders. Their concern was not to burden the board with unrealistic or overly dogmatic environmentalists, or folks the entrepreneurs might not know or get along with. The intent was to create some tax benefits that go to the overall benefit of the biosphere. They figured that local government folks would take care of the local environmental concerns. But, the biosphere concerns don't have easily determined advocates who can also understand the business and get along with the entrepreneur. The CO2 and LEED credits are merely examples. Environmental experts could help us find other similar items.

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