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Profit and Purpose: Two New Types of California Corporation that Promote Social as well as Financial Benefits

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I. Background

Effective January 1, 2012, California companies are able to incorporate under two new forms of corporation: the Benefit Corporation¹ and the Flexible Purpose Corporation.² These new corporate forms facilitate companies' efforts to advance social welfare and environmental sustainability objectives while creating profits and value for their shareholders.

The primary purposes of traditional for-profit corporations are to promote long-term value growth and maximize shareholder profit. Other purposes, such as social benefit, should not conflict with these primary goals. Although some for-profit corporations are currently able to devote resources to advancing social benefit goals, these efforts must be balanced with the corporate directors' mandate of maximizing growth and profit.

Corporate directors who prioritize social benefit objectives to the detriment of profitability or value optimization risk being sued for breaching their fiduciary duty to the shareholders.³ Conversely, non-profit corporations have flexibility to pursue social welfare goals, but are prohibited from earning profit for shareholders. Traditional for-profit and non-profit corporations that seek to pursue blended objectives of profit and social benefit face potential liability from shareholder suits (in the case of for-profits) and heightened IRS scrutiny (in the case of non-profits).

Benefit Corporations and Flexible Purpose Corporations are hybrids between for-profit and non-profit corporate forms that permit corporations to pursue profits as well as social benefit goals. The new corporate structures:

- Require directors to consider not only shareholders' interests, but also the interests of stakeholders such as employees, suppliers, customers and community (which includes environmental concerns); and
- Create transparency and accountability in the implementation of social benefit goals by requiring the company to publish an annual report which provides an assessment of the successes, failures and hurdles to be overcome in achieving those goals.

¹ The Benefit Corporation was created by California Assembly Bill 361, which adds Part 13 to Division 3 of Title 1 of the California Corporations Code (http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_0351-0400/ab_361_bill_20111009_chaptered.pdf). Codified at California Corporations Code, Section 14600 *et seq.*

² The Flexible Purpose Corporation was created by California Senate Bill 201, which adds Division 1.5 to Title 1 of the California Corporations Code and amends other related sections of the Code (http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0201-0250/sb_201_bill_20111009_chaptered.pdf). Codified at California Corporations Code, Section 2500 *et seq.*

³ While constituency statutes available in some states (but not California) do permit directors to consider non-economic matters, they are permissive rather than obligatory, such that these interests are not required to be considered.

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California is the first state to adopt the Flexible Purpose Corporation form. It is among a growing number of states that have adopted the Benefit Corporation form. Similar Benefit Corporation laws exist in Hawaii, Maryland, New Jersey, New York, Vermont and Virginia. Benefit Corporation legislation is moving forward in Michigan, North Carolina, and Pennsylvania.

These corporate forms are new and have not yet been widely adopted. It is uncertain how they will be construed in states that have not yet adopted similar statutes. As more states adopt similar statutes this should facilitate planning to organize a company using one of these forms.

II. The Evolution of Corporate Purposes

An increasing number of companies consider sustainability and/or social benefits to be important goals. In a recent survey of 4,000 managers and executives of companies from 113 countries, 70% of survey respondents indicated that their company has placed sustainability permanently on the management agenda.⁴ Indeed, two-thirds indicated that sustainability was necessary to being competitive in today's marketplace. This trend is increasing in both size and momentum, with 68% of survey respondents reporting that their organization's commitment to sustainability has increased in the past year and an even larger proportion confirming that they plan to increase their commitment to sustainability.

Many survey respondents cited external factors as the driving force behind their companies' growing focus on social benefit purposes, including: customer preferences for sustainable products and services; legislative and political pressure; an increased commitment to sustainability on the part of competitors; stricter requirements from partners along the value chain; demands for broader value creation (i.e. in addition to profit); demands of institutional investors; and bottom line savings.

In short, a number of different market forces are contributing to the increasing desire on the part of many companies to adopt and incorporate sustainability and social benefit goals. The Benefit Corporation and the Flexible Purpose Corporation are tools that provide companies the flexibility to accommodate these new demands.

III. Benefit Corporations

A. Overview

A Benefit Corporation must pursue social welfare objectives and must meet more transparency requirements than those required of traditional for-profit corporations. Benefit Corporations are generally well suited for use by private companies that are focused on social and environmental goals and that are able to avail themselves of socially responsible capital funding sources.

A Benefit Corporation must be formed for the broad purpose of creating a "general public benefit," which is defined as "a material positive impact on society and the environment, taken as a whole" as assessed against a third party standard. In addition, the corporation may elect to also identify one or more specific public benefits for society or the environment, including:

- Providing low-income or underserved individuals or communities with beneficial products or services.

⁴ 2011 *Sustainability & Innovation Global Executive Study and Research Report*, prepared by Massachusetts Institute of Technology ("MIT") Sloan Management Review in partnership with the Boston Consulting Group (2011).

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- Promoting economic opportunity for individuals or communities beyond the creation of jobs in the ordinary course of business.
- Preserving the environment.
- Improving human health.
- Promoting the arts, sciences, or advancement of knowledge.
- Increasing the flow of capital to entities with a public benefit purpose.
- Accomplishing any other particular benefit for society or the environment.

B. Accountability

Directors must consider the impact of their actions upon the following:

- The shareholders of the Benefit Corporation;
- The employees and workforce of the Benefit Corporation and its subsidiaries and suppliers;
- The interests of customers of the Benefit Corporation as beneficiaries of the general or specific public benefit purposes of the Benefit Corporation;
- Community and societal considerations, including those of any community in which offices or facilities of the Benefit Corporation or its subsidiaries or suppliers are located;
- The local and global environment;
- The short-term and long-term interests of the Benefit Corporation, including benefits that may accrue to the Benefit Corporation from its long-term plans and the possibility that these interests may be best served by retaining control of the Benefit Corporation rather than selling or transferring control to another entity; and
- The ability of the Benefit Corporation to accomplish its general, and any specific, public benefit purpose.

Directors are not required to give priority to any particular consideration or stakeholder unless the corporation's Articles of Incorporation ("Articles") indicate such a priority of purpose. Benefit Corporation directors do not have a fiduciary duty to a beneficiary of the corporation's general or specific public benefit purposes arising solely from such persons' status as actual or intended beneficiaries of a public benefit. The statute does not otherwise limit directors' fiduciary duties.

A for-profit corporation can convert into a Benefit Corporation by amending its Articles upon approval of at least two-thirds of the outstanding shares of each class or series of stock of the corporation (with dissenters' rights). In addition, any change of control, benefit purpose, or structure requires a two-thirds shareholder majority vote.

C. Transparency

A Benefit Corporation must deliver an annual benefit report, prepared in accordance with an independent third party standard, which defines, assesses and reports on the corporation's overall social and environmental performance. Specifically, the benefit report is a narrative description of the ways in which the corporation pursued its general (and if applicable, specific) public benefit(s), as well as the successes, failures and hurdles associated with each.

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The benefit report must be delivered to shareholders and posted on a public website (proprietary information may be redacted), but does not have to be audited or certified by a third party.

D. Litigation

No person may bring an action under the California Corporations Code (the “Code”) against a Benefit Corporation or its directors except in a benefit enforcement proceeding. Available claims in these proceedings are limited to the corporation’s failure to pursue the general or specific public benefit purpose, violation of a duty or standard of conduct, or failure to deliver or post the annual benefit report. Parties entitled to initiate a benefit enforcement proceeding are limited to the Benefit Corporation itself; shareholders; directors; and where the corporation is a subsidiary, any person or persons owning 5% or more of the parent.

In addition, directors cannot be held personally liable for monetary damages for the failure of the corporation to create general or specific public benefits.

E. Potential Advantages

Benefit Corporations offer a number of benefits over traditional for-profit and non-profit corporations:

Protection from Liability. Directors owe no fiduciary duties to beneficiaries of the Benefit Corporation's general or specific public benefit purposes arising solely from such persons’ status as actual or intended beneficiaries of a public benefit.

Third Party Standards. Accountability associated with assessment and reporting of general and specific public benefit goals to third party standards allows a Benefit Corporation to substantiate social and environmental performance, thereby differentiating itself from “greenwashing” competitors that make unsubstantiated claims to be operating responsibly.

Shareholder Protection. A Benefit Corporation protects mission-focused investors by requiring directors in board decision-making to consider a specific set of considerations and requiring a two-thirds majority vote to approve any conversion, merger, or change in specific benefit purpose.

IV. Flexible Purpose Corporations

A. Overview

A Flexible Purpose Corporation permits the pursuit of profit in addition to one or more specific purposes, which may be broad (e.g., reducing GHG emissions) or narrow (e.g., providing an after school music program) in scope. The statute seeks to protect directors who perform their duties according to relevant statutory provisions from liability for any alleged breach of their fiduciary duties.

A Flexible Purpose Corporation is required to adopt one or more of the following “special purposes”:

- Charitable or public purpose activities that a non-profit public Benefit Corporation is authorized to carry out, or
- Purposes aimed at promoting positive short-term or long-term benefits (or minimizing adverse short-term or long-term impacts) upon the company’s stakeholders including employees,

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suppliers, customers, and creditors specifically, the community and society in general, or the environment.

The special purpose or purposes must be set forth in the corporate Articles filed with the Secretary of State as well as share certificates, which must also state that the company is a Flexible Purpose Corporation. The Articles may also specify the duration of the company's existence and can limit or restrict the business of the company so long as those limitations are aligned with the stated special purpose.

B. Accountability

In performing their duties, the directors of a Flexible Purpose Corporation have considerable discretion and flexibility to consider those impacts they deem relevant in the decision-making process, including the short-term and long-term goals of the company, the best interests of the company and its shareholders, and the special purposes set forth in the company's Articles. The decisions and actions taken by directors need not favor one purpose over another, and in appropriate circumstances and subject to reasonableness and materiality standards, directors may prioritize the pursuit of a special purpose goal over economic interests.

Once adopted, a special purpose may only be materially changed or terminated through the affirmative vote of at least two-thirds of each class of voting shares. A two-thirds vote is also required for a Flexible Purpose Corporation to amend its Articles to convert into a traditional California corporation. A unanimous vote of all shareholders is required to amend a Flexible Purpose Corporation's Articles to convert it into a non-profit corporation.

C. Transparency

Directors are required to prepare an annual report which includes a management discussion and analysis (a "special purpose MD&A") that reports upon the following items:

- The short-term and long-term objectives of the entity relating to its special purpose or purposes;
- Material actions taken both in the current fiscal year and proposed on a going-forward basis, as well as intended impacts including the causal relationships between the actions and reported outcomes;
- Future material actions expected to be taken in the short-term and long-term to achieve the entity's special purpose objectives;
- The selection process associated with the financial and operating metrics used to evaluate the corporation's performance in achieving its special purposes and the rationale behind any changes; and
- Operating and capital expenditures incurred during the fiscal year, as well as a good faith estimate of any additional operating or capital expenditures to be incurred over the next three years.

The special purpose MD&A must also be made publicly available by posting it on the corporation's website or through similar electronic means.

Flexible Purpose Corporations are also required to provide shareholders with, and to make publicly available, current reports summarizing the following items:

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- Any expenditure or group of expenditures that are likely to have a material adverse impact on the company's operations or financial condition for a quarterly or annual fiscal period; or
- Any decision by the board or the officers of the company to:
 - withhold expenditures that were likely to have a material positive impact in furtherance of the company's special purpose objectives or
 - determine that the special purpose has been satisfied or should no longer be pursued.

D. Litigation

Flexible Purpose Corporation shareholders have traditional enforcement remedies available to them with respect to any failure on the part of directors to perform their duties in accordance with the short-term and long-term goals of the company, the best interests of the company and its shareholders, and the purposes of the company as set forth in its Articles. However, there is no third party stakeholder right of action which would permit a non-shareholder to sue a Flexible Purpose Corporation for an alleged failure to pursue or achieve its special purposes.

E. Potential Advantages

Flexible Purpose Corporations offer a number of benefits over traditional for-profit and non-profit corporations:

Protection from Liability. Directors owe no fiduciary duties to beneficiaries of the Flexible Purpose Corporation's public benefit purposes arising solely from such persons' status as actual or intended beneficiaries of a public benefit.

Special Purpose MD&A. Accountability associated with reporting of public benefit objectives, planning and material actions taken in the prior year provides shareholders of a Flexible Purpose Corporation with the means to evaluate the effectiveness of the company in pursuing its public benefit objectives. Mandatory public availability of the special purpose MD&A provides increased public oversight.

Shareholder Protection. A Flexible Purpose Corporation protects mission-focused investors by providing them with recourse against the company for failure to pursue its public benefit goals, requiring a two-thirds majority vote to approve any material changes in the company's special purpose or to convert to a traditional for-profit corporation and requiring a unanimous vote to convert the company to a non-profit corporation.

V. Contrasting Benefit Corporations and Flexible Purpose Corporations

There are two key differences between the Benefit Corporation and the Flexible Purpose Corporation:

- The Flexible Purpose Corporation allows its directors to adopt a broad mandate of making a profit while also seeking to improve the social welfare in one or more specific ways, whereas Benefit Corporation directors are required to consider the effect of each decision on a list of potential beneficiaries in the context of a general public benefit. Thus, Flexible Purpose Corporations offer more flexibility with regard to determining the purpose(s) of the company

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and provide directors with a high level of discretion in how they balance and prioritize both traditional economic and special purpose goals

- A Benefit Corporation must issue an annual benefit report that must be prepared subject to a third party standard. Flexible Purpose Corporations are required to issue an MD&A that is very similar to the benefit report, but which is not subject to assessment in accordance with any third party standard

It should be noted that Benefit Corporations are recognized in a handful of states, while Flexible Purpose Corporations exist only in California.

Flexible Purpose Corporations are closer in nature to traditional for-profit corporations due to their clear profit motive and deference to shareholder oversight. On the other hand, Benefit Corporations are closer in nature to non-profit corporations because, though they are entitled to make a profit, they are required to create a public benefit and must use a third party standard to evaluate the progress of the company towards achieving its goal. The decision of which corporate form to adopt should take into account the specific circumstances and goals of a given company.

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