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FLEXIBLE PURPOSE CORPORATIONS, BENEFIT CORPORATIONS, AND THE NONPROFIT SECTOR: OPPORTUNITIES FOR COLLABORATION

BACKGROUND PAPER

INFORMATIONAL HEARING OF THE

SENATE BANKING AND FINANCIAL INSTITUTIONS COMMITTEE
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INTRODUCTION

In October 2011, Governor Jerry Brown signed two bills creating new corporate forms. As described in more detail below, SB 201 (DeSaulnier), Chapter 740, Statutes of 2011, authorized the creation of flexible purpose corporations (FPCs), and AB 361 (Huffman), Chapter 728, Statutes of 2011, authorized the creation of benefit corporations. Both of these new corporate forms authorize so-called blended corporations – i.e., companies whose articles of incorporation authorize the simultaneous pursuit of public good and private wealth, with the knowledge and support of the companies' shareholders.

During legislative hearings, individuals representing the California Association of Nonprofits (CAN) and the California Society of Association Executives (CalSAE) testified in opposition to both bills. CAN's concerns were centered on four issues -- capacity, sustainability, efficiency, and oversight. In its letters of opposition, CAN posed the following questions:

- Will either of the new corporate forms reduce demands on the capacity of already over-extended, existing nonprofit and public entities to meet social, educational, cultural, and environmental needs? Or will they simply dilute the pool of funds available to meet these needs?

- Will either of the new corporate forms be independently self-sustaining, or will they compete in the philanthropic and financial marketplace with existing nonprofit entities?

- Will the addition of these new corporate forms as potential competitors with nonprofits result in more innovative, more efficient, and more effective use of public, private, and charitable resources?

CalSAE shared many of CAN's concerns, and raised questions about the extent to which the new corporate forms would be externally accountable. CalSAE, in particular, recommended that both FPCs and benefit corporations should be encouraged to partner with existing nonprofits to pursue public benefits.

Both CAN and CalSAE asked the Legislature to convene one or more informational hearings to evaluate the potential impact of the bills, before moving either bill to the Governor. Although CAN's and CalSAE's arguments in opposition were insufficient to prevent either bill from becoming law, the organizations' requests for further legislative study did not fall on deaf ears. On Thursday, March 15, 2012, the California Senate Banking and Financial Institutions Committee will convene an informational hearing on the Stanford University campus, in the heart of social entrepreneurship, to study the potential impact of both new corporate forms on the nonprofit sector, and to explore opportunities for collaboration that will benefit both sectors. The committee will hear from academics and practitioners with expertise in these topics.

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WHAT PROMPTED LEGISLATION PROPOSING THE CREATION OF NEW CORPORATE FORMS?

Over the past decade, it has become increasingly common for corporations to integrate social and/or environmental goals within their profit-driven business models. Yet, many organizations that seek to achieve multiple or blended objectives are forced to take on risks and potential liability as a result of that choice.

These risks are most often borne by corporate directors trying to weigh the trade-offs between profitability and their organization's attempt to achieve one or more societal benefits. Courts have traditionally weighed fiduciary duties of care and loyalty by corporate directors using the so-called "business judgment rule," which typically permits some flexibility to consider social and environmental factors when pursuing the long-term best interests of the corporation and its shareholders. However, the business judgment rule may not afford boards of directors and other corporate managers sufficient protection and flexibility to consider blended value in all operating decisions. Further, this rule does not come into play in change-of-control situations, when boards and management generally have a fiduciary duty to act solely in the interest of maximizing shareholder value.

The traditional corporate form also presents risks for companies seeking to maintain societal benefit(s) as a mission during their early stages. In the early years, before profitability has been attained, or when profitability is tenuous at best, there is a strong possibility that early-stage investors may shift the company away from its beneficial mission, in order to attain profitability.

This difficulty in anchoring the mission also represents a significant issue for entrepreneurs who try to use a traditional, mature corporation to implement a blended value model. Traditional corporate attempts to anchor the mission either tend towards being overly broad or overly narrow, where they may either be ignored if they conflict with a director's fiduciary duty, or diluted or deleted by amendment.

Finally, even if the risk of director liability could be eliminated and an equitable means for anchoring the mission were possible, traditional corporation statutes do not provide the transparency necessary for shareholders to evaluate how, nor the extent to which, the corporation is achieving a societal benefit.

Why not use a limited liability company instead of creating a new type of corporation? In short, because LLCs have trouble attracting equity capital. The pass-through status of LLCs creates tax implications for potential investors. According to members of the working group that drafted SB 201, LLCs are also disfavored as an entity choice for widely held companies, because markets favor the standardization of entities formed by statute. The cost and effort of understanding the nuanced differences of operating agreements, and the cost and risk of drafting a prospectus that

captures those nuances and fully discloses the risk factors to be considered by potential investors, each represent a difficult and time-consuming effort that companies and investment bankers would be required to undertake on behalf of each individual LLC seeking equity capital. Investors vastly prefer the standardization in statutory approach and the standard set of articles of incorporation common to most corporations.

A BRIEF INTRODUCTION TO FLEXIBLE PURPOSE AND BENEFIT CORPORATIONS

FPCs: Effective January 1, 2012, one or more natural persons, partnerships, associations, FPCs, benefit corporations, or general corporations may form an FPC under the California Corporations Code, by executing and filing articles of incorporation with the California Secretary of State. In its articles of incorporation, each FPC must list its flexible purposes, which can be any of the following:

a) One or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out; and/or

b) Promoting the positive short-term or long-term effects of, or minimizing the adverse short-term or long-term effects of the FPC's activities on the FPC's employees, suppliers, customers, and creditors, the community and society, and/or the environment.

Each FPC's articles of incorporation may also provide for, but are not required to include, the following: a provision limiting the duration of the FPC's existence to a specified date; a provision limiting or restricting the business in which the FPC may engage or the powers that the FPC may exercise, or both, provided these restrictions are consistent with the purpose(s) of the FPC; and a provision requiring shareholder approval for any corporate action.

Each company wishing to become an FPC through conversion or reorganization of an existing corporate entity requires an affirmative vote of at least two-thirds of each of its classes of shareholders, or a higher vote threshold, if required in its articles of incorporation. The same supermajority vote threshold is required to amend an FPC's articles of incorporation or to create or dissolve an FPC through merger or acquisition.

Shareholders of an existing corporation that decides to convert to an FPC are entitled to dissenter's rights. These rights (see Corporations Code Section 1300) generally entitle dissenting shareholders to be cashed out for their shares at the shares' fair market value, as of the day before the first announcement of the terms of the proposed reorganization or merger, adjusted for any stock split, reverse stock split, or share dividend which becomes effective after that date.

Under the provisions of SB 201, each FPC must prepare an annual report, which must be sent to its shareholders and published on its Internet web site. In addition to a balance sheet, income statement, and a statement of cash flows for that fiscal year, the annual report must include a management discussion and analysis (MD&A) regarding the FPC's stated purpose or purposes, as set forth in its articles of incorporation.

Each FPC's MD&A is required to include all of the following information, at a minimum:

a) An identification and discussion of the short-and long-term objectives of the FPC that relate to its special purpose(s), and an identification and explanation of any changes made to those special purpose objectives during the fiscal year.

b) An identification and discussion of material actions taken by the FPC during the fiscal year to achieve its special purpose objectives; the impact of those actions, including the causal relationships between the actions and the reported outcomes; and the extent to which those actions achieved the special purpose objectives for the fiscal year.

c) An identification of material actions, together with the intended impact of those actions, which the FPC expects to take in the short- and long-term to achieve its special purpose objectives.

d) An identification and description of the financial, operating, and other measures used by the FPC during the fiscal year to evaluate its performance in achieving its special purpose objectives, including an explanation of why the FPC selected those measures and an identification and discussion of the nature and rationale for any material changes to those measures during the fiscal year.

e) An identification and discussion of any material operating and capital expenditures incurred by the FPC during the fiscal year in furtherance of its special purpose objectives; a good faith estimate of any additional material operating or capital expenditures the FPC expects to incur over the next three fiscal years in order to achieve its special purpose objectives; and other material expenditures of resources incurred by the FPC during the fiscal year, including employee time, in furtherance of its special purpose objectives, including a discussion of the extent to which that capital or use of other resources served purposes other than, and in addition to, furthering the special purpose objectives.

In addition to the annual report described above, each FPC must prepare and distribute a special purpose current report within 45 days of any expenditure, which is made in furtherance of its

special purpose objectives, and which had or is believed likely to have a material adverse impact on the FPC's results of operations or financial condition for a quarterly or annual fiscal period. This special purpose current report must identify the expenditure or group of related or planned expenditures, which had or is likely to have a material adverse impact on the FPC's financial condition.

Benefit Corporations: Effective January 1, 2012, one or more natural persons, partnerships, associations, benefit corporations, FPCs, or general corporations, may form a benefit corporation under the California Corporations Code, by executing and filing articles of incorporation with the California Secretary of State.

Each benefit corporation must have the purpose of creating a general public benefit, which is defined as a material positive impact on society and the environment, taken as a whole, resulting from the business and operations of the benefit corporation, as assessed against a third-party standard. In its articles of incorporation, each benefit corporation may also list one or more specific public benefits, which may be additional purposes of the corporation. Specific public benefits are defined as all of the following: providing low-income or underserved individuals or communities with beneficial products or services; promoting economic opportunity for individuals or communities beyond the creation of jobs in the ordinary course of business; preserving the environment; improving public health; promoting the arts, sciences, or advancement of knowledge; increasing the flow of capital to entities with a public benefit purpose; or accomplishing any other particular benefit for society or the environment.

As noted immediately above, benefit corporations are required to use a third party standard to define, report, and assess their overall corporate social and environmental performance. Several third party standards which meet the requirements of the benefit corporation statute currently exist, including, but not limited to, the standards developed by B Lab, Green Seal, the Global Rating Initiative, Global Investment Rating System, International Standards Organization, and Underwriters Laboratory.

Any third party standard used by a benefit corporation must meet all of the following criteria:

a) The standard must provide a comprehensive assessment of the impact of the business and the business' operations on employees of the benefit corporation and its subsidiaries and suppliers, customers of the benefit corporation, the communities in which the benefit corporation and its subsidiaries and suppliers are located, society, and the local and global environments.

b) The standard must have been developed by an entity that has no material financial relationship with the benefit corporation or any of its subsidiaries. AB 361 also established several firewalls intended to ensure that individuals heading up

organizations that develop third-party standards are not subject to inappropriate influence by certain businesses, certain industries, or certain industry trade associations that have benefit corporations among their membership.

c) The standard must be developed by an entity that accesses necessary and appropriate expertise to assess overall corporate social and environmental performance, and that uses a balanced, multi-stakeholder approach, including a public comment period of at least 30 days to develop the standard.

In addition, in order for a third party standard to be acceptable for use pursuant to the benefit corporation statute, all of the following information about the third party standard must be publicly available:

a) The criteria considered when measuring the overall social and environmental performance of a business, and the relative weightings assigned to each criterion.

b) The identity of the directors, officers, any material owners, and the governing body of the entity that developed and controls revisions to the standard.

c) The process by which revisions to the standard and changes to the membership of the governing body are made.

d) An accounting of the sources of financial support for the entity, with sufficient detail to disclose any relationships that could reasonably be considered to present a potential conflict of interest.

Just as is true of FPCs, each business entity wishing to become a benefit corporation through conversion or reorganization requires an affirmative vote of at least two-thirds of each of its classes of shareholders, or a higher vote threshold, if required in its articles of incorporation. The same supermajority vote threshold is required to amend a benefit corporation's articles of incorporation, or to create or dissolve a benefit corporation through merger or acquisition. Furthermore, as is the case for FPCs, shareholders of an existing corporation that decides to convert to a benefit corporation are entitled to dissenter's rights, which generally entitle dissenting shareholders to be cashed out for their shares at the shares' fair market value.

Like FPCs, benefit corporations are required to prepare an annual report, which must be distributed to its shareholders and made public on its Internet web site. Annual benefit reports must include narrative descriptions of all of the following:

a) The process and rationale for selecting the third-party standard used to prepare the benefit report.

b) The ways in which the benefit corporation pursued a general public benefit and one or more specific public benefits during the applicable year, and the extent to which those benefits were created.

c) Any circumstances that hindered the creation of a general or specific public benefit by the benefit corporation.

d) An assessment of the overall social and environmental performance of the benefit corporation, prepared in accordance with a third-party standard applied consistently with any application of that standard in prior benefit reports or accompanied by an explanation of the reasons for any inconsistent application. The assessment does not need to be audited or certified by a third party.

e) The name of each person or more that owns 5% or more of the outstanding shares of the corporation.

f) A statement from the board of directors indicating whether, in the opinion of the board of directors, the benefit corporation failed to pursue its general, and any specific, public benefit during the period covered by the report. If, in the opinion of the board of directors, the benefit corporation failed to pursue its general, and any specific, public benefit, this statement would have to include a description of the ways in which the benefit corporation failed to pursue that benefit/those benefits.

g) A statement of any connection between the entity that established the third-party standard, or its directors, officers, or material owners, and the benefit corporation, or its directors, officers, and material owners, including any financial or governance relationship that might materially affect the credibility of the objective assessment of the third-party standard.

The benefit corporation statute expressly absolves directors of benefit corporations and the benefit corporations themselves of liability for failing to create a general or specific public benefit. Under the provisions of the benefit corporation statute, a director of a benefit corporation does not have a fiduciary duty to a person that is a beneficiary of the general or specific public benefit purposes of a benefit corporation. No person may bring an action or asserting a claim against a benefit corporation or its directors, except in a benefit enforcement proceeding. These types of proceedings may only be commenced or maintained by the corporation, a shareholder, a director, a person or persons that hold 5% or more of the equity interests in an entity of which the benefit corporation is a subsidiary, or other persons

specified in the articles or bylaws of the benefit corporation.

HOW MANY COMPANIES HAVE FILED PAPERS WITH THE SECRETARY OF STATE TO BECOME FPCs AND BENEFIT CORPORATIONS?

According to the Secretary of State's office, sixteen companies have filed paperwork to become benefit corporations since enactment of AB 361. These companies include The Ideal World, Strozzi Institute, Great Pacific Iron Works, Lost Arrow Corporation, Patagonia, Opticos Design, Give Something Back, JP & Sun, Thinkshift, Dopehut, The University of the Brain, Farm From a Box, Search Inside Yourself Leadership Initiative, Patagonia Provisions, Terrassure, Sun Light & Power.

One firm (Prometheus Civic Technologies) has filed to become an FPC.