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").[1] 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.

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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.[5]

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:

1) 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.
3) 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 court-appointed 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 interest-trustee 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., multi-variable 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, power-generating 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]