WHITE PAPER

THE NEED AND RATIONALE FOR THE BENEFIT CORPORATION:

WHY IT IS THE LEGAL FORM THAT BEST ADDRESSES THE NEEDS OF SOCIAL ENTREPRENEURS, INVESTORS, AND, ULTIMATELY, THE PUBLIC

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Executive Summary

There is significant interest in state legislatures and bar associations across the United States regarding legislation to introduce a new type of corporate legal entity – the benefit corporation. Legislation establishing the benefit corporation as a new type of corporate entity has already been passed and signed into law in California, Hawaii, Illinois, Louisiana, Massachusetts, Maryland, New Jersey, New York, Pennsylvania, South Carolina, Vermont, and Virginia, and has been introduced in several other states.

The sustainable business movement, impact investing and social enterprise sectors are developing rapidly but are constrained by an outdated legal framework that is not equipped to accommodate for-profit entities whose social benefit purpose is central to their existence. The benefit corporation is the most comprehensive yet flexible legal entity devised to address the needs of entrepreneurs and investors and, ultimately, the general public. Benefit corporations offer clear market differentiation, broad legal protection to directors and officers, expanded shareholder rights, and greater access to capital than current alternative approaches. As a result, the benefit corporation is also attracting broad support from entrepreneurs, investors, legal experts, citizens, and policy makers interested in new corporate form legislation.

The major characteristics of the benefit corporation form are: 1) a requirement that a benefit corporation must have a corporate purpose to create a material positive impact on society and the environment; 2) an expansion of the duties of directors to require consideration of non-financial stakeholders as well as the financial interests of shareholders; and 3) an obligation to report on its overall social and environmental performance using a comprehensive, credible, independent and transparent third-party standard. The enacting state's benefit corporation statutes are placed within existing state corporation codes so that the enacting state's existing corporation code applies to benefit corporations in every respect except those explicit provisions unique in the benefit corporation form.

The purpose of this white paper is to set out the need and rationale for this legislative initiative. The paper includes a brief discussion of demand in the market by business leaders and investors, an analysis of why current legal frameworks do not accommodate the activities of mission-driven private sector entities, a discussion of the benefit corporation form, why the model legislation is drafted the way it is and why it is the legal form that best addresses the needs of social entrepreneurs, investors and, ultimately, the public.

I. Market Demand by Consumers, Investors and Social Entrepreneurs

For-profit social entrepreneurship, social investing and the sustainable business movement have reached critical mass and are now at an inflection point. Accelerating consumer and investor demand has resulted in the formation of a substantial marketplace for companies that put purpose, not profit, at the center of the business.

(A) Consumers

A significant and growing population of consumers already aligns their purchases with their values, and many more have become conscious of the issue. Approximately 68 million U.S. consumers have stated a preference for making purchasing decisions based upon their sense of social and environmental responsibility.[1] Some consumers use their purchasing power to punish companies for negative corporate behavior,[2] and many other consumers use their purchasing power to reward companies that positively address a social or environmental issue. For example, surveys have shown that 49% of Americans would boycott companies whose behavior they perceive is not in the best interest of society.[3] Meanwhile, recent research has also indicated that where price and quality are equal, 86% of consumers would switch from their current brand to a brand that is socially responsible.[4] These consumer behaviors apply not just to purchases related to popular consumer products but also many other industries including telecommunications, banking, and professional services (e.g. law firms).[5]

As consumer demand for socially responsible products and companies is increasing, consumer trust in corporations is decreasing. Marketers use the terms "green," "responsible," "sustainable," "charitable," and words like them on a daily basis to describe their products or their companies. However, the more these terms are used, the less meaning they have because there are no standards to back up the claims.[6] This problem, often referred to as "greenwashing,"

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[1]Natural Marketing Institute ecoefficiency , *Benefits of Becoming a Sustainable Business,* Natural Marketing Institute (2008), *available at* http://www.eco-officiency.com/benefits_becoming_sustainable_business.html.
[2] *See*, *e.g.*, Lawrence Glickman, *Buying Power: A History of Consumer Activism in America* (University of Chicago Press 2009); Steven Levingston, *Whole Foods Boycott: the Long View* (September 2, 2009), *available at* http://voices.washingtonpost.com/shortstack/2009/09/whole_foods_boycott_the_long_v.html?hpid=news-col-blog.
[3] The McKinsey Quarterly, Shiela Bonini, Kerrin McKillop & Lenny Mendonca, *The trust gap between consumers and corporations*, 10 (2007).
[4] Cone Communications, *Cone Cause Evolution & Environment Survey*, Cone Research Report, 8 (2007), *available at* http://www.coneinc.com/files/2007ConeSurveyReport.pdf.
[5] Cone Communications, *2010 Cone Cause Evolution Study*, Cone Research Report, 10 (2010), *available at* http://www.coneinc.com/files/2010-Cone-Cause-Evolution-Study.pdf.
[6] For example, Exxon Mobile was named "Green Company of the Year" by Forbes Magazine in 2009 for its focus on natural gas (as opposed to coal). Christopher Hellman, *ExxonMobile: Green Company of the Year*, Forbes Magazine (August 24, 2009), *available at* http://www.forbes.com/forbes/2009/0824/energy-oil-exxonmobil-green-company-of-year.html. However, the Forbes article failed to assess its performance on other environmental issues, such as its lobbying against climate change or even the negative effects of natural gas on the environment. *See* Josh Harkinson, *Exxon Mobile: "Green Company of the Year?"* Mother Jones (August 27, 2009), *available at* http://motherjones.com/blue-marble/2009/08/exxonmobil-green-company-year-0. In the UK, Exxon advertisements claiming to be "eco-friendly" for its natural gas projects was banned as misleading in 2008.

is misleading for consumers and frustrating for businesses that try to distinguish themselves based on their social and environmental business practices. Consumers are less likely to trust a company's claims versus consumer reports or third party certifications.[7] As a result, various certifications, such as "Organic", "Fair Trade," "Energy Star", "Green Seal", "LEED" and "Forest Stewardship Council" have emerged to provide insight on particular aspects of a company's social or environmental performance.[8] Although there has been a proliferation of narrow product or practice specific standards like those mentioned, there are fewer standards that provide a comprehensive understanding of a company's performance as a whole. The lack of comprehensive and transparent standards is making it difficult for a consumer to tell the difference between a "good company" and just good marketing.

The general public preference for supporting "good companies" is not limited to purchases. People also prefer to work for companies who are committed to social and environmental issues. More than two-thirds of employees (69%) consider the social and environmental track record of a company in deciding where to work.[9] This preference is especially strong among MBA graduates, who overwhelmingly (88%) have said that they would be comfortable taking a pay cut to work for a company that has ethical businesses practices versus one that does not.[10]

(B) Investors

The socially responsible investing (SRI) movement has grown over the past 30 years to represent nearly 10% of U.S. assets under management, or roughly $2.3 trillion.[11] SRI has evolved in both the public and private markets, becoming an institutionalized sector of the professional asset management market and giving rise to a distinct venture capital and private equity industry of funds and individual investors seeking values-aligned investment opportunities.

Some SRI investors use screens to avoid "sin" (e.g., tobacco, alcohol, gaming) and weapons stocks or to reward social or environmental "best in class" companies in each industry sector in their portfolio; others engage with corporations to change their behaviors through shareholder resolutions or other forms of activism; while others, increasingly being called impact investors, seek to create more direct social impact through targeted direct equity and debt investments in businesses such as community banks, microfinance institutions, clean-tech or

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[7] BBMG, *Conscious Consumers Report: Redefining Value in a New Economy*, 16 (2009), *available at* http://bbmg.com/.

[8] For a description of these and other symbols, *see Guide to Green Symbols*, *available at* http://www.easywaystogogreen.com/green-guides/guide-to-green-symbols/ (last visited September 9, 2011).

[9] *2010 Cone Cause Evolution Study*, 8 (2010).

[10] Harvard Business Review, *New MBAs Would Sacrifice Pay for Ethics,* The Daily Stat (May 17, 2011), *available at* http://web.hbr.org/email/archive/dailystat.php?date=051711. The average pay cut the MBA students would accept to work for a responsible business is about $8,000 per annum. *Id*.

[11] US SIF: The Forum for Sustainable and Responsible Investment, *2010 Report on Socially Responsible Investing* (2010), *available at* http://ussif.org/. *See also* US SIF Website, *Socially Responsible Investing Facts* (visited on September 9, 2011), *available at* http://ussif.org/resources/sriguide/srifacts.cfm.

green businesses or social venture funds investing globally across developed and emerging markets.[12]

A November 2010 report by J.P. Morgan, entitled "Impact Investments: An emerging asset class," estimates the size of this market opportunity at between $400 billion and $1 trillion.[13] This only included investment opportunities in emerging markets across five sectors: housing, rural water delivery, maternal health, primary education, and financial services. J.P. Morgan estimates the 10-year profit potential from these opportunities alone ranged between $183 billion and $667 billion.[14] Approaching it from the demand side of the equation, and focused only on U.S. individual investors, a June 2010 "Money for Good" report from Hope Consulting estimates a demand for impact investments among U.S. high net worth individuals at $120 billion.[15]

Like consumers, investors lack the comprehensive tools to understand the complete picture of a company's performance across the full range of social and environmental measures. Likewise, businesses may have a hard time attracting investors by distinguishing themselves among the sea of companies that claim to be "socially responsible." Furthermore, the current trend, particularly in the public capital markets and among policy makers and large public corporations serious about sustainability, is to encourage integrated sustainability reporting using credible third party standards. According to Institutional Shareholder Services (ISS), the largest shareholder proxy advisory organization in the world, this trend is also true for institutional investors who "appear to be increasingly incorporating social and environmental considerations into their proxy voting decisions, as demonstrated by voting trends and institutional investor initiatives."[16]

(C) Entrepreneurs

For-profit social entrepreneurs have gained increasing prominence on the business landscape. Probably the highest profile example of this has been the awarding of the Nobel Peace Prize to Muhammad Yunus for his pioneering work in microfinance, but there are many other examples.[17] Although there is no reliable data on "social enterprise" company revenues, an

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[12] *See Socially Responsible Investing Facts*, *supra* note 11 (highlighting screening, shareholder advocacy and community investing as typical investor approaches).
[13] J.P. Morgan Global Research, *Impact Investments: An Emerging Asset Class* (Nov. 29, 2010), *available at* http://www.jpmorgan.com/pages/jpmorgan/investbk/research/impactinvestments. *See also* Nicholas Timmons, *Impact Investment "a burgeoning asset class,"* Financial Times (Nov. 28, 2010), *available at* http://www.ft.com/intl/cms/s/0/e875dda6-fae6-11df-b576-00144feab49a.html?ftcamp=rss#axzz1XUogcz2a (summarizing the J.P. Morgan report).
[14] Id.
[15] Hope Consulting, Strategies for Social Change, *Money for Good Report* (2010)., http://www.hopeconsulting.us/money-for-good.
[16] Carolyn Mathiasen & Erik Mell, Institutional Shareholder Serv., *Corporate Social Issues: A 2011 Proxy Season Preview: United States* 1 (2011).
[17] Muhammad Yunus is known as a "banker for the poor" and won the Nobel Prize in 2006 for his work with the Grameen Bank in Bangladesh. For a biography of Muhammad Yunus and information regarding his work *see* Nobelprize.org, Nobel Peace Prize 2006, *available at* http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/yunus-bio.html.

aggregation of businesses belonging to membership associations generally identified with the sustainable business movement reveals a marketplace of over 65,000 businesses with over $40 billion in revenues.[18]

The pipeline of future for-profit social entrepreneurs is filling rapidly as most top business schools offer a program in Social Entrepreneurship.[19] The membership of Net Impact, a network of business school students and young professionals using business as a tool for social change, is over 10,000 in 125 chapters globally. There are numerous additional companies that do not self-identify as "socially responsible" but nevertheless behave that way, and there are other sectors of the economy such as health care, education, housing, food, agriculture and consumer products with concentrations of high-impact businesses.

The current marketplace, however, continues to be fragmented and confusing. As noted above, entrepreneurs that are "sustainable," "green" or "socially responsible," may find that it is hard to distinguish themselves from other companies that make similar claims but don't actually behave as they advertise. Furthermore, the current legal framework is structured to ensure profit maximization, not social responsibility.[20] Because of this, entrepreneurs with a mission-driven business may be reluctant to accept outside capital from investors who may not share their long term vision for social and environmental responsibility.

(D) Certified B Corporations

In 2007, in response to this fragmentation and confusion, B Lab, a 501(c)(3) not-for-profit organization, initiated a certification system for companies interested in distinguishing themselves in this cluttered marketplace. B Lab developed a set of transparent, comprehensive and comparable standards designed to enable the marketplace to identify and support companies that meet rigorous third-party standards for social and environmental performance.

An important issue these certification standards address is the legal issue arising out of the tension between a corporation pursuing a social mission, on the one hand, and the more conventional corporate mandate of maximizing shareholder value, on the other, by requiring companies to consider stakeholders[21] other than shareholders when making corporate decisions.

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[18] A partial listing of these associations includes: Green America, Social Venture Network, Investors Circle, Business Alliance for Local Living Economies, Transfair USA, Social Investment Forum, National Cooperative Business Association and the National Center for Employee Ownership.

[19] For example, Duke University's Fuqua School of Business has the Center for the Advancement of Social Entrepreneurship, University of Pennsylvania's Wharton School of Business has several social entrepreneurship programs, including the Social Enterprise Fellowship Program, and Northwestern University's Kellogg School of Management provides the Carol and Larry Levy Social Entrepreneurship Lab.

[20] For a discussion of the objective and conduct of a corporation generally, *see*, *e.g.*, 1 Principles of Corporate Governance, § 2.01 (Am. Law Inst., May 13, 1992) (noting that a business corporation should have as its objective the conduct of such activities with a view to enhancing corporate profit and shareholder gain, but that its pursuit of the economic objective must be constrained by social imperatives and *may* be qualified by social needs).

[21] The term "stakeholder" is commonly used to refer to a person, group, or organization that has a direct or indirect stake in an organization because it can affect or be affected by the organization's actions, objectives and policies. Key stakeholders in a business organization include customers, directors, employees, shareholders, suppliers, the

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For-profit companies pursuing a social mission face increasing difficulty as they scale; as officers and directors of these entities consider investments, mergers or liquidity events, the default position tends to favor the traditional fiduciary responsibility to maximize returns to shareholders over the company's social mission. Many leaders of early and growth-stage mission-driven businesses fear being pressured to change business practices or pursue strategic alternatives to independent growth by investors whose financial interests often diverge over time from the social mission of the company. Whatever the letter of the law, these fears, combined with both prevailing business culture and advice of counsel about the risk of litigation if one fails to maximize shareholder value, have a chilling effect on corporate behavior as it relates to pursuit of a social mission. These fears are exacerbated by cautionary tales of investor-led board takeovers of private companies and stories like the iconic forced sale of Ben & Jerry's to Unilever.

As a result of these perceived legal and marketing needs of mission-driven businesses, more than 460 companies from more than 60 different industries have become Certified B Corporations over the last four years, indicating a strong desire among leaders within the sustainable business movement to adopt a legal framework with this higher standard of consideration of stakeholder interests.

Although the B Corporation certification process requires a company to implement certain "fixes" to its articles of incorporation and other organizational documents, these "fixes" can be difficult because they must be made within the context of existing legal frameworks (discussed in greater detail in Section III below).

The legal framework currently used by companies to earn certification as a B Corporation is generally seen as not being available to companies incorporated in any of the nineteen states that do not have a statute that explicitly allows directors to consider the interests of constituencies other than shareholders (called a "constituency statute"). Even in states with constituency statutes, the creation of a new corporate entity provides additional legal clarity that the fiduciary duty of directors of a benefit corporation includes consideration of stakeholder interests and that shareholders have the right to enforce that standard of consideration.

In addition to addressing these legal limitations, legal recognition of a new corporate entity creates legitimacy for and accelerates growth of this emerging marketplace by making it easier for the next generation of entrepreneurs and investors to build businesses that seek to create value for both shareholders and society. The new benefit corporation form facilitates greater recognition of these businesses by consumers, investors and policy makers by establishing a higher bar of corporate governance without requiring certification by a third party for a fee and without prescribing specific corporate activities.

All of these factors call for the creation of a legal framework for a new class of corporations that are designed to create benefit for all stakeholders, not just shareholders.

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community from which the business draws its resources, etc. *See* definition of stakeholder, BusinessDictionary.com (last visited September 27, 2011).

II. Existing Legal Frameworks Do Not Accommodate For-Profit Mission-Driven Companies

Historically, the U.S. legal system governing corporate entities and their activities has not been structured or tailored to address the situation of for-profit companies who seek to use the power of business to solve social problems. This white paper will not detail all of the legal distinctions between for-profit and not-for-profit entities but, broadly speaking, at the federal level the system is structured as a binary one, dividing business organizations into either for-profit or not-for-profit, with U.S. federal tax law guarding the divide between these sectors and their mandated and permissible activities.[22]

Social entrepreneurs have recognized the limitations of the not-for-profit form and the potential power of business and are increasingly deciding to organize and operate as for-profit entities. This decision gives rise to a complex set of legal issues at the state level, which in turn leads to uncertainty and impairs the growth of these types of entities and this new sector of the economy.

(A) Background

The notion that a business corporation has as its purpose creating financial gain for its shareholders was forcefully articulated by the Michigan Supreme Court almost 100 years ago in the following statement in *Dodge v. Ford*:[23]

"A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes."

Dodge v. Ford does not stand alone, and cases in other jurisdictions have reiterated the shareholder maximization duty that "[i]t is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders."[24] Though still a staple in many law school casebooks, a strict reading of *Dodge v. Ford* and other cases that specify shareholder wealth maximization as a fiduciary duty has been criticized by those who believe that these cases do not represent the current state of modern corporate law.[25] Nevertheless,

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[22] Generally, not-for-profit entities are afforded certain tax benefits (including tax-exempt status and deductibility of contributions by financial supporters) so long as they pursue a clearly-defined charitable purpose and comply with other requirements. Among other things, federal tax law (i) precludes not-for-profit entities from distributing any profits, thus making it difficult for nonprofits to attract capital; (ii) limits financial remuneration of employees, thus making it difficult for nonprofits to attract and retain talent; and (iii) limits the revenue-generating activities of such entities which would in the private sector ordinarily accompany sustainably operating and expanding like a successful business. For a further discussion of nonprofits see the discussion in Appendix C.

[23] 204 Mich. 459, 507, 170 N.W. 668, 684 (1919).

[24] *Katz v. Oak Indus., Inc.* 508 A.2d 873, 879 (Del. Ch. 1986). *See also Long v. Norwood Hills Corp.*, 380 S.W.2d 451 (Mo. Ct. App. 1964); *Granada Invs., Inc. v. DWG Corp.*, 823 F. Supp. 448, 459 (N.D. Ohio 1993).

[25] Some commentators have suggested that the decision in *Dodge v. Ford* to award the shareholders a special dividend was not based on shareholder wealth maximization principles, but rather a breach of duty of good faith to

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Dodge v. Ford remains good law and many still maintain that its "theory of shareholder wealth maximization has been widely accepted by courts over an extended period of time."[26] It is against the paradigm of shareholder primacy that directors and their advisors analyze corporate decision making.

(B) Fiduciary Duties

In the United States, corporations and other types of business entities are constituted under state law, and their directors and managers are subject to standards of conduct imposed by state law (both statutes as well as judicial interpretations thereof). Generally, these laws require the directors, who are elected by the shareholders, to manage or direct the management of the corporation's business and affairs. The directors may (and typically do) delegate some of their authority to the corporation's officers, insofar as the day-to-day activities of the corporation are concerned.

In discharging their statutory obligations, directors owe certain duties–referred to as fiduciary duties–to the corporation itself and to the corporation's shareholders. Corporate law has long recognized two basic fiduciary duties for corporate directors: a duty of loyalty and a duty of care. Under the duty of loyalty, directors are required to pursue the best interests of the corporation and to place those interests above their own whenever those interests conflict. Under the duty of care, directors must exercise good business judgment and use ordinary care and prudence in the operation of the business.

Although corporate law is state-specific, the general concept of fiduciary duties is fairly standard across jurisdictions. "Constituency" statutes, discussed in greater detail below, are one of the main statutory differentiators from state to state with respect to fiduciary duties. Constituency statutes, which were developed mainly by state legislatures as a defensive mechanism for local companies that are subject to a hostile takeover, give the target company's board the discretion to favor a deal that is better for the company's employees, the community and the local economy over a deal with a higher purchase price but more detrimental effects to the community. If there is no competing deal, the constituency statute permits a board to examine the potential transaction's impact on the community and reject it on that basis.

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minority shareholders by withholding special dividends to freeze them out. Judd F. Sneirson, *Green is Good: Sustainability, Profitability, and a New Paradigm for Corporate Governance*, 94 Iowa L. Rev. 987, 1001-1003 (2009) (noting that *Dodge v. Ford* has only been cited by Delaware three times, twice as authority for the close corporation issue, and arguing that it should not be taught as a case of precedential value with respect to a duty of shareholder maximization). Sneirson describes three other cases that clearly identify a duty of shareholder maximization of value, but dismisses the precedential value of these cases on that point and notes that they are rarely cited for that proposition. *Id*. at 1004. *But see* Jonathan R. Macey, *A Close Read of an Excellent Commentary on Dodge v. Ford*, 3 Va. L. & Bus. Rev. 177, 179 (2008) (stating that the shareholder maximization ideal in *Dodge v. Ford* actually drives the holding and is not mere dicta); Stephen M. Bainbridge, *Corporation Law and Economics* §§ 1.4(b), 9.2, and 9.3 (2002).

[26] Stephen M. Bainbridge, *Corporation Law and Economics* §§ 1.4(b), 9.2, and 9.3 (accepting the theory of shareholder maximization expressed in *Dodge v. Ford*). *See also* Macey, *supra* note 25, 3 Va. L. & Bus. Rev. at 179 (stating that the shareholder maximization ideal in *Dodge v. Ford* is widely accepted as a matter of rhetoric).

With the increase of mission-driven and "triple bottom line corporations,"[27] these constituency statutes are now being analyzed outside the context of a hostile takeover. For these businesses, the answer to a key question–whether a company's directors may consider non-financial interests when making a decision as to the "the best interest of the corporation"–depends to a significant extent on the laws of the state where the company is incorporated. In this regard the states can be divided into two categories: "constituency" states and "non-constituency" states.

1. Constituency States

The directors of companies incorporated in constituency states are expressly permitted by statute to consider persons other than shareholders in the discharge of their fiduciary duties. Constituency statutes generally provide that, in fulfilling their fiduciary duties, directors may consider the effects of a decision not only on shareholders, but also on a list of other "constituency" groups.[28] These permissible constituency groups vary state by state, but usually include employees, creditors, suppliers, consumers and the community at large.[29] Thirty-three states now have some version of a constituency statute.[30] Conspicuously absent from the list of

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[27] The phrase "the triple bottom line" was first coined in 1994 by John Elkington, the founder of a British consultancy called SustainAbility. *See* The Economist, *Triple Bottom Line: It consists of Three Ps: Profit, Planet and People*, http://www.economist.com/node/14301663 (November 17, 2009). Elkington argued that businesses should considers three "bottom lines" of people, planet and profit rather than the traditional formula of pure profit as the bottom line of a business. *Id*. Today, this term, like "mission driven," "sustainable," and other similar terms, is commonly used among social entrepreneurs and investors to refer to businesses that consider other interests in additions to profits and shareholder value maximization.

[28] As noted above, many constituency provisions in state corporate statutes were enacted in response to takeover activity in the 1980s as a way to protect local businesses. Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 23-26 (1992). It is worth noting that these constituency statutes are permissive rather than mandatory, i.e., they provide that the directors may consider the interests of stakeholders other than shareholders but are not required to. *See id*. at 26-31 (discussing varieties of state constituency statutes).

[29] *See, e.g.*, 805 ILL. COMP. STAT. § 5/8.85 (2004) (stating directors "may . . . consider the effects of any action . . . upon employees, suppliers and customers of the corporation or its subsidiaries, communities in which offices or other establishments of the corporation or its subsidiaries are located, and all other pertinent factors"); N.Y. BUS. CORP. LAW § 717(b)(2)(i)-(v) (McKinney 2003) (stating directors "shall be entitled to consider . . . the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following: (i) the prospects for potential growth, development, productivity and profitability of the corporation; (ii) the corporation's current employees; (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation; (iv) the corporation's customers and creditors; and (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business"); 15 PA. CONS. STAT. § 1715(a)(1) (West 1995) (stating directors may consider "[t]he effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located").

[30] *See* ARIZ. REV. STAT. ANN. § 10-2702 (2004); CONN. GEN. STAT. § 33-756(D) (2007); FLA. STAT. § 607.0830(3) (2008); GA. CODE ANN. § 14-2-202(B)(5) (2003); HAW. REV. STAT. § 414-221(A)-(B) (2008); IDAHO CODE ANN. § 30-1602 (2010); 805 ILL. COMP. STAT. 5/8.85 (2004); IND. CODE § 23-1-35-1(D) (1999); IOWA CODE § 490.1108A (1999); KY. REV. STAT. ANN. § 271B.12-210(4) (LEXISNEXIS 2006); LA. REV. STAT. ANN. § 12:92(G) (1994); ME. REV. STAT. ANN. TIT. 13-C, § 832 (2005); MD. CODE ANN., CORPS. & ASS'NS § 2-104(B)(9) (West 2008); MASS. GEN. LAWS CH. 156B, § 65 (2006); MINN. STAT. § 302A.251(5) (2008); MISS. CODE ANN. § 79-4-8.30 (2001); MO.

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states adopting constituency statutes is Delaware, where more than 900,000 business entities have their legal home, including more than 50% of all U.S. publicly-traded companies and 63% of the Fortune 500.[31] Most states, including those with constituency statutes, will at a minimum consider Delaware law when interpreting local corporate law.

While it is clear that directors of mission-driven companies incorporated in constituency statute jurisdictions may take into consideration the interests of various constituencies when exercising their business judgment, the lack of case law interpreting constituency statutes, coupled with the context in which many of these statutes were enacted, makes it difficult for directors to know exactly how, when and to what extent they can consider those interests. For example, neither the constituency statutes themselves nor state case law address questions such as how directors should decide which parties fall within a protected constituency category, what weight the directors should assign to shareholder and non-shareholder interests and what standards a court should use in reviewing directors' decisions to consider (or not to consider) non-shareholder interests. Based on the limited case law available, courts seem reluctant to wade into these issues and often fall back on shareholder primacy.[32]

Without clear authority explicitly permitting directors to pursue both profit and a company's mission, even directors of mission-driven companies in constituency statute jurisdictions may be hesitant to "consider" their social missions for fear of breaching their fiduciary duty.[33] This uncertainty and resulting hesitation makes it difficult for the directors of mission-driven companies to feel they are legally protected in considering the interests of constituencies other than the shareholders who have elected them (and can therefore replace them).

Further, permissive constituency statutes only create the option (and not the requirement) for directors to consider interests of constituencies other than shareholders. Thus, directors have the permission not to consider interests other than shareholder maximization of value. Mission-driven executives and investors are often in minority shareholder positions and would prefer that directors and officers be required to consider these expanded interests when making decisions,

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REV. STAT. § 351.347(1) (2000); NEB. REV. STAT. § 21-2432(2) (2007); NEV. REV. STAT. ANN. § 78.138(4) (2007); N.J. STAT. ANN. § 14A:6-1(2) (West 2003); N.M. STAT. ANN. § 53-11-35(D) (West 2003); N.Y. BUS. CORP. LAW § 717(B) (MCKINNEY 2003); N.D. CENT. CODE § 10-19.1-50(6) (2005); OHIO REV. CODE ANN. §§ 1701.59(E) (LEXISNEXIS 2004); OR. REV. STAT. § 60.357 (2007); 15 PA. CONS. STAT. § 1715(A)(1) (West 1995); R.I. GEN. LAWS § 7-5.2-8 (1999); S.D. CODIFIED LAWS § 47-33-4 (2002); TENN. CODE ANN. § 48-103-204 (West 2008); VT. STAT. ANN. TIT. 11A, § 8.30 (2008); VA. CODE ANN. § 13.1-727.1 (2006); WIS. STAT. § 180.0827 (2006); WYO. STAT. ANN. § 17-16-830(E) (2007).

[31] Division of Corporations Website, http://corp.delaware.gov/ (visited on August 22, 2011).

[32] *See, e.g.*, *Baron v. Strawbridge & Clothier*, 646 F. Supp. 690, 697 (E.D. Pa. 1986) (stating that, while it was proper for directors facing takeover attempts to consider corporation's employees, customers and community, their fiduciary duty was still "to act in the best interests of the corporation's shareholders"). Also, it is either expressly provided or generally understood that these non-shareholder constituencies do not have standing to sue on the basis that the directors failed to consider their interests, making it less likely that directors will be concerned about them.

[33] Directors who have invoked constituency statutes have usually done so when sued for breach of fiduciary duty in the course of defending against takeover attempts. Constituency statutes are just one of many potential defenses that directors may use, and directors have been more likely to rely on anti-takeover mechanisms that have been proven in court and that do not call into question the directors' fiduciary duties.

with a shareholder right of action providing the "teeth" to enforce such consideration. This is particularly true in situations where a company is considering strategic alternatives and directors' discretion in making business decisions is more limited by traditional principles requiring shareholder value maximization.[34]

2. Non-Constituency States

In non-constituency states, including Delaware, consideration of a public mission is even more problematic, because under the corporate laws of those states the directors are not expressly permitted to consider the interests of stakeholders or constituents other than shareholders in the discharge of their duties.[35]

As mentioned above, Delaware is the state under which a majority of U.S. public companies, and numerous private companies, particularly those with or interested in attracting outside capital, are incorporated, due in significant part to its well-developed body of corporate law, and Delaware does not have a constituency statute. In *eBay Domestic Holdings, Inc. v. Newmark*,[36] the Delaware Court of Chancery recently reaffirmed its position that corporate directors are obligated pursuant to their fiduciary duties to maximize shareholder value.[37] Chancellor Chandler also made clear that a public-service mission which "seeks not to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders" is an invalid corporate purpose and inconsistent with directors' fiduciary duties.[38]

(C) Levels of Scrutiny of Director Decisions

It is important to note that, as a general matter, the level of scrutiny a court will give to the decisions of a director (in both constituency and non-constituency states) is dependent in part on the context in which the decision is being made. To use Delaware as an example again, its courts review director decision-making in three broad categories, or scenarios: (1) day-to-day decisions, (2) defensive decisions,[39] and (3) change of control decisions.[40]

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[34] *See, e.g.*, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (stating that directors, faced with a hostile takeover bid for a corporation, may only consider various non-shareholder constituencies if "there are rationally related benefits accruing to the stockholders").

[35] *See, e.g.*, CA. CORP. CODE § 309(a) (West 2011) (stating that director must discharge his or her duties "in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances"); MICH. COMP. LAWS § 450.1541a (2011) (stating similarly that director must discharge his or her duties "[i]n good faith . . . [w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances . . . [i]n a manner he or she reasonably believes to be in the best interests of the corporation"); N.C. GEN. STAT. § 55-8-30 (2011) (same).

[36] 16 A.3d 1 (Del. Ch. 2010) ("*eBay*").

[37] *Id.*, at 34.

[38] *Id.*; *see id.* at 33 (stating that "promoting, protecting or pursuing non-stockholder considerations [with defensive measures] must lead at some point to value for stockholders").

[39] Defensive decisions are those taken by directors in an effort to ward off potential bidders, whether friendly or hostile.

[40] Change of control decisions are those decisions taken by directors once it is clear that a company will be sold.

In the day-to-day context, directors can consider non-shareholder interests as long as they can show a rational connection between that consideration and shareholder value.[41] This is because courts review director decisions in the day-to-day context under the deferential "business judgment rule." The business judgment rule is a rebuttable presumption by courts that "in making a business decision the directors of a corporation act on an informed basis, in good faith, and in the honest belief that the action taken [is] in the best interest of the company."[42] In other words, courts reviewing decisions made in the day-to-day context will not question rational judgments about how seemingly promoting non-shareholder interests (such as a corporation's decision to make charitable contributions or to otherwise support the community in which their operations are located) ultimately promote shareholder value.[43]

Even in the day-to-day context in which directors enjoy most discretion, decisions must show some connection to shareholder value. While it is not true that all decisions that reflect consideration of non-shareholder interests lead to a reduction in shareholder value (and some in fact may lead to its increase), it is true that some might result in a diminishment of shareholder value, even over the long term. Moreover, some mission-driven business executives and investors may be comfortable with that result in the pursuit of their social mission, whether that mission is reflected in providing below-market pricing of health insurance to the otherwise uninsured, accepting higher cost of production from overseas factories audited by a third party for their social and environmental standards, or focusing on smaller, less profitable market segments that seek "better" products or need basic services. In these instances, the resolution of litigation by a shareholder seeking maximized financial return against the directors of such a mission-driven company, even under this level of scrutiny, would be uncertain at best from the perspective of the mission-driven company and its directors. This uncertainty can have a chilling effect on the pursuit of social missions.

When defending takeover attempts, directors generally enjoy significantly less deference regarding decisions (including consideration of non-shareholder interests) that on their face do not seem designed to maximize shareholder value. When directors act defensively, Delaware courts apply the standards set forth in *Unocal Corporation. v. Mesa Petroleum Company*.[44] Under *Unocal*, Delaware courts will give directors the benefit of the business judgment rule only if the directors can first demonstrate that they were responding to a legitimate threat to corporate policy and effectiveness and that their response was "reasonable in relation to the threat posed."[45] As previously mentioned, Chancellor Chandler found in eBay that a public-service mission was not a legitimate corporate policy, and thus taking defensive measures to protect that mission violates *Unocal*.[46] The court stated:

> "Directors of a for-profit Delaware corporation cannot deploy a [policy] to defend a business strategy that openly eschews stockholder wealth

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[41] *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating that director's decisions must be "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company").
[42] *Aronson*, 473 A.2d at 812.
[43] *eBay*, 16 A.3d at 33-34.
[44] 493 A.2d 946 (Del. 1985) ("*Unocal*").
[45] *Unocal*, 493 A.2d at 949.
[46] *eBay*, 16 A.3d at 32, 34.

> maximization – at least not consistently with the directors' fiduciary duties under Delaware law."[47]

While the facts of *eBay* are unique and a different company's publicly-oriented mission may be considered a legitimate corporate policy, Chancellor Chandler's language suggests that Delaware courts will seek to limit the "purely philanthropic ends" of mission-driven companies, especially when their directors' decisions are reviewed under *Unocal's* scrutiny.

If defending takeover attempts severely restricts directors' ability to consider non-shareholder interests, a corporate sale effectively eradicates any such ability in a non-constituency state. A company goes "up for sale" when it initiates an active bidding process to sell itself or to reorganize itself in a way that will clearly break up the company, or when, in response to an active bidder's offer, the company abandons its long-term strategy and seeks an alternative transaction with a preferred party that will result in a change of control of the company.48 In these circumstances, Delaware and other state case law has made clear that the directors' only duty is to maximize shareholder value by securing the highest bid reasonably available and that "concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress."[49] These duties—the duty to maximize shareholder value and the corollary obligation to disregard all other considerations—are referred to as 'Revlon duties,' and originate from the landmark case Revlon Inc. v. MacAndrews & Forbes Holding, Inc.50 While skilled legal counsel can give directors guidance on how to attempt to circumvent Revlon duties, there remains ambiguity about when Revlon duties are triggered. That ambiguity frequently leads to Revlon-based lawsuits.

There is a credible view among some academic legal experts that because there is no specific provision in the Delaware statute preventing consideration of other stakeholder interests, if a company were to actually include the requirement of such consideration, including the possibility of not maximizing shareholder value, in the purpose clause of its certificate of incorporation or in defining the directors' fiduciary standards, such a requirement might withstand the court's scrutiny in a defensive or change of control situation and be given effect. However, in addition to there being no underlying statute that permits such consideration, there is no case law to support this view. In the absence of statutory authority or precedent and in light of decisions including Revlon and eBay, the practical reality is that practitioners – general counsel and outside counsel – are typically unwilling to recommend such a course of action because the legal analysis is so unclear.

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[47] *Id*. at 35.

[48] *See Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1989) (outlining two circumstances in which directors must consider maximizing shareholder value above any other consideration).

[49] *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173, 182 (Del. 1986) ("*Revlon*"); *see also Plaza Sec. Co. v. Fruehauf Corp.*, 643 F. Supp. 1535, 1543 (E.D. Mich. 1986) (stating "[i]n a contest for corporate control, when directors have determined that it is inevitable that the corporation be sold, . . . the directors' cardinal fiduciary obligation to the corporation and its shareholders is to ensure 'maximization of the company's value at a sale for the stockholders' benefit.'" (citing *Revlon*, 506 A.2d at 182.)).

[50] *Revlon*, 506 A.2d 173 (Del. 1986).

(D) Impact of Legal Framework on Mission-Driven Companies

Based on the established state legal frameworks, directors face legal uncertainty in all of the aforementioned contexts. In the day-to-day context where the business judgment rule applies, a judge may not find it to be appropriate to consider and advance non-shareholder interests for their own sake (i.e., as part of the company's mission) and not as a way of maximizing long-term shareholder financial value; in a *Unocal* context a corporate mission or culture that is not based on maximizing shareholder value may not be seen as legitimate and capable of being the subject of a defensive measure; and in a *Revlon* context it would certainly be a breach of fiduciary duty based on existing case law in a non-constituency state (and since there is a dearth of case law on the subject, arguably in a constituency state as well) to consider non-shareholder interests if such consideration did not maximize shareholder value.

These legal uncertainties and the need for greater clarity have led to calls for new legal solutions that address the unique needs of for-profit mission-driven businesses. However, none of the alternatives to benefit corporations devised to date (namely, hybrid nonprofits, low-profit limited liability companies (L3Cs) and Flexible Purpose Corporations, each of which is discussed in Appendix C to this paper) meet the needs of the entrepreneurs, investors, and consumers described in Section II and all have significant technical and policy issues associated with their approach that make them relatively ineffective in serving the public interest.

III. Benefit Corporations

To date, California, Hawaii, Illinois, Louisiana, Massachusetts, Maryland, New Jersey, New York, Pennsylvania, South Carolina, Vermont, and Virginia have changed their corporate law to allow for a new entity called the "benefit corporation."[51] Six other states (Alabama, Arizona, Michigan, New Mexico, North Carolina, Oregon) and the District of Columbia, have

[51] *See* CAL. CORP. CODE § 14600 (Deering 2013) ("California Statute"); HAW. REV. STAT. § 420D-1 (2013) ("Hawaii Statute"); 805 ILL. COMP. STAT. 40/1 (2013) ("Illinois Statute"); LA. REV. STAT. ANN. § 12:1801 (2013) ("Louisiana Statute"); MASS. ANN. LAWS ch. 156E, § 1 (LexisNexis 2013) ("Massachusetts Statute"); MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01 (LexisNexis 2013) ("Maryland Statute"); N.J. STAT. ANN. § 14A:18-1 (2013) ("New Jersey Statute"); N.Y. BUS. CORP. LAW § 1701 (Consol. 2013) ("New York Statute"); 15 PA. CONS. STAT. § 3301 (2013) ("Pennsylvania Statute"); S.C. CODE ANN. § 33-38-110 (2013) ("South Carolina Statute"); VT. STAT. ANN. tit. 11A, § 21.02 (2013) ("Vermont Statute"); VA. CODE ANN. § 13.1-782 (2013) ("Virginia Statute"). California's legislation was signed into law on October 9, 2011 and became effective on January 1, 2012. Hawaii's legislation was signed into law on July 8, 2011 and became effective upon signing. Illinois's legislation was signed into law on August 2, 2012 and became effective on January 1, 2013. Louisiana's legislation was signed into law on May 31, 2012 and became effective on August 1, 2012. Maryland's legislation was signed into law on April 13, 2010 and became effective on October 1, 2010. Massachusetts's legislation was signed into law on August 7, 2012 and became effective on December 1, 2012. New Jersey's legislation passed on January 10, 2011 and became effective when it was signed into law on March 1, 2011. New York's legislation was signed into law on December 12, 2011 and became effective on February 10, 2012. Pennsylvania's legislation was signed into law on October 24, 2012 and will become effective on January 22, 2013. South Carolina's legislation was signed into law on June 14, 2012 and became effective upon signing. Vermont's legislation was signed into law on May 19, 2010 and became effective on July 1, 2011. Virginia's legislation was signed into law on March 26, 2011 and became effective on July 1, 2011.

introduced benefit corporation legislation.[52] The following discussion refers to the model benefit corporation legislation attached as Appendix A, hereinafter the "Model Legislation," which reflects the basic structure and content of benefit corporation statutes.[53]

The Model Legislation has been drafted so that the existing corporation code applies to benefit corporations in every respect except those explicitly stipulated in the Model Legislation. This drafting approach avoids the potential legal and administrative issues that will arise in keeping a new corporate form in conformity to the corporation code as changes to the corporation code occur over time.

There are three major provisions in benefit corporation legislation that are consistent from state to state. These provisions address corporate purpose, accountability and transparency, and state that a benefit corporation has: 1) a corporate purpose to create a material positive impact on society and the environment; 2) expanded fiduciary duties of directors which require consideration of non-financial interests; and 3) an obligation to report on its overall social and environmental performance as assessed against a comprehensive, credible, independent and transparent third-party standard.

Thus, among other issues described below, and unlike alternate approaches, the benefit corporation addresses the principal legal impediments, as well as the business and public concerns, described in Sections II and III above.

(A) Existing Benefit Corporation Statutes

1. Election and Disclosure

Electing in or out of benefit corporation status is a voluntary act requiring a two-thirds vote of shareholders.[54] Likewise, in a merger or sale situation, a supermajority shareholder vote

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[52] *See* S.B. 14, Reg. Sess. 2013 (Ala. 2013); H.B. 2276, 51st Leg., First Reg. Sess. 2013 (Ariz. 2013); B19-0584, 19th Council Period (D.C. 2011); H.B. 40, 51st Leg., First Sess. 2013 (N.M. 2013); S.B. 26, 2011-2012 Gen. Assemb., Reg. Sess. (N.C. 2011); S.B. 360, 96th Leg., Reg. Sess. (Mich. 2011); H.B. 2296 and S.B. 144, 77th Or. Leg. Assembly, 2013 Reg. Sess. (Or. 2013). Benefit corporation legislation in Colorado S.B. 11-005, 68th Gen. Assemb., Reg. Sess. (Colo. 2011) has been indefinitely postponed in Colorado's Senate Committee on Business, Labor and Technology, after compromises were made to several major provisions via amendments from the Business Section of the Colorado State Bar.

[53] Benefit corporation legislation varies slightly from state to state based on the individual characteristics of each state's business entity statutory scheme, input from legislators, state bar associations, practitioners, the business community and others. The essential provisions for each state, both where the legislation has been enacted and in those states where it has been introduced, are constant across jurisdictions. The model benefit corporation legislation in Appendix A (hereinafter, the "Model Legislation") collects the best features of the statutes enacted to date and represents the ideal legislation to create benefit corporations.

[54] *See* Model Legislation §§ 104, 105. *See also, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-03(b) (referencing two-thirds standard for amending corporate charters in MD. CODE ANN., CORPS. & ASS'NS § 2-604(e)); VT. STAT. ANN. tit. 11A, § 21.05 (setting two-thirds minimum but permitting higher standard if articles of incorporation so require). *But see* VA. CODE ANN. § 13.1-785 (requiring all shareholders to approve election to benefit corporation status).

would be required if the surviving entity would not be a benefit corporation. [55] A corporation may elect in to benefit corporation status by amending or including in its articles of incorporation a statement that the corporation is a benefit corporation.[56] A benefit corporation may elect out of benefit corporation status by supermajority vote of the shareholders and by deleting the statement that the corporation is a benefit corporation. [57]

2. Corporate Purpose: General Public Benefit

Benefit corporations are required to have a purpose of creating "general public benefit" and are *allowed* to identify one or more "specific public benefit" purposes.[58] This differs from general corporations, which are *allowed* to form for any lawful purpose but have no explicit purpose requirement.

General public benefit is defined as a "material, positive impact on society and the environment, taken as a whole, as assessed against a third-party standard, from the business and operations of a benefit corporation."[59]

The Model Legislation lists seven non-exhaustive possibilities for specific public benefits, which are:

(1) Providing low-income or underserved individuals or communities with beneficial products or services;
(2) Promoting economic opportunity for individuals or communities beyond the creation of jobs in the ordinary course of business;
(3) Preserving the environment;
(4) Improving human health;
(5) Promoting the arts, sciences, or advancement of knowledge;
(6) Increasing the flow of capital to entities with a public benefit purpose; or
(7) The accomplishment of any other particular benefit for society or the environment. [60]

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[55] *See* Model Legislation §§ 104, 105. *See also, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-04(b) (proscribing same § 2-604(e) standard for terminating benefit corporation status).
[56] *See* Model Legislation § 104.
[57] *See* Model Legislation § 105. *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-03(a), -04(a). Vermont and New Jersey have similar provisions in their statutes. VT. STAT. ANN. tit. 11A, §§ 21.05, 21.07; N.J. STAT. ANN. §§ 14A:18-2, 18-4. It should also be noted that the benefit corporation legislation is drafted in a way that does not affect general corporations because it permits electing corporations to move in and out of benefit corporations status without changing general corporation standards.
[58] *See* Model Legislation § 201. *See also, e.g.,* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-06(a)(1)-(2), (b)(1).
[59] *See* Model Legislation § 102(a). *See also*, *e.g.*, CAL. CORP. CODE § 14601(c); MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01(b) (slight variation of definition); VT. STAT. ANN. tit. 11A, § 21.03. The New Jersey statute defines general public benefit as " a material positive impact on society and the environment by the operations of a benefit corporation through activities that promote some combination of specific public benefits." N.J. STAT. ANN. § 14A:18-1.
[60] *See* Model Legislation § 102(a). CAL. CORP. CODE § 14601(e). *See also, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01(d); N.J. STAT. ANN. § 14A:18-1; VT. STAT. ANN. tit. 11A, § 21.03(6).

The Model Legislation explicitly states that "[t]he creation of a general public benefit and specific public benefit . . . is in the best interests of the benefit corporation."[61] This serves to protect against the presumption that the financial interests of the corporation take precedence over the public benefit purposes, which maximizes the benefit corporation's flexibility in corporate decision-making.

3. Accountability: Consideration of Stakeholders

The directors of a benefit corporation, in considering the best interests of the corporation:

> *shall* consider the effects of any action or inaction upon: (i) the shareholders of the benefit corporation, (ii) the employees and workforce of the benefit corporation, its subsidiaries and its suppliers, (iii) the interests of customers as beneficiaries of the general public benefit or specific public benefit purposes of the benefit corporation, (iv) community and societal factors, including those of each community in which offices or facilities of the benefit corporation, its subsidiaries and its suppliers are located, (v) the local and global environment, (vi) the short-term and long-term interests of the benefit corporation, including any benefits that may accrue to the benefit corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the benefit corporation and (vii) the ability of the benefit corporation to accomplish its general benefit purpose and any specific public benefit purpose.[62]

The statutes also allow directors to consider "any other pertinent factors or the interests of any other group that [the directors] deem appropriate."[63] The stakeholder consideration mandate is an important distinguishing feature from the basic corporation statutes in "constituency" states discussed in Section II above; under constituency statutes, the consideration of non-shareholder interests is permissive, while under the Model Legislation it is mandatory.

4. Transparency: Third-Party Standard and Overall Performance

A benefit corporation is required to deliver an annual benefit report to the shareholders and to post it on its website so it is available to the public.[64] The report must be filed with a department of the state.[65]

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[61] *See* Model Legislation § 201(c).

[62] *See* Model Legislation § 301(a)(1). *See also, e.g.,* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a)(1); VT. STAT. ANN. tit. 11A, § 21.09(a)(1)(F); N.J. STAT. ANN. § 14A:18-6(a)(6).

[63] *See* Model Legislation § 301(a)(2). *See also, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a)(2). Vermont and New Jersey have similar provisions. VT. STAT. ANN. tit. 11A, § 21.09(a)(2); N.J. STAT. ANN. § 14A:18-6(b)(2).

[64] *See* Model Legislation § 401(b)-(c). *See also*, *e.g.,* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-08(a); N.J. STAT. ANN. § 14A:18-11(c); VT. STAT. ANN. tit. 11A, § 21.14(d). Not all states require a benefit report to be filed with a department of the state.

[65] *See* Model Legislation § 401(e). *See also*, *e.g.*, N.J. STAT. ANN. § 14A-18-11(d); S.B. 79-A, 2011-2012 Gen. Assemb., Reg Sess. (N.Y. 2011).

The report must include a narrative description of the ways in which the benefit corporation pursued a general public benefit and the extent to which it was created, the ways the benefit corporation pursued any specific benefit (if stated in the company's articles) and the extent to which it was created, any circumstances that may have hindered creation of general public benefit or specific public benefit and the process and rationale for selecting or changing the third-party standard used to prepare the benefit report.[66]

In addition to disclosure requirements about the material shareholders of the benefit corporation and a statement of any connection of the benefit corporation to the third-party standard, the report must also include "an assessment of the overall social and environmental performance of the benefit corporation against 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."[67]

Since in many ways the third-party standard is the heart of benefit corporation legislation(and for many observers, the most contentious and misunderstood provision in benefit corporation legislation), presented below from the Model Legislation is a full definition of third-party standard and a full description of the reporting requirements for benefit corporations, for which the third-party standard is essential. A full discussion of the rationale behind the third-party standard is presented below in Section IV.

"Third-party standard" is defined as "a recognized standard for defining, reporting and assessing overall corporate social and environmental performance" which is:

(1) Comprehensive in that it assesses the effect of the business and its operations upon the interests listed in section 301(a)(1)(ii), (iii), (iv) and (v).

(2) Developed by an organization that is independent of the benefit corporation and satisfies the following requirements:

(i) Not more than one-third of the members of the governing body of the organization are representatives of any of the following:

(A) An association of businesses operating in a specific industry the performance of whose members is measured by the standard.

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66 *See* Model Legislation § 401(a). *See also, e.g.,* CAL. CORP. CODE § 14630(a)(1)(A); S.B. 79-A, 2011-2012 Gen. Assemb., Reg Sess. (N.Y. 2011). Other states have similar variations of this provision. *See, e.g.,* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-08(a)(1)(i)-(iii); N.J. STAT. ANN. § 14A:18-11(a)(1)(a)-(c); VT. STAT. ANN. tit. 11A, § 21.14(a)(1)(A)-(C). Vermont benefit corporations must additionally suggest specific actions the benefit corporation can take to improve upon the attainment of its identified goals, VT. STAT. ANN. tit. 11A, § 21.14(a)(1)(D), and shareholders must approve or reject the annual benefit report by majority vote. VT. STAT. ANN. tit. 11A, § 21.14(a)(7).

67 *See* Model Legislation § 401(a)(2). *See also*, e.g., MD. CODE ANN., CORPS. & ASS'NS § 5-6C-08(a)(2); N.J. STAT. ANN. § 14A:18-11(a)(2); VT. STAT. ANN. tit. 11A, § 21.14(a)(2).

(B) Businesses from a specific industry or an association of businesses in that industry.

(C) Business whose performance is assessed against the standard.

(ii) The organization is not materially financed by an association or business described in subparagraph (i).

(3) Credible because the standard is developed by a person that both:

(i) Has access to necessary expertise to assess overall corporate social and environmental performance.

(ii) Uses a balanced multistakeholder approach, including a public comment period of at least 30 days to develop the standard.

(4) Transparent because the following information is publicly available:

(i) About the standard:

(A) The criteria considered when measuring the overall social and environmental performance of a business.

(B) The relative weightings, if any, of those criteria.

(ii) About the development and revision of the standard:

(A) The identity of the directors, officers, material owners and the governing body of the organization that developed and controls revisions to the standard.

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

(C) An accounting of the sources of financial support for the organization, with sufficient detail to disclose any relationships that could reasonably be considered to present a potential conflict of interest.[68]

By assessing and disclosing the benefit corporation's overall social and environmental performance against an independent third-party standard, shareholders and the public are provided an easy way to evaluate the company on these criteria, which for typical companies, is otherwise almost impossible to determine. Based upon the research cited in Section II, it is

[68] *See* Model Legislation § 102(a). *See also, e.g.,* CAL. CORP. CODE § 14601(g) (2011). Similar third party standards have been included in the legislation introduced in Pennsylvania, Illinois, Colorado, Washington and the District of Columbia.

anticipated that this simplified "due diligence" tool will facilitate greater investment in benefit corporations and improve customer loyalty by enabling consumers to differentiate good deeds from merely good marketing. Over time, this has the potential to create market-driven positive feedback loops rewarding companies that adopt this higher standard of corporate governance and demonstrate higher levels of overall social and environmental performance.

5. Scope of Director Liability

Directors of benefit corporations are afforded certain protections under the Model Legislation. First, the Model Legislation expressly states that the consideration of all stakeholders shall not constitute a violation of the general standards for directors, which require good faith, the care of an ordinarily prudent person and the consideration of the best interests of the corporation.[69] In an effort to restrict potential liability, the Model Legislation specifically excludes director, officer and corporate liability for monetary damages.[70] This decision was driven by twin desires to (i) eliminate concerns of directors that they will be subject to personal liability in the face of no court precedent by which such liability could be quantified and (ii) focus courts on the exclusive remedy of awarding injunctive relief requiring the benefit corporation to simply live up to the commitments it voluntarily undertook.[71]

Directors are also protected from suits by beneficiaries of the corporation's public purpose. The Model Legislation expressly states that third parties have no right of action. The Model Legislation further states that it does not create a fiduciary duty to anyone who cannot bring a "benefit enforcement proceeding."[72] Benefit enforcement proceedings are a right of action only for shareholders, directors, investors in the parent company of a benefit corporation subsidiary with a 5% or more equity interest, and any other persons specified in the company's articles of incorporation.[73]

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[69] *See* Model Legislation § 301(b)(1). *See also*, *e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(c) (referencing general standards for director conduct under § 2-405.1); N.J. STAT. ANN. § 14A:18-6(b)(1) (referencing general standard under § 14A:6-1); VT. STAT. ANN. tit. 11A, § 21.09(b) (referencing general standard of care under § 11A:8.30).

[70] *See* Model Legislation § 301(c), 303(c) and 305(a)(2).

[71] The Model Legislation, as well as Vermont, California and New Jersey statutes, make clear that, unless expressly provided in the company's articles of incorporation, the directors are not required to give priority to the interests of any particular person or group referred to in the statute over any other person or group. *See* Model Legislation § 301(3); CAL. CORP. CODE § 14620(d), available at 2011 Cal. Legis. Serv. Ch. 728 (A.B. 361) (filed with the Secretary of State, October 9, 2011; to be codified); N.J. STAT. ANN. § 14A:18-6(c); VT. STAT. ANN. tit. 11A, § 21.09(a)(3). The Vermont statute further provides that a director shall not be subject to a different or higher standard of care in a potential change of control situation (e.g., the *Unocal* or *Revlon* situations discussed in Section III above). VT. STAT. ANN. tit. 11A, § 21.09(a)(4). The Vermont and New Jersey statutes also make clear that a director will not be liable for the failure to actually create a general or specific public benefit. N.J. STAT. ANN. § 14A:18-6(d); VT. STAT. ANN. tit. 11A, § 21.09(c).

[72] *See* Model Legislation § 301(d). *See also, e.g.,* VT. STAT. ANN. tit. 11A, § 21.09(e); MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(b); N.J. STAT. ANN. § 14A:18-10(a)-(b).

[73] *See* Model Legislation § 305(a). *See also, e.g.*, N.J. STAT. ANN. § 14A:18-10(b); VT. STAT. ANN. tit. 11A, § 21.13(b).

A shareholder is expressly given the right to bring a legal action on the basis that a director or officer failed to pursue or create the stated general or specific public benefit purposes, failed to *consider* the interests of the various stakeholders set forth in the statute, or failed to meet the transparency requirements in the statute.[74] For reasons stated in Section III, this expanded accountability to shareholders is specifically desired by most of the mission-driven entrepreneurs and investors interested in new corporate form legislation. Similarly, the exclusion of any right of action by third parties protects the benefit corporation from unknown, expanded liability that would otherwise operate as a disincentive to becoming a benefit corporation.

6. Benefit Director

A "benefit director" is a director who is specifically designated to oversee benefit issues.[75] This director is responsible for preparing the annual benefit report and preparing a statement for inclusion in the annual report of whether, in the opinion of the benefit director, the benefit corporation acted in accordance with its general public benefit purpose and any specific benefit purpose.[76]

IV. Drafting Analysis of Particular Benefit Corporation Statutory Provisions

Questions have sometimes arisen, particularly as states begin to consider enactment of their own benefit corporation legislation, as to why particular provisions of the benefit corporation legislation were drafted they way they were and what the implications of these provisions might be. The following discussion addresses some of these questions.

(A) General Public Benefit Requirement

1. General vs. Specific

Some observers have questioned why the statute should require the creation of "general public benefit" rather than simply the creation of one or more "specific public benefits."

The first reason is directly related to the purpose of the legislation itself. One of the main purposes of benefit corporation legislation is to create a voluntary new corporate form that has the corporate purpose to create benefit for society and the environment generally as well as shareholders. The entrepreneurs, investors, consumers and policy makers interested in new corporate form legislation are not interested in, for example, reducing waste while increasing carbon emissions, or reducing both while remaining indifferent to the creation of economic opportunity for low-income individuals or underserved communities. They are interested in creating a new corporate form that gives entrepreneurs and investors the flexibility and

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[74] *See* Model Legislation § 305(a). *See also, e.g.*, N.J. STAT. ANN. § 14A:18-10(b); VT. STAT. ANN. tit. 11A, § 21.13(b).

[75] *See* Model Legislation § 302 (a). Some states have incorporated benefit director provisions into their benefit corporation legislation. *See*, *e.g.*, N.J. STAT. ANN. § 14A:18-1; VT. STAT. ANN. tit. 11A, § 21.03(a)(2). In other states, the benefit director's duties are shared by the entire board. *See, e.g.,* California Statute.

[76] *See* Model Legislation § 302(a). *See also, e.g.,* N.J. STAT. ANN. § 14A:18-7(c); VT. STAT. ANN. tit. 11A, § 21.10.

protection to pursue all of these public benefit purposes. The best way to give them what they need is to create a corporate form with a general public benefit purpose.

The second reason is to avoid unintended consequences. The "general public benefit" purpose helps to prevent abuse of the legislation by corporations interested in "greenwashing." Without the general public benefit purpose, a corporation could name a single, narrow "specific public benefit" purpose (e.g., keeping the river in back of the factory free from toxic effluents) and then "consider" and dismiss all other non-financial interests when making decisions. This would undermine one of the main purposes of the legislation, namely the creation of a new corporate form whose corporate purpose is to create benefit for society generally.

2. Flexibility and Legislating Morality

Some have expressed concern that the definition of general public benefit is prescriptive, lacks flexibility and legislates morality. In fact, the legislation does the opposite specifically through the general public benefit provision that recognizes that different companies will pursue the creation of a material positive impact on society and the environment in a variety of ways. A general public benefit provision encourages flexibility and enables innovation by simply setting a "directional" performance requirement (i.e., "material positive impact on society and the environment") without creating unnecessarily prescriptive performance requirements (e.g., achieve zero waste or be carbon neutral).

3. "Create" vs. "Pursue" and Directors Liability

Some observers have expressed concern that directors of benefit corporations would be exposed to liability if the benefit corporation did not "create a material positive impact on society and the environment." The Model legislation specifically states that a benefit enforcement proceeding can only be brought for a "failure to pursue or create general public benefit or a specific public benefit purpose set forth in its articles; or violation of a duty or standard of conduct under the [chapter]."[77] This provision must be read and understood in conjunction with the inclusion of the provision that makes clear that directors and officers are not liable for monetary damages.[78] By including both the failure to "create" and "pursue," the drafters intended to clarify that the benefit enforcement proceeding is intended to be the sole cause of action available to shareholders with respect to general and specific public benefit purpose and that monetary damages are not available as a remedy.

4. Positive Impact vs. Net Impact

Some observers have expressed concern that "material positive impact" takes no account of potential "negative impacts" of the business or operations of a benefit corporation. This is true and intentional. A "net positive impact" would imply that one could add and subtract impacts from diverse activities (e.g., add 2 units for reducing energy usage per unit of production, subtract 1 unit for a discrimination lawsuit, etc.) based upon some common unit of

[77] *See*, *e.g.*, VA. CODE ANN. § 13.1-782 (West 2011).
[78] *See infra* Section V.E.

measure. Such a unit of measure does not exist and is unlikely to exist at least for a considerable period of time. Rather, the legislation recognizes that numerous existing standards already aggregate diverse corporate activities into an overall assessment for a corporation's social and environmental performance. This is an important first step that, when coupled with the legislation's requirement that the benefit corporation's performance be assessed against a comprehensive, credible, independent, and transparent third-party standard, moves the market closer to a desired "net impact" assessment.

5. Society and the Environment vs. Society or the Environment

Some observers have been concerned that the requirement to create "a material positive impact on society and the environment" places too high a burden on benefit corporations in that very few businesses can do both. For this reason, the model benefit corporation legislation includes the phrase "taken as a whole" after "society and the environment" so that the legislation's intent is clear that, as the corporate purpose ought to be to create general rather than specific public benefit, the assessment of the benefit corporation's pursuit of this objective should also be "taken as a whole" as it relates to both social and environmental impact.

6. Interpreting "Material Positive Impact"

Some observers have expressed a concern that the requirement for a benefit corporation to create a "material positive impact on society and the environment" is too vague, and the concept of "general public benefit" too broad to be meaningful. To address this concern, the Model Legislation provides for this requirement to be assessed against a comprehensive, credible, independent and transparent third-party standard. The comprehensive criteria specifically ensures that the corporation's impact on each of the non-financial interests that directors are required to consider are assessed in the annual benefit report. The Model Legislation thus strikes a balance between specifically enumerating those interests to be considered and linking them to those impacts to be assessed without being overly prescriptive in listing specific metrics to be used to make those assessments or to weight those metrics or interests.

Furthermore, legislation with more prescriptive performance criteria would likely have several problems. First, as a general matter it would likely make legislation more difficult to pass as special interests attach an increasingly cumbersome series of narrow and likely contentious performance standards and a list of prohibited activities. Such prescription would have the undesirable effect of presuming a capacity in (and desirability for) government to establish and administer performance standards across a wide range of corporate activities, or would require legislators to "anoint" one or more third-party standards and/or appoint and fund a government entity to administer accreditation. Such an approach would also potentially have a chilling effect on market innovation to develop generally accepted performance standards. All of the foregoing ultimately undermine the objectives of the legislation, as fewer companies could be expected to adopt a new corporate form with a cumbersome list of prescriptive and prohibited activities.

It has also been suggested by some observers that without more prescriptive performance standards the benefit corporation would just become a legalized form of "greenwashing." This observation is simply at odds with the legislation. A company deciding to become a benefit corporation will necessarily be legally required to meet higher standards of corporate purpose, accountability and transparency. Unlike existing corporations, benefit corporations can be held liable for the failure to pursue the purpose of creating a material positive impact on society and the environment as measured by an independent third-party standard and for the failure to consider the enumerated mandatory stakeholder interests. Benefit corporations are required to publish publicly on an annual basis a benefit report in accordance with recognized standards for assessing social and environmental performance, including an assessment of its successes and failures in achieving its public benefit purpose and in considering effects of decisions on stakeholders. The requirement to have a benefit director is an additional legal requirement designed to ensure that the general and specific public benefit purposes are pursued.

(B) Consideration of Stakeholder Interests

It is important to note that shareholders are among the stakeholders whose interests the directors of a benefit corporation are required to consider; in fact they are listed first, and remain the only stakeholder entitled to bring a legal action against the corporation or its directors. Therefore, directors of benefit corporations may not simply disregard financial stakeholders in pursuing their stated purpose; rather they must balance the interests of shareholders as financial stakeholders with the enumerated other interests.

While a shareholder of a benefit corporation could still bring a traditional action for the failure of the directors to adequately consider shareholder financial interests, such a shareholder could also now bring a benefit enforcement proceeding for failure to consider other stakeholder interests, e.g., for failure of the directors to adequately consider the impact of a particular action on the workforce of the company. While this grants shareholders an expanded right of action, it is important to note that the consideration standard does not require a particular outcome of the directors' decision-making, but rather that there is a decision-making process that considers all of the enumerated stakeholders.

(C) Importance of Third-Party Standards

The requirement that the annual benefit report assess the overall social and environmental performance of the benefit corporation against a third-party standard is an essential requirement of the Model Legislation. Below is a discussion of concerns that have been expressed regarding the third-party standard requirement

1. Choice

The Model Legislation does not require a benefit corporation to use any particular third-party standard to prepare its benefit report. There are many third-party standards organizations that meet the statutory criteria for a third party standard to be comprehensive, credible, independent, and transparent. The Global Reporting Initiative (GRI), GreenSeal, Underwriters Laboratories (UL), ISO2600, Green America and B Lab are a few well-known examples. Both GRI and B Lab offer companies the use of their reporting (GRI) and assessment (B Lab) tools for free. In addition to the examples listed above, more than 100 "raters" of corporate sustainability practices are listed in the "Rate the Raters" report published by the research and consulting firm SustainAbility. This list is available for free at http://www.sustainability.com/library/rate-the-raters-phase-two. The management, and ultimately, directors and shareholders, of benefit corporations are free to decide for themselves which of these or other standards they feel meet the statutory requirements and their needs.

While allowing benefit corporations to choose a third party standard against which they will assess their overall social and environmental performance, to guard against "greenwashing," the Model Legislation provides management, directors, shareholders, and ultimately judges, criteria for what constitutes an acceptable third-party standard. This definition of third party standard is the result of research into the criteria used by international standards organizations (e.g., American National Standards Institute, International Standards Organization, ISEAL) and regulatory bodies (e.g., U.S. Federal Trade Commission) to identify high quality standards and certifications.

2. Verification

Benefit corporations are not required to have their benefit report certified or audited by a third party. Mandatory verification has been omitted from the requirements for an acceptable third-party standard for several reasons.

First, mandatory verification would place a cost burden on benefit corporations to meet the reporting requirements of the statute. While free third-party standards exist that can be used to generate a benefit report, no third-party standard provider will perform verification services for free. Requiring annual verification would impose a cost that would greatly reduce adoption, particularly among small businesses interested in new corporate form legislation.

Second, while SEC rules do require audited financial reports of publicly-traded companies, ordinary corporations are not required under state corporate statutes to have audited financial reports and benefit corporations should not be required to have audited benefit reports of their social and environmental performance.

Third, directors of benefit corporations are already subject to litigation for fraud if they report false or intentionally misleading information in their benefit report.

Finally, verification can and will become a means by which certain benefit corporations distinguish themselves on a competitive basis to attract greater confidence in their claims of environmental and social performance.

3. Accreditation

Mandatory accreditation of the third-party standard by the American National Standards Institute (ANSI) or other national or international standards bodies has been omitted from the criteria for an acceptable third-party standard for several reasons.

First, mandatory accreditation creates a likely monopoly for ANSI or creates costs for a government regulatory body to determine which organizations would qualify as approved accreditation bodies. It seemed more appropriate to strengthen the definitions of "credible" and "independent" to include as many of the criteria as practicable currently cited by ANSI and other international standards organizations as best practice among standards developers. This promotes a proliferation of standards and competition among them so that the market can select the best ones.

Second, since ANSI would likely be the sole accreditor of developers, the ANSI requirement that accredited developers conform with a consensus approach requiring a two-thirds vote of the governing body to approve or revise the standard seems overly restrictive in the governance of a standard for assessing overall corporate social and environmental performance in which a greater diversity of experience and opinion will necessarily exist among members of the governing body than would be the case in a governing body for a single industry or attribute standard, which are more typical of existing ANSI accredited standards and standard developers. It seems more appropriate that a simple majority vote of the governing body would be appropriate in the instance of a third-party standard for benefit corporations.

Third, the ANSI consensus approach requirement also requires significant written documentation of objections and efforts to respond to objections which would place a significant burden on standards developers for overall corporate social and environmental performance given the early stage of development of this area of standards development. For this reason alone, many highly respected standards have forsaken the ANSI process because it enables detractors to slow down the standards development process while increasing costs, both of which often run counter to the objectives for which these standards are created. It seems more appropriate to strengthen the definition of an acceptable third-party standard through other means such as more detailed requirements regarding the standards' comprehensiveness, credibility, independence and transparency and additional disclosure requirements within the annual benefit report.

4. Independence

The definition of "independent" reflects consideration of important criteria regarding governance, transparency and reporting.

First, regarding governance, to ensure a balanced approach to the weighting, evolution and application of the standard, no industry group, trade association or individual interests assessed by the third-party standard can represent more than one-third of the controlling interest of the governing body of the standard.

Second, regarding transparency, to ensure that potential financial influence is disclosed, an accounting of the sources of financial support for the standard organization, including but not limited to fees, grants, investments and material in-kind support, with sufficient detail to disclose any relationships which could reasonably be considered to present a potential conflict of interest, must be made publicly available.

Third, regarding reporting, the benefit corporation is required to include in its annual benefit report a statement of any connection to the third-party standard, or its directors officers, or material owners from 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.

(D) Dissenters' Rights

Because the Model Legislation works within the existing corporate statutory framework, the Model Legislation conforms its treatment of dissenters' rights with respect to amendments of the articles and to the way they are already treated under a particular state's corporate code. Thus, in states where dissenters' rights exist, they exist in the same situations for shareholders of benefit corporations. In states where dissenters' rights do not exist for amendments of the articles or mergers, dissenters' rights are not given to shareholders of benefit corporations.

The Model Legislation does not create specific dissenters rights for the election or termination of status where they would not otherwise exist.[79] Unlike in events that typically trigger dissenters' rights, opting in or out of benefit corporation status is not a liquidity event that provides a pool of cash to satisfy existing shareholders. Instead, any cash to be paid to shareholders would be required to come from the corporation itself. Since most businesses interested in new corporate form legislation are private, small, and growing ("cash-poor"), the existence of dissenters' rights where none existed prior would have a chilling effect on adoption. By requiring a higher two-thirds supermajority shareholder vote to opt in or out, instead of a typical simple majority vote required for changes of corporate structure or control, Model Legislation raises the standard without making it unnecessarily difficult and ultimately limiting the legislation's effectiveness.

(E) Remedies

Observers, as well as early adopters and attorneys advising them, have asked, "For what remedies might a shareholder sue?" As this is a new corporate form, there is no case law from which to provide authoritative answers.

In an effort to restrict potential liability, the Model Legislation specifically excludes director, officer and corporate liability for monetary damages.[80] As mentioned in Section III above, this decision was driven by the twin desires to (i) eliminate such concern in the face of no court precedent by which such liability could be quantified and (ii) to focus courts on the exclusive remedy of awarding injunctive relief to require the benefit corporation to simply live up to its voluntary commitments.

While the following is purely hypothetical, below are some thoughts on the issue of remedies in different "benefit enforcement proceedings."

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[79] Only California has specifically included a provision in its legislation granting dissenter's rights based on benefit corporation status. *See* California Statute. Virginia does not provide for dissenter's rights, but does require that the benefit corporation status be approved by 100% of the shareholders. *See* Virginia Statute.

[80] *See*, *e.g.*, CAL. CORP. CODE § 14620(f), available at 2011 Cal. Legis. Serv. Ch. 728 (A.B. 361) (filed with the Secretary of State, October 9, 2011; to be codified).

1. Purpose

The most difficult obligation for a court to enforce would be the requirement that the corporation "pursue the creation of a material positive impact on society and the environment, taken as a whole, as assessed against a third-party standard." If the corporation could show a meaningful good faith effort to pursue such positive impacts, then a judge would likely be reticent to interpose his or her judgment for the corporation's. Absent such effort, a judge might give directors a fixed period of time to undertake such action, which could perhaps be demonstrated by the corporation achieving a higher performance level under the third-party standard it had applied in earlier benefit reports.

2. Accountability

If directors were found to have violated their duty to consider stakeholder interests, a judge might give directors a fixed period of time to do some or all of the following: 1) consider the issue(s) deemed to have not been adequately considered and 2) implement a policy to ensure adequate consideration is made in future decisions.

3. Transparency

If directors were found to have failed to meet the transparency requirements of benefit corporation legislation, a judge might give directors a fixed period of time to publically publish a benefit report that meets the statutory requirements.

(F) Access to Capital

Benefit corporations are able to attract the same types of capital as regular corporations. Additionally, for reasons described in Section II, benefit corporations can be expected to be more successful in accessing socially responsible or impact investments, because in contrast to alternative new business forms benefit corporations have more consistent, clear and flexible statements of purpose and more robust accountability and transparency mechanisms for those purposes. Lastly, for reasons also described in Section I, benefit corporations may even be more attractive to mainstream capital providers as they increasingly incorporate integrated social and environmental factors into their investment decisions.

V. Conclusion

Benefit corporations best meet the needs of entrepreneurs, investors, consumers and policy makers interested in using the power of business to solve social and environmental problems. Benefit corporations offer clear market differentiation, broad legal protection to directors and officers, expanded shareholder rights and greater access to capital than other new corporate forms.

The sustainable business movement, impact investing and social enterprise sectors are developing rapidly but are constrained by an outdated legal framework that is not equipped to accommodate for-profit entities whose social benefit purpose is central to their existence. The benefit corporation, which has already been established by statute in seven states and which is the subject of legislative initiatives in several others, is the most comprehensive yet flexible legal entity devised to address the needs of entrepreneurs and investors and, ultimately, the general public. As a result, it has also attracted broad support from entrepreneurs, investors, citizens and policy makers interested in new corporate form legislation.

Attorneys and members of the bar associations of the various states are encouraged to express their views on the matters discussed herein and, to the extent there is concurrence, to sign on to the views expressed in this paper.

Additional information on benefit corporations is available at www.benefitcorp.org. This website is administered as a service at no cost to the public by the 501(c)(3) nonprofit organization B Lab. For further information please contact info@benefitcorp.org.

<u>Appendix A</u>

MODEL BENEFIT CORPORATION LEGISLATION

With Explanatory Comments[81]

[*Chapter*] __
Benefit Corporations

[*Subchapter*] 1
Preliminary Provisions

§ 101. Application and effect of [*chapter*].

(a) General rule. – This [*chapter*] shall be applicable to all benefit corporations.

(b) Application of business corporation law generally. – The existence of a provision of this [*chapter*] shall not of itself create an implication that a contrary or different rule of law is applicable to a business corporation that is not a benefit corporation. This [*chapter*] shall not affect a statute or rule of law that is applicable to a business corporation that is not a benefit corporation.

(c) Laws applicable. – Except as otherwise provided in this [*chapter*], [*the enacting state's business corporation law*] shall be generally applicable to all benefit corporations. The specific provisions of this [*chapter*] shall control over the general provisions of [*cite the business*

[81] For a detailed discussion of the issues to be considered when preparing legislation for introduction in a state see Clark et al, *The Need and Rationale for the Benefit Corporation* (2011), available at www.benefitcorp.org. See generally, William H. Clark, Jr. and Elizabeth K. Babson, "*How Benefit Corporations are Redefining the Purpose of Business Corporations*," 38 WM. MITCHELL L. REV. 817 (2012).

corporation law]. A benefit corporation may be subject simultaneously to this [*chapter*] and one or more other [*cite any statutes that provide for the incorporation of a specific type of business corporation, such as a professional corporation*].

(d) Organic records. – A provision of the articles of incorporation or bylaws of a benefit corporation may not limit, be inconsistent with, or supersede a provision of this [*chapter*].

Comment:

This chapter authorizes the organization of a form of business corporation that offers entrepreneurs and investors the option to build, and invest in, businesses that operate with a corporate purpose broader than maximizing shareholder value and a responsibility to consider the impact of its decisions on all stakeholders, not just shareholders. Enforcement of those duties comes not from governmental oversight, but rather from new provisions on transparency and accountability included in this chapter.

The last sentence of subsection (c) makes clear that if a state provides for the incorporation of specialized types of business corporations, such as statutory close corporations, insurance corporations, or professional corporations, those corporations may also be benefit corporations. In the case of a professional corporation, section 201(e) provides a special rule that eliminates any conflict between this chapter and the requirement found in many professional corporation laws that limits the purposes or business of a professional corporation to providing a particular type of professional service.

As a result of subsection (d), a corporation that elects to be subject to this chapter will be subject to all of the provisions of the chapter and will not be able to vary their application to the corporation.

The term "benefit corporation" used in this section is defined in section 102.

§ 102. Definitions.

The following words and phrases when used in this [*chapter*] shall have the meanings given to them in this section unless the context clearly indicates otherwise:

"Benefit corporation." A business corporation:

(1) which has elected to become subject to this [*chapter*]; and

(2) the status of which as a benefit corporation has not been terminated.

"Benefit director." [*Either:*]

[*(1)*] the director designated as the benefit director of a benefit corporation under section 302[*; or*

(2) a person with one or more of the powers, duties or rights of a benefit director to the extent provided in the bylaws under section 302(f)].

"Benefit enforcement proceeding." Any claim or action or proceeding for:

(1) failure of a benefit corporation to pursue or create general public benefit or a specific public benefit purpose set forth in its articles; or

(2) violation of any obligation, duty, or standard of conduct under this [*chapter*].

"Benefit officer." The individual designated as the benefit officer of a benefit corporation under section 304.

"General public benefit." A material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation.

"Independent." Having no material relationship with a benefit corporation or a subsidiary of the benefit corporation. Serving as benefit director or benefit officer does not make an individual not independent. A material relationship between an individual and a benefit corporation or any of its subsidiaries will be conclusively presumed to exist if any of the following apply:

(1) The individual is, or has been within the last three years, an employee other than a benefit officer of the benefit corporation or a subsidiary.

(2) An immediate family member of the individual is, or has been within the last three years, an executive officer other than a benefit officer of the benefit corporation or a subsidiary.

(3) There is beneficial or record ownership of 5% or more of the outstanding shares of the benefit corporation, calculated as if all outstanding rights to acquire equity interests in the benefit corporation had been exercised, by:

(i) the individual; or

(ii) an entity:

(A) of which the individual is a director, an officer, or a manager; or

(B) in which the individual owns beneficially or of record 5% or more of the outstanding equity interests, calculated as if all outstanding rights to acquire equity interests in the entity had been exercised.

"Minimum status vote."

(1) In the case of a business corporation, in addition to any other required approval or vote, the satisfaction of the following conditions:

(i) The shareholders of every class or series shall be entitled to vote as a [*separate voting group*] [*class*] on the corporate action regardless of a limitation stated in the articles of incorporation or bylaws on the voting rights of any class or series.

(ii) The corporate action must be approved by vote of the shareholders of each class or series entitled to cast at least two-thirds of the votes that all shareholders of the class or series are entitled to cast on the action.

[*(2) In the case of a domestic entity other than a business corporation, in addition to any other required approval, vote, or consent, the satisfaction of the following conditions:*

(i) The holders of every class or series of equity interest in the entity that are entitled to receive a distribution of any kind from the entity shall be entitled to vote on or consent to the action regardless of any otherwise applicable limitation on the voting or consent rights of any class or series.

(ii) The action must be approved by vote or consent of the holders described in subparagraph (i) entitled to cast at least two-thirds of the votes or consents that all of those holders are entitled to cast on the action.]

"Publicly traded corporation." A business corporation that has shares listed on a national securities exchange or traded in a market maintained by one or more members of a national securities association.

"Specific public benefit." Includes:

(1) providing low-income or underserved individuals or communities with beneficial products or services;

(2) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;

(3) protecting or restoring the environment;

(4) improving human health;

(5) promoting the arts, sciences, or advancement of knowledge;

(6) increasing the flow of capital to entities with a purpose to benefit society or the environment; and

(7) conferring any other particular benefit on society or the environment.

"Subsidiary." In relation to a person, an entity in which the person owns beneficially or of record 50% or more of the outstanding equity interests.

"Third-party standard." A recognized standard for defining, reporting, and assessing corporate social and environmental performance that is:

(1) Comprehensive because it assesses the effect of the business and its operations upon the interests listed in section 301(a)(1)(ii), (iii), (iv) and (v).

(2) Developed by an entity that is not controlled by the benefit corporation.

(3) Credible because it is developed by an entity that both:

(i) has access to necessary expertise to assess overall corporate social and environmental performance; and

(ii) uses a balanced multistakeholder approach to develop the standard, including a reasonable public comment period.

(4) Transparent because the following information is publicly available:

(i) About the standard:

(A) The criteria considered when measuring the overall social and environmental performance of a business.

(B) The relative weightings, if any, of those criteria.

(ii) About the development and revision of the standard:

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

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

(C) An accounting of the revenue and 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.

<u>Comment</u>:

"Benefit corporation." The provisions of this chapter apply to a business corporation while it has the status of a benefit corporation because its articles contain a statement that it is a benefit corporation. If that statement is deleted under section 105(a), the corporation will cease to be a benefit corporation immediately upon the effectiveness of the deletion.

"Benefit director." Paragraph (2) of this definition should be used in states that permit a corporation to provide that the functions of the board of directors will be discharged by persons other than directors. *See* section 302(f). *See also* section 401(a)(8) which requires a benefit corporation that has so varied its governance to describe the alternative arrangements in its annual benefit report.

"Benefit enforcement proceeding." This definition not only describes the action that may be brought under section 305, but it also has the effect of excluding other actions against a benefit corporation and its directors and officers because section 305(a)(1) provides that "no person may bring an action or assert a claim against a benefit corporation or its directors or officers" with respect to violation of the provisions of this chapter except in a benefit enforcement proceeding.

The obligations that may be enforced through a benefit enforcement proceeding include the obligations of a benefit corporation under section 401(c) to post its benefit reports on its Internet website and to supply copies of its benefit report if it does not have an Internet website. In the case of a failure to provide a copy of a benefit report, a benefit enforcement proceeding to enforce that obligation may only be brought by the persons listed in section 305 and not by the person requesting the copy of the report.

"General public benefit." By requiring that the impact of a business on society and the environment be looked at "as a whole," the concept of general public benefit requires consideration of all of the effects of the business on society and the environment. What is involved in creating general public benefit is informed by section 301(a) which lists the specific interests that the directors of a benefit corporation are required to consider.

"Minimum status vote." An amendment of the articles or a fundamental change that has the effect of changing the status of a corporation so that it either becomes a benefit corporation or ceases to be a benefit corporation must be approved by the minimum status vote. *See* sections 104 and 105. The purpose of requiring a two-thirds vote under this chapter is to ensure that there is broad shareholder support for an action. This definition will not be needed in states that require a supermajority vote of two-thirds or more for amendments of the articles or fundamental changes.

The second paragraph of the definition extends its policy to other forms of entities so that, for example, a merger of a limited liability company into a benefit corporation must be approved by the members of the limited liability company by at least a two-thirds vote. The second paragraph should be omitted by those states that require a supermajority vote of two-thirds or more by the owners of an unincorporated entity to approve a fundamental change. See, e.g., Uniform Limited Liability Company Act (2006) § 1003, which requires a unanimous vote by the members of a limited liability company to approve a merger.

The two-thirds vote required by the definition is in addition to any other vote required in the case of any particular corporation or other form of entity. If the articles of a corporation were to require, for example, an 80% supermajority vote to approve a merger, a 70% vote to approve a merger of the corporation into a benefit corporation would be sufficient to satisfy the requirement that the merger be approved by the minimum status vote but would not be sufficient for valid approval of the merger.

"Publicly traded corporation." This definition is used in section 302 and makes the requirement of a benefit director mandatory for publicly traded corporations. The definition is patterned after Model Business Corporation Act § 1.40(18A) (2010).

"Specific public benefit." Every benefit corporation has the purpose under section 201(a) of creating general public benefit. A benefit corporation may also elect to pursue one or more specific public benefit purposes. Since the creation of specific public benefit is optional, paragraph (7) of this definition permits a benefit corporation to identify a specific public benefit that is different from those listed in paragraphs (1) through (6).

"Third-party standard." The requirement in section 401 that a benefit corporation prepare an annual benefit report that assesses its performance in creating general public benefit against a third-party standard provides an important protection against the abuse of benefit corporation status. The performance of a regular business corporation is measured by the financial statements that the corporation prepares. But the performance of a benefit corporation in creating general or specific public benefit will not be readily apparent from those financial statements. The annual benefit report is intended to permit an evaluation of that performance so that the shareholders can judge how the directors have discharged their responsibility to manage the corporation and thus whether they should be retained in office. The annual benefit report is also intended to reduce "greenwashing" (the phenomenon of businesses seeking the cachet of being more environmentally and socially responsible than they actually are) by giving consumers and the general public a means of judging whether a business is living up to its claimed status as a benefit corporation.

The financial support that must be disclosed by entity if it wishes to make available a third party standard should include investment income, grants, and other types of support in addition to revenue it receives from its operations.

§ 103. Incorporation of benefit corporation.

A benefit corporation shall be incorporated in accordance with [*cite incorporation provisions of the business corporation law*], but its articles of incorporation must also state that it is a benefit corporation.

<u>Comment</u>:

This section provides for how a corporation that is being newly formed may elect to be a benefit corporation. Existing corporations may become benefit corporations in the manner provided in section 104.

This chapter only applies to domestic business corporations. A foreign business corporation that has a status in its home jurisdiction similar to the status of a benefit corporation under this chapter is not subject to this chapter and has the status simply of a foreign business corporation for purposes of the state's business corporation law.

The term "benefit corporation" used in this section is defined in section 102.

§ 104. Election of benefit corporation status.

(a) Amendment. – An existing business corporation may become a benefit corporation under this [*chapter*] by amending its articles of incorporation so that they contain, in addition to the requirements of [*cite section of the business corporation law on the required contents of articles of incorporation*], a statement that the corporation is a benefit corporation. In order to be effective, the amendment must be adopted by at least the minimum status vote.

(b) Fundamental transactions. –

(1) This subsection applies if both of the following subparagraphs apply:

(i) An entity that is not a benefit corporation is[*:*

(A)] a party to a merger[*, consolidation, or conversion*]; or

[*(B) the exchanging entity in a share exchange*].

(ii) The surviving[*, new, or resulting*] entity in the merger, [*consolidation, conversion, or share exchange*] is to be a benefit corporation.

(2) In order to be effective, a plan of merger[*, consolidation, conversion, or share exchange*] subject to this subsection must be adopted by at least the minimum status vote.

Comment:

This section provides the procedures for an existing corporation to become a benefit corporation. A corporation that is being newly formed may become a benefit corporation in the manner provided in section 103. Subsection (a) applies to a business corporation that is directly electing to be a benefit corporation by amending its articles of incorporation. Subsection (b) applies when a corporation is becoming a benefit corporation indirectly in the context of a fundamental transaction. In both cases, the change to benefit corporation status must be approved by at least the minimum status vote.

Subsection (b) also applies to an entity that is not a corporation when the entity is a party to a transaction that will result in a benefit corporation. In those situations, a supermajority vote of the owners of the entity is required by subsection (b).

See section 201(d) with respect to changing the identification of a specific public benefit that it is the purpose of a benefit corporation to pursue.

The following terms used in this section are defined in section 102:

"benefit corporation"
"minimum status vote"

§ 105. Termination of benefit corporation status.

(a) Amendment. – A benefit corporation may terminate its status as such and cease to be subject to this [*chapter*] by amending its articles of incorporation to delete the provision required by section 103 or 104 to be stated in the articles of a benefit corporation. In order to be effective, the amendment must be adopted by at least the minimum status vote.

(b) Fundamental transactions. – If a plan of merger[*, consolidation, conversion, or share exchange*] would have the effect of terminating the status of a business corporation as a benefit corporation, the plan must be adopted by at least the minimum status vote in order to be effective. Any sale, lease, exchange, or other disposition of all or substantially all of the assets of a benefit corporation, unless the transaction is in the usual and regular course of business, shall not be effective unless the transaction is approved by at least the minimum status vote.

Comment:

This section provides the procedures for a benefit corporation to terminate voluntarily its status as a benefit corporation. As with an election of benefit corporation status under section 104, the termination may be accomplished either directly by an amendment of the articles or indirectly through a fundamental transaction.

The last sentence of subsection (b) provides a special rule for a sale of all or substantially all of the assets of a benefit corporation. Such a transaction will not result in a termination of the status of the corporation as a benefit corporation, but will have effectively the same result since it will terminate the operations of the business. Thus it was considered appropriate to require approval of a sale of assets by the minimum status vote. Whether a sale of assets is in the usual and regular course will be determined under the same standards as apply to that question under the state's business corporation law. *See, e.g.*, Model Business Corporation Act §§ 12.01 and 12.02.

The following terms used in this section are defined in section 102:

"benefit corporation"
"minimum status vote"

Subchapter 2

Corporate Purposes

§ 201. Corporate purposes.

(a) General public benefit purpose. – A benefit corporation shall have a purpose of creating general public benefit. This purpose is in addition to its purpose under [*cite section of the business corporation law on the purpose of business corporations*].

(b) Optional specific public benefit purpose. – The articles of incorporation of a benefit corporation may identify one or more specific public benefits that it is the purpose of the benefit corporation to create in addition to its purposes under [*cite section of the business corporation law on the purpose of business corporations*] and subsection (a). The identification of a specific public benefit under this subsection does not limit the purpose of a benefit corporation to create general public benefit under subsection (a).

(c) Effect of purposes. – The creation of general public benefit and specific public benefit under subsections (a) and (b) is in the best interests of the benefit corporation.

(d) Amendment. – A benefit corporation may amend its articles of incorporation to add, amend, or delete the identification of a specific public benefit that it is the purpose of the benefit corporation to create. In order to be effective, the amendment must be adopted by at least the minimum status vote.

(e) Professional corporations. – A professional corporation that is a benefit corporation does not violate [*cite section of professional corporation law, if any, that restricts the business in which a professional corporation may engage*] by having the purpose to create general public benefit or a specific public benefit.

Comment:

Every benefit corporation has the corporate purpose of creating general public benefit. A benefit corporation may also elect to pursue specific public benefits under subsection (b).

Subsection (c) confirms that pursuing general and specific public benefit is in the best interests of the benefit corporation. Because the basic duty of a director is to act in a manner that the director reasonably believes to be in the best interests of the corporation, decisions by the board of directors that promote the creation of general or specific public benefit will satisfy the requirement to act in the best interests of the corporation. If an ordinary business corporation includes in its articles of incorporation a statement of a specific purpose, it is by definition in the best interests of the corporation for the directors to pursue that purpose. Thus the rule in subsection (c) would be the case in any event, but has been stated expressly in subsection (c) because of the importance to the concept of a benefit corporation of the creation of public benefit.

Some professional corporation statutes provide that a professional corporation may not engage in any business other than rendering the professional service for which it was specifically incorporated. Subsection (e) makes clear that such a limitation will not interfere with a professional corporation electing to be a benefit corporation. In such a case, the professional corporation (such as a law firm, accounting firm, or medical practice) will be limited to providing the professional services for which it was incorporated, but it will be able to provide those services in a manner that creates general public benefit or a specific public benefit (for example, a medical practice that focuses on providing care for low-income individuals).

The following terms used in this section are defined in section 102:

"benefit corporation"
"general public benefit"
"minimum status vote"
"specific public benefit"

Subchapter 3
Accountability

§ 301. Standard of conduct for directors.

(a) Consideration of interests. – In discharging the duties of their respective positions and in considering the best interests of the benefit corporation, the board of directors, committees of the board, and individual directors of a benefit corporation:

(1) shall consider the effects of any action or inaction upon:

(i) the shareholders of the benefit corporation;

(ii) the employees and work force of the benefit corporation, its subsidiaries, and its suppliers;

(iii) the interests of customers as beneficiaries of the general public benefit or specific public benefit purposes of the benefit corporation;

(iv) community and societal factors, including those of each community in which offices or facilities of the benefit corporation, its subsidiaries, or its suppliers are located;

(v) the local and global environment;

(vi) 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 the continued independence of the benefit corporation; and

(vii) the ability of the benefit corporation to accomplish its general public benefit purpose and any specific public benefit purpose; and

(2) may consider:

[*(i) the interests referred to in [cite constituencies provision of the business corporation law if it refers to constituencies not listed above]; and*

(ii)] other pertinent factors or the interests of any other group that they deem appropriate; but

(3) need not give priority to the interests of a particular person or group referred to in paragraph (1) or (2) over the interests of any other person or group unless the benefit corporation has stated in its articles of incorporation its intention to give priority to certain interests related to its accomplishment of its general public benefit purpose or of a specific public benefit purpose identified in its articles.

(b) Coordination with other provisions of law. –The consideration of interests and factors in the manner required by subsection (a)[*:*

(1)] does not constitute a violation of [*cite provision of the business corporation law on the duties of directors generally*] [*; and*

(2) is in addition to the ability of directors to consider interests and factors as provided in [cite constituencies provision of the business corporation law]].

(c) Exoneration from personal liability. – Except as provided in the [*articles of incorporation*] [*bylaws*], a director is not personally liable for monetary damages for:

(1) any action or inaction in the course of performing the duties of a director under subsection (a) if the director performed the duties of office in compliance with [*cite provision of the business corporation law on the duties of directors generally*] and this section; or

(2) failure of the benefit corporation to pursue or create general public benefit or specific public benefit.

(d) Limitation on standing. – A director does not have a duty to a person that is a beneficiary of the general public benefit purpose or a specific public benefit purpose of a benefit corporation arising from the status of the person as a beneficiary.

(e) Business judgments. – A director who makes a business judgment in good faith fulfills the duty under this section if the director:

(1) is not interested in the subject of the business judgment;

(2) is informed with respect to the subject of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the benefit corporation.

Comment:

This section is at the heart of what it means to be a benefit corporation. By requiring the consideration of interests of constituencies other than the shareholders, the section rejects the holdings in *Dodge v. Ford*, 170 N.W. 668 (Mich. 1919), and *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010), that directors must maximize the financial value of a corporation.

In a state that has adopted a "constituency statute," directors are authorized to consider the interests of corporate constituencies other than the shareholders, but the directors are not *required* to do so. Subsection (a) makes it mandatory for the directors of a benefit corporation to consider the interests and factors that they would otherwise simply be permitted to consider in their discretion under the typical constituency statute.

Subsection (d) negates any enforceable duty of directors to non-shareholder constituents. *But see* section 305(b) which permits a benefit corporation to provide in its articles that an identified category of persons may bring a benefit enforcement proceeding. If a benefit corporation were to do so, the identified non-shareholder constituents would be able to allege a breach of duty by the directors under this chapter for failing to pursue or create general or specific public benefit, but subsection (d) would prevent those constituents from alleging a breach of duty to them.

Subsection (e) confirms that the business judgment rule applies to actions by directors under this section. The formulation of the rule is patterned after American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.01(c). If the law of the enacting state is not clear that the business judgment rule applies generally to actions by directors of corporations that are not business corporations, consideration should be given to confirming that the rule applies more broadly than just under this chapter. The best interests of the corporation referred to in subsection (e)(3) include the creation of general public benefit and specific public benefit under section 201(c) and the determination of what is in the best interests of the benefit corporation requires consideration of the interests and factors listed in subsection (a).

The following terms used in this section are defined in section 102:

"benefit corporation"
"general public benefit"
"specific public benefit"
"subsidiary"

§ 302. Benefit director.

(a) General rule. – The board of directors of a benefit corporation that is a publicly traded corporation shall, and the board of any other benefit corporation may, include a director, who:

(1) shall be designated the benefit director; and

(2) shall have, in addition to the powers, duties, rights, and immunities of the other directors of the benefit corporation, the powers, duties, rights, and immunities provided in this [*subchapter*].

(b) Election, removal, and qualifications. – The benefit director shall be elected, and may be removed, in the manner provided by [*cite provisions of the business corporation law on the election and removal of directors generally*]. [*Except as provided in subsections (f) and (g),*] the benefit director shall be an individual who is independent. The benefit director may serve as the benefit officer at the same time as serving as the benefit director. The articles of incorporation or bylaws of a benefit corporation may prescribe additional qualifications of the benefit director not inconsistent with this subsection.

(c) Annual compliance statement. – The benefit director shall prepare, and the benefit corporation shall include in the annual benefit report to shareholders required by section 401, the opinion of the benefit director on all of the following:

(1) Whether the benefit corporation acted in accordance with its general public benefit purpose and any specific public benefit purpose in all material respects during the period covered by the report.

(2) Whether the directors and officers complied with sections 301(a) and 303(a), respectively.

(3) If, in the opinion of the benefit director, the benefit corporation or its directors or officers failed to act or comply in the manner described in paragraphs (1) and (2), a description of the ways in which the benefit corporation or its directors or officers failed to act or comply.

(d) Status of actions. – The act or inaction of an individual in the capacity of a benefit director shall constitute for all purposes an act or inaction of that individual in the capacity of a director of the benefit corporation.

(e) Exoneration from personal liability. – Regardless of whether the articles of incorporation or bylaws of a benefit corporation include a provision eliminating or limiting the personal liability of directors authorized by [*cite section of the business corporation law permitting exoneration of directors*], a benefit director shall not be personally liable for an act or omission in the capacity of a benefit director unless the act or omission constitutes self-dealing, willful misconduct, or a knowing violation of law.

[***(f) Alternative governance arrangements.*** –

(1) The articles of incorporation or bylaws of a benefit corporation must provide that the persons or shareholders who perform the duties of the board of directors include a person with the powers, duties, rights and immunities of a benefit director if either of the following applies:

(i) The articles of incorporation or bylaws of the benefit corporation provide that the powers and duties conferred or imposed upon the board of directors shall be exercised or performed by a person other than the directors under [cite section, if any, of the business corporation law permitting alternative governance arrangements].

(ii) The articles of incorporation or bylaws of a statutory close corporation that is a benefit corporation provide that the business and affairs of the corporation shall be managed by or under the direction of the shareholders.

(2) A person that exercises one or more of the powers, duties or rights of a benefit director under this subsection:

(i) does not need to be independent of the benefit corporation;

(ii) shall have the immunities of a benefit director;

(iii) may share the powers, duties, and rights of a benefit director with one or more other persons; and

(iv) shall not be subject to the procedures for election or removal of directors in [cite applicable provisions of the business corporation law] unless:

(A) the person is also a director of the benefit corporation; or

(B) the articles or bylaws make those procedures applicable.]

[***(g) Professional Corporations****. – The benefit director of a professional corporation does not need to be independent.*]

<u>Comment</u>:

The statement of the benefit director required by subsection (c) is an important part of the transparency required under this chapter. The perspective of the benefit director on whether the corporation has been successful in pursuing its general and any named specific public benefit purpose will be an important source of information for the shareholders as to whether the directors have adequately discharged their stewardship of the benefit corporation and its resources.

Subsection (d) makes clear that the actions of a benefit director are actions of a director of the benefit corporation and are subject to the same standards as actions of directors generally.

The wording of subsection (e) should be conformed to the provision of the state's business corporation law that permits the shareholders to adopt a provision of the articles of incorporation or bylaws exonerating directors from liability for breach of duty. But unlike existing exoneration provisions, subsection (e) does not require the benefit corporation to adopt an implementing provision in the articles or bylaws. Instead the liability shield provided by subsection (e) automatically applies to all benefit directors.

Subsection (f) should be adopted in those states that authorize a business corporation to vary the usual functions of the board of directors, either in the general business corporation law or, more typically, a statutory close corporation statute. If a benefit corporation chooses to vary the usual governance paradigm under one of those sections, subsection (f) explains how this section will apply to the corporation. *See* section 401(a)(8) which requires a benefit corporation that has so varied its governance to describe the alternative arrangements in its annual benefit report.

The following terms used in this section are defined in section 102:

"benefit corporation"
"benefit director"
"benefit officer"
"general public benefit"
"independent"
"publicly traded corporation"
"specific public benefit"

§ 303. Standard of conduct for officers.

(a) General rule. – Each officer of a benefit corporation shall consider the interests and factors described in section 301(a) in the manner provided in that subsection if:

(1) the officer has discretion to act with respect to a matter; and

(2) it reasonably appears to the officer that the matter may have a material effect on the creation by the benefit corporation of general public benefit or a specific public benefit identified in the articles of incorporation of the benefit corporation.

(b) Coordination with other provisions of law. – The consideration of interests and factors in the manner described in subsection (a) shall not constitute a violation of [*cite provision of the business corporation law on the duties of officers*].

(c) Exoneration from personal liability. – Except as provided in the [*articles of incorporation*] [*bylaws*], an officer is not personally liable for monetary damages for:

(1) an action or inaction as an officer in the course of performing the duties of an officer under subsection (a) if the officer performed the duties of the position in compliance with [*cite provision of the business corporation law on the duties of officers*] and this section; or

(2) failure of the benefit corporation to pursue or create general public benefit or specific public benefit.

(d) Limitation on standing. – An officer does not have a duty to a person that is a beneficiary of the general public benefit purpose or a specific public benefit purpose of a benefit corporation arising from the status of the person as a beneficiary.

(e) Business judgments. – An officer who makes a business judgment in good faith fulfills the duty under this section if the officer:

(1) is not interested in the subject of the business judgment;

(2) is informed with respect to the subject of the business judgment to the extent the officer reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the benefit corporation.

Comment:

As an agent of the corporation, an officer is generally required to follow the instructions of his or her principal. But in those instances where an officer has discretion to act with a respect to a matter, subsection (a) requires the officer to consider the interests of the benefit corporation's constituencies in the same manner as required of the directors by section 301.

This section applies to all of the officers of the benefit corporation and is not limited just to the benefit officer, if any, of the benefit corporation.

Subsection (d) provides an exoneration from personal liability for officers similar to the exoneration provided for directors. If the law of the enacting state is not clear that officers can be exonerated in the same manner as directors, consideration should be given to confirming that officers of business corporations that are not benefit corporations may be exonerated. *See also* the Comment to section 301(d) with respect to subsection (d).

Subsection (e) confirms that the business judgment rule applies to actions by officers under this section. The formulation of the rule is patterned after American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.01(c). If the law of the enacting state is not clear that the business judgment rule applies generally to actions by officers of corporations that are not business corporations, consideration should be given to confirming that the rule applies more broadly than just under this chapter. The best interests of the corporation referred to in subsection (e)(3) include the creation of general public benefit and specific public benefit under section 201(c) and the determination of what is in the best interests of the benefit corporation requires consideration of the interests and factors listed in section 301(a).

The following terms used in this section are defined in section 102:

“benefit corporation”
“benefit officer”
“general public benefit”
“specific public benefit”

§ 304. Benefit officer.

(a) Designation. – A benefit corporation may have an officer designated the benefit officer.

(b) Functions. – A benefit officer shall have:

(1) the powers and duties relating to the purpose of the corporation to create general public benefit or specific public benefit provided:

(i) by the bylaws; or

(ii) absent controlling provisions in the bylaws, by resolutions or orders of the board of directors.

(2) the duty to prepare the benefit report required by section 401.

Comment:

The designation of a benefit officer is optional. But if a benefit officer is designated, one of the duties of that officer will be to prepare the annual benefit report required by section 401.

The following terms used in this section are defined in section 102:

“benefit corporation”
“benefit officer”
“general public benefit”
“specific public benefit”

§ 305. Right of action.

(a) Limitations. –

(1) Except in a benefit enforcement proceeding, no person may bring an action or assert a claim against a benefit corporation or its directors or officers with respect to:

(i) failure to pursue or create general public benefit or a specific public benefit set forth in its articles of incorporation; or

(ii) violation of an obligation, duty, or standard of conduct under this [*chapter*].

(2) A benefit corporation shall not be liable for monetary damages under this [*chapter*] for any failure of the benefit corporation to pursue or create general public benefit or a specific public benefit.

(b) Standing. – A benefit enforcement proceeding may be commenced or maintained only:

(1) directly by the benefit corporation; or

(2) derivatively [*in accordance with [cite sections of business corporation law on derivative suits]*] by:

(i) a person or group of persons that owned beneficially or of record at least 2% of the total number of shares of a class or series outstanding at the time of the act or omission complained of;

(ii) a director;

(iii) a person or group of persons that owned beneficially or of record 5% or more of the outstanding equity interests in an entity of which the benefit corporation is a subsidiary at the time of the act or omission complained of; or

(iv) other persons as specified in the articles of incorporation or bylaws of the benefit corporation.

(c) Beneficial ownership. – For purposes of this section, a person is the beneficial owner of shares or equity interests if the shares or equity interests are held in a voting trust or by a nominee on behalf of the beneficial owner.

<u>Comment</u>:

Standing in an action against the directors or officers of a business corporation that is not a benefit corporation for breach of duty is limited in most states just to the corporation or shareholders bringing a derivative suit. This section broadens the categories of persons that can bring a derivative suit to include directors, 5% owners of a parent entity, and other persons to which a benefit corporation grants standing in its articles of incorporation or bylaws. To reduce the possibility of nuisance suits, a shareholder or group of shareholders bringing a derivative suit must own at least 2% of the outstanding shares of the benefit corporation.

This section only applies to actions or claims arising under this chapter. Lawsuits for breaches of duty arising outside of this chapter, or for breach of contract by directors, officers, or the benefit corporation are not subject to this section.

The following terms used in this section are defined in section 102:

"benefit corporation"
"benefit enforcement proceeding"
"general public benefit"
"specific public benefit"
"subsidiary"

Subchapter 4
Transparency

§ 401. Preparation of annual benefit report.

(a) Contents. – A benefit corporation shall prepare an annual benefit report including all of the following:

(1) A narrative description of:

(i) The ways in which the benefit corporation pursued general public benefit during the year and the extent to which general public benefit was created.

(ii) Both:

(A) the ways in which the benefit corporation pursued a specific public benefit that the articles of incorporation state it is the purpose of the benefit corporation to create; and

(B) the extent to which that specific public benefit was created.

(iii) Any circumstances that have hindered the creation by the benefit corporation of general public benefit or specific public benefit.

(iv) The process and rationale for selecting or changing the third-party standard used to prepare the benefit report.

(2) An assessment of the overall social and environmental performance of the benefit corporation against a third-party standard:

(i) applied consistently with any application of that standard in prior benefit reports; or

(ii) accompanied by an explanation of the reasons for:

(A) any inconsistent application; or

(B) the change to that standard from the one used in the immediately prior report.

(3) The name of the benefit director and the benefit officer, if any, and the address to which correspondence to each of them may be directed.

(4) The compensation paid by the benefit corporation during the year to each director in the capacity of a director.

(5) The statement of the benefit director described in section 302(c).

(6) A statement of any connection between the organization that established the third-party standard, or its directors, officers or any holder of 5 percent or more of the governance interests in the organization, and the benefit corporation or its directors, officers or any holder of 5 percent or more of the outstanding shares of the benefit corporation, including any financial or governance relationship which might materially affect the credibility of the use of the third-party standard.

[*(7) If the benefit corporation has dispensed with, or restricted the discretion or powers of, the board of directors, a description of:*

(i) the persons that exercise the powers, duties, and rights and who have the immunities of the board of directors; and

(ii) the benefit director, as required by section 302(f).]

(b) Change of benefit director. – If, during the year covered by a benefit report, a benefit director resigned from or refused to stand for reelection to the position of benefit director, or was removed from the position of benefit director, and the benefit director furnished the benefit corporation with any written correspondence concerning the circumstances surrounding the resignation, refusal, or removal, the benefit report shall include that correspondence as an exhibit.

(c) Audit not required. – Neither the benefit report nor the assessment of the performance of the benefit corporation in the benefit report required by subsection (a)(2) needs to be audited or certified by a third party standards provider.

Comment:

A benefit corporation may change from year to year the standard it uses under subsection (a)(2) for assessing its performance. But if a benefit corporation uses the same standard for assessing its performance in more than one year, the standard must either be applied consistently or the benefit corporation must provide an explanation of the reasons for any inconsistent use of the standard.

Subsection (a)(5) requires the disclosure of all record shareholders that own 5% or more of the benefit corporation. The benefit corporation must also disclose in its annual benefit report any beneficial owners of 5% or more that are known to the benefit corporation, but it does not have an obligation to inquire as to the existence of any such owners.

Subsection (b) is patterned after Item 5.02(a)(2) of Form 8-K under the Securities Exchange Act of 1934.

The following terms used in this section are defined in section 102:

"benefit corporation"
"benefit director"
"general public benefit"
"specific public benefit"
"third-party standard"

§ 402. Availability of annual benefit report.

(a) Timing of report. – A benefit corporation shall send its annual benefit report to each shareholder:

(1) within 120 days following the end of the fiscal year of the benefit corporation; or

(2) at the same time that the benefit corporation delivers any other annual report to its shareholders.

(b) Internet website posting. – A benefit corporation shall post all of its benefit reports on the public portion of its Internet website, if any; but the compensation paid to directors and financial or proprietary information included in the benefit reports may be omitted from the benefit reports as posted.

(c) Availability of copies. – If a benefit corporation does not have an Internet website, the benefit corporation shall provide a copy of its most recent benefit report, without charge, to any person that requests a copy, but the compensation paid to directors and financial or proprietary information included in the benefit report may be omitted from the copy of the benefit report provided.

(d) Filing of report. –

(1) Concurrently with the delivery of the benefit report to shareholders under subsection (c), the benefit corporation shall deliver a copy of the benefit report to the [Secretary of State] for filing, but the compensation paid to directors and financial or proprietary information included in the benefit report may be omitted from the benefit report as delivered to the [Secretary of State].

(2) The [Secretary of State] shall charge a fee of $__ for filing a benefit report.

<u>Comment</u>:

Subsection (b) requires a benefit corporation to post all of its annual benefit reports on its website, but subsection (c) only requires that the most recent benefit report be supplied if the benefit corporation does not have a website.

The term "benefit corporation" used in this section is defined in section 102.

"benefit corporation"
"benefit director"

Appendix B

State by State Comparison of Benefit Corporation Legislation

See Attached.

Appendix C

<u>Alternative Corporate Structures Intended to Address the Legal Issues Described Above</u>

In recognition of the legal impediments described above, actors in the social enterprise community and their legal advisors have put forth a number of alternative legal structures with the ultimate goal of removing the legal jeopardy companies and their directors face when a for-profit entity pursues an objective or set of objectives other than solely maximizing shareholder value. The following discussion touches briefly on why not-for-profit organizations are subject to limitations as the appropriate vehicles for social entrepreneurs, and then summarizes the main alternative corporate entities being discussed in various states.

I. <u>Not for Profits</u>

One of the greatest challenges of conducting public benefit activities within a nonprofit legal entity is that they are usually organized for charitable purposes, which are very limited. Many environmental and social objectives fall outside of the narrow state and federal definitions of charitable purposes, so these broader considerations cannot be effectively advanced through nonprofit organizations. In situations where overlap does exist, nonprofits are hindered by their inability to raise investment/equity capital (because nonprofits cannot distribute profits to their owners and so as a practical matter cannot raise equity capital). Debt financing is sometimes available for nonprofits, but it is much more limited and expensive than in the for-profit context because the nonprofit's ability to repay the loan is constrained by its lack of access to equity. Put simply, many nonprofits face a daily battle for survival and sustainability and spend a significant amount of time and resources seeking contributions from foundations, governments and the public, all of which grow increasingly scarce in challenging economic conditions, such as those we face today.

While there are cases of nonprofit "hybrid" entities which provide a viable legal infrastructure for organizations conducting both tax-exempt and nonexempt activities, hybrid nonprofit legal infrastructures often involve complex organizational and operational structures that are typically expensive to construct and maintain and may also not be legally secure.[82] Tax-exempt organizations are also subject to extensive annual IRS reporting and regulatory scrutiny.

Not-for-profit organizations are also limited in their ability to hire and retain talented executives and employees because, although they are legally allowed to pay "reasonable" compensation to their employees, nonprofits usually pay less than the for-profit market rate for a given position in order to ensure that their decision to pay the rate will not come into question as "excessive compensation." Nonprofits often legitimize the lower pay rate on the ground that their employees are more fulfilled by their contribution to the charitable purpose of the

[82] *See* Allen R. Bromberger, *A New Type of Hybrid*, STANFORD SOC. INNOVATION REV., 52-53 (Spring 2011) (discussing legal issues facing social enterprises structured as hybrid nonprofit/for-profit entities, such as complying with IRS joint venture rules, private benefit concerns, unrelated business income tax, conflicts of interest, related party transactions, and IRS Form 990 disclosures).

organization, but in reality, nonprofit staff are almost always overworked because funding sources are constantly threatening to cut back or completely stop funding programs altogether.[83]

II. The L3C (and LLCs)

The L3C (short for low-profit limited liability company) is similar to a regular LLC (limited liability company) as an organizational form in which to conduct business in that it provides significant flexibility in structuring governance provisions, provides legal protection to owners and managers, and can attract private capital investment (including equity capital). However, unlike a corporation or most traditional LLCs, an L3C expressly recognizes that its social mission takes priority over its profit objective.[84] Currently eight U.S. states have passed L3C legislation.[85] L3Cs are variants of the traditional LLC form, and are incorporated into the preexisting LLC statutory framework. Thus, they are subject to the same general governance properties provided by the traditional LLC statute of the state.

(A) Program-Related Investments

The L3C was essentially designed to facilitate "program-related investments" (or "PRIs") by charitable foundations in a for-profit entity. Program-related investments are investments made by foundations to support charitable activities that involve the potential return of capital within an established time frame.[86] Tax-exempt section 501(c)(3) private foundations are required to distribute 5% of their income each year for charitable purposes, either in the form of grants or investments. If they choose to invest the money, any investment must qualify as a PRI, which as defined by sections 4944(c) and 170(c)(2)(B) of the Internal Revenue Code are those investments with primarily religious, charitable, scientific, literary, or educational purposes. Also, the PRI must not have a significant investment purpose and must not be used to fund political activity. Private foundations that fail to meet those requirements could be subject to significant tax penalties and may risk losing their exempt status; as a result of these risks, PRIs have traditionally been made only in IRS-recognized not-for-profit entities.

There are a number of issues associated with the use of an L3C to attract PRIs. The IRS has not approved L3Cs as a target entity for program related investments. While L3C proponents maintain that the L3C statutory language is uniquely adapted to the IRS's program related

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[83] Not-for-profit entities are subject to federal tax laws and regulations. Among other things, federal tax law (i) precludes not-for-profit entities from distributing any profits, thus making it difficult for nonprofits to attract capital; (ii) limits financial remuneration of employees, thus making it difficult for nonprofits to attract and retain talent; and (iii) limits the revenue-generating activities of such entities which would in the private sector ordinarily accompany sustainably operating and expanding like a successful business.

[84] *See* VT. STAT. ANN. tit. 11 § 3001(27)(B) (2011) (requiring that "[n]o significant purpose of the company is the production of income or the appreciation of property"); 805 ILL. COMP. STAT. 180/1-5 (2011) (same); WYO. STAT. ANN. § 17-15-102(a)(ix)(B) (2011) (same).

[85] 805 ILL. COMP. STAT. § 180/1-26; LA. REV. STAT. ANN. § 12:1302 (2011); ME. REV. STAT. ANN. tit. 9, § 1611 (2011); MICH. COMP. LAWS § 450.4101 (2011); N.C. GEN. STAT. § 57C-2-01 (2011); UTAH CODE ANN. § 48-2c-412 (West 2011); VT. STAT. ANN. tit. 11 § 3001(27); WYO. STAT. ANN. § 17-15-102(a)(ix).

[86] PRIs are attractive to recipients because they generally represent a lower cost of capital than a market-rate investment. To the foundation investor, PRIs are attractive (as an alternative to outright grants) because they allow for the potential for return of capital (with investment return) that can then be used for another purpose later.

investment regulations,[87] numerous authorities recognize that the L3C language – while mimicking the IRS program related investment regulations – neither binds the IRS to approve program related investments in L3Cs, nor gives any indication that the IRS is likely to approve investments in L3Cs over investments in any other legal entity. This poses a significant risk to foundations who might consider investing in an L3C as somehow "pre-approved" by the IRS as a PRI since the IRS determination as to whether an investment qualifies as a PRI is a transaction-specific one.

(B) Other Issues Concerning L3Cs and LLCs

L3Cs can also be expected to have substantial difficulty attracting market-rate investments because of the L3C moniker ("low-profit") and statutory language limiting income production. Although most statutes carve out an opportunity for incidental financial success,[88] investors seeking market-rate returns do not typically invest in companies that *might* only *incidentally* provide them with such a return – they do not invest in companies that do not seek to produce the income from which the company may provide them the market-rate return that is the goal and purpose of the investment.

It is also the case that many investors have a policy, or at least a strong preference, for investing in a corporation rather than an LLC. While some LLC's have gone public, LLCs still represent a small minority of IPOs over the last decade,[89] and there remains material resistance among venture firms to investing in LLCs. Below are some of the reasons given for this, followed by some reasons why resistance ought to be less to investing in a new corporate form:

- Venture firms are more comfortable with C corporation structures. They have all the form documents, feel they understand the legal precedents with conflicts, and do not typically care about pass-through treatment of profits since venture-funded companies don't often generate profits due to the early stage of investment.

- There is minimal case history about LLC liability issues (e.g., piercing the corporate veil) and Investment Company Act/corporate control issues for venture firms to rely on even if they are willing to think outside the typical C corporation box.

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[87] PRI categorization requires that: (1) the *primary purpose* of the investment is to accomplish a charitable or educational purpose; (2) *no significant purpose* is the production of income or asset appreciation; and (3) no purpose is to promote a prohibited political or legislative purpose. I.R.C. § 4944 (2006); Treas. Reg. § 53.4944-3(a)(1)(i)-(iii), (a)(2)(iv) (1972); *see also* Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 249 (2010) (discussing PRI requirements). L3C statutory requirements in Vermont pose three analogous requirements: (a) the LLC *significantly furthers* the accomplishment of one or more charitable or educational purposes *and would not have been formed but for* its relationship to the accomplishment of such purposes, (b) *no significant purpose* of the LLC is income production or capital appreciation, and (c) no purpose of the LLC is to accomplish political or legislative purposes. VT. STAT. ANN. tit. 11, § 21:3001(27).

[88] *See*, *e.g.*, VT. STAT. ANN. tit. 11, § 21:3001(27)(B) ("[H]owever, [ ] the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.").

[89] Practical Law Company, *Preparing a Company for an Initial Public Offering*, available at www.practicallaw.com (last visited September 27, 2011).

- LLCs are governed almost entirely by the terms of the LLC Operating Agreement (a contract), which differ significantly from one LLC to the next, whereas corporations are governed largely by corporate law statutes and relatively standard-form constituent documents (articles/by-laws).

- For private equity investors (and even more so for public market investors), the lack of formulaic content in a LLC agreement means too much work and too much risk, and therefore many have policies against making these investments.

Below are several reasons a new corporate form ought not meet similar objections:

- A new corporate form is a corporation governed predominantly by corporate law, not by contract law, so most of the (more extensive) body of corporate legal precedent will apply.

- The governing documents of a new corporate form will typically be more uniform than those of an LLC, making due diligence easier for investors.

There is at least one important additional reason why a new corporate form would be a better solution to provide the clear safe harbor desired by social entrepreneurs and investors. The law of fiduciary duties (which can theoretically be contracted away in the operating agreement of an LLC) are the product of case law in many states (including Delaware) and it is unclear whether efforts to provide managing members with protection from suit when pursuing a trade-off between increasing financing value in favor of increasing social impact would be upheld by the courts. The advantage of a statutory safe-harbor like the one created by benefit corporation legislation is that the courts must abide by the statutory framework.[90]

In addition to these investor issues, because of L3Cs' inability to pursue production of income as a significant purpose of their activities, L3Cs may experience many of the same difficulties in hiring effective talent as do nonprofits.

Many commentators have also argued that the L3C as a separate legal entity is unnecessary, since any of the L3C's statutorily-mandated provisions could always be adopted into the traditional LLC form by way of the LLC's operating agreement.[91] As a matter of transparency and accountability, L3Cs have no third-party evaluator to determine whether or not they are pursuing their charitable purpose and/or achieving a measurable social impact. Unlike nonprofits which must comply with annual reporting requirements imposed by the IRS in exchange for exempt status, and benefit corporations as discussed above, L3Cs are free to self-regulate their charitable purpose and the extent to which they report publicly on their activities.

III. <u>The Flexible Purpose Corporation (FPC)</u>

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[90] Additionally, L3C statutes do not address the scope of directors' duties, stating simply that an L3C's operating agreement may not "eliminate or reduce a member's fiduciary duties" (though it may define what is or is not a breach of such duties). *See* 805 ILL. COMP. STAT. 180/15-5 (listing requirements for LLC operating agreements).

[91] *See*, *e.g.*, Bishop, *supra* note 25, at 249 (stating L3C statutory provisions provide no advantage, apart from branding, that could not otherwise be achieved via contract or operating agreement).

Legislation to create the "Flexible Purpose Corporation" ("FPC") as a new type of corporate entity has been enacted only in California.[92] FPCs are a variation of California corporation and, as such, the full range of equity and debt private options are available to capitalize such an entity. As with the benefit corporation, financial profitability as an objective need not be subordinated to the entity's public purpose.

(A) Drafting Approach

According to its principal author, FPC legislation was drafted primarily to meet the needs of larger, often publicly-traded companies interested in possessing a safe harbor to pursue at least one "special purpose" beyond the maximization of shareholder value.[93] It was drafted recognizing the significant constraints publicly-traded companies would face in adopting a new corporate form.[94] As a result, and as described below, FPC legislation does not meet the needs of most of the consumers, investors, and entrepreneurs described in Section I.

Before discussing why the flexible purpose corporation does not meet the needs of the consumers, investors, and entrepreneurs described in Section I, there is an additional issue with the approach taken in drafting FPC legislation.

Unlike benefit corporation statutes which have been drafted so that the existing corporation code applies to benefit corporations in every respect except those explicitly stipulated in the benefit corporation legislation, FPC legislation adds an entirely new Division and two new Sections, as well as amends 12 Sections of the California corporate law code.[95] The drafting approach results in legislation that is 86 pages in length, making it more cumbersome for attorneys to reference than the typically 13 page benefit corporation statutes.

More importantly, this drafting approach creates potential legal and administrative issues in keeping the FPC in conformity to the corporation code as changes to the code occur over time. Any change to the California corporate code would require a corresponding change to the flexible purpose code. In addition to the potential risk of non-conformity, this approach also likely creates additional administrative burden and expense for the state in monitoring and maintaining conformity over time. It is also not clear to what extent existing California corporate case law and authority would apply to FPCs.

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[92] FPCs would be organized pursuant to the California Corporate Flexibility Act of 2011, which was signed into law on October 9, 2011 and becomes effective on [_____]. *See generally* California Corporate Flexibility Act (Cal. 2011).

[93] W. Derrick Britt, R. Todd Johnson and Susan H. MacCormac, *FAQ, Proposed Amendments to the California Corporations Code for a New Corporate Form: The Flexible Purpose Corporation and Senate Bill 201* (February 23, 2011), *available at* http://www.thecorporatecounsel.net/member/FAQ/Flexible/02_11_FAQ.pdf.

[94] *See* Joel Makower, *California's Bold Move to Legitimize Sustainable Business*, GREENBIZ.COM (Feb. 14, 2011), http://www.greenbiz.com/blog/2011/02/14/california%E2%80%99s-move-legalize-sustainable-business (stating large California corporations face significant risks if they "embed" social or environmental criteria into their articles of incorporation).

[95] S.B. 201, 2011-2012 Leg., Reg. Sess. (Cal. 2011). "An act to amend Sections 102, 107, 158, 201, 1100, 1113, 1152, 1155, 1201, 5122, 7122, and 9122 of, to add Sections 171.08 and 1112.5 to, and to add Division 1.5 (commencing with Section 2500) to Title 1 of, the Corporations Code, relating to corporations."

(B) "Special Purpose"

To become an FPC, a company's articles of incorporation need to specify at least one "special purpose" that the corporation will pursue, which can include (but is not limited to) charitable or public benefit activities. The directors and officers of the FPC would effectively enjoy a safe harbor in pursuit of any such "special purpose." However, while a "special purpose" could be defined broadly (e.g., as broadly as corporate purpose is defined in benefit corporation legislation; namely, "to create material positive impact on society and the environment"), that "special purpose" can also be defined narrowly, and be limited in duration.

While this may accomplish the more narrow legal objective of the executives, directors, and investors of an FPC, from the point of view of the consumers, investors, and entrepreneurs described in Section II, such an FPC would receive the unintended halo effect of being recognized by the state as a "new kind of company" simply by pursuing the most modest and short-term socially or environmentally responsible activity – potentially even something it already does, like buying enough carbon offsets to be "carbon neutral" this year, or building a playground.

In addition to the above consumer and investor protection issues, creating a new corporate form for companies making such potentially limited commitments, creates significant risk from the perspective of policy makers. For example, a hypothetical FPC oil company could declare its "special purpose" to support renewable energy projects making up less than 5% of its revenues while being cited by regulators for hundreds of violations in its core oil business, all the while marketing itself as a "new kind of company" with the imprimatur of the state.

Another example demonstrates a technical challenge for policy makers in the FPC approach to corporate purpose. A hypothetical FPC could declare, achieve, and report on its "special purpose" to be "carbon neutral" this year. What happens next year? Should this FPC receive the long-term, indeed perpetual, benefits of state recognition as a "new kind of company" while only achieving a short-term "special purpose"? While FPC legislation does require disclosure that the company has achieved its limited "special purpose", this does not solve the problem created for consumers and investors who may have supported or invested in the company because of its FPC status and the distinction that such a state recognized corporate form implies.

Another challenge in the FPC approach to corporate purpose is the lack of flexibility it affords entrepreneurs. Entrepreneurs are forced to declare one or more "special purposes" at the time of incorporation or election of FPC status. This forces entrepreneurs to do one of two things: either 1) declare a broad "special purpose" that gives them flexibility to adapt, innovate, and respond to changes in the market or to evolved understanding of how to achieve most effectively their social or environmental goals; or 2) declare a narrow "special purpose" that might then limit their flexibility, and perhaps even create additional legal exposure, to pursue other later-identified or simply undeclared beneficial activities without the additional administrative burden of declaring another "special purpose."

The narrow "special purpose" approach also fails to recognize that most of the entrepreneurs, investors, and consumers described in Section I understand that their public benefit objectives, and thus their public benefit activities, are not narrow, but indeed broad, and often inter-related. Entrepreneurs, investors, and consumers that care about the environment, most often also care about how workers are treated, vice versa and etcetera.

Lastly, large public companies already pursue a wide variety of specific "CSR" (Corporate Social Responsibility) activities and need no new corporate form to do so. The safe harbor created by FPC legislation would indeed give directors of these large public corporations the additional legal protection to pursue named "special purposes" even in a defensive or other Revlon scenario, but it seems unlikely that a large public company would be in a position to need this safe harbor given the likely narrow impact of its "special purpose" activities relative to its overall financial performance. The vast majority of companies pursuing more comprehensive mission-driven business models or sustainability activities that have expressed a need for a legal protection, particularly in defensive and Revlon scenarios, support the alternative approach of benefit corporation legislation.

(C) Transparency and Accountability

As discussed above, there are two basic ways to create legal (as opposed to market-based) discipline to keep an organization accountable to its stated purposes: first, through transparent, credible, third-party reporting requirements; and second, through empowering stockholders to pursue causes of action against the corporation and its directors when corporate interests and purposes are not pursued.

As regards the first, the FPC statute's § 3500(a) provides that an FPC board of directors must provide an annual report to shareholders and publish it publicly on the internet,[96] and §3500(b) further provides that the annual report must contain a section providing "a management discussion and analysis (special purpose MD&A) concerning the flexible purpose corporation's stated purpose or purposes in its articles."[97] This means that the hypothetical FPC oil company mentioned above would be required only to report on its efforts to support renewable energy projects, which comprise less than 5% of its overall revenues, while not reporting on the fact that they were cited by regulators for scores of violations that year in its core oil business.

While this is an extreme example, it is true that no company does everything well as it relates to social and environmental performance (its treatment of its workforce, suppliers, consumers, community, and the environment) and as a result, the FPC reporting requirement seems insufficient to give the consumers and investors mentioned in Section I the information they need to make more informed decisions.

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[96] *See* California Corporate Flexibility Act of 2011, § 3500(a), S.B. 201, 2011-2012 Leg., Reg. Sess. (Cal. 2011) ("The board of a flexible purpose corporation shall cause an annual report to be sent to the shareholders not later than 120 days after the close of the fiscal year [and] . . . shall cause [the annual report] to be made publicly available by posting it on the flexible purpose corporation's Internet Web site or providing it through similar electronic means.")

[97] *Id.* § 3500(b); *see also id.* ("The special purpose MD&A shall include the information specified in this subdivision and any other information that the flexible purpose corporation's officers and directors believe to be reasonably necessary or appropriate to an understanding of the flexible purpose corporation's efforts in connection with its special purpose or purposes.")

The last point about third-party standards is critical. Unlike benefit corporation legislation, FPC legislation does not require the application of any independent third-party standard based upon which such a report is required to be made, leaving it to each individual flexible purpose corporation to report on its "special purpose" activities and their impacts as it sees fit. Proposed FPC legislation thus exacerbates the current lack of clarity about the social and environmental performance of companies by encouraging a proliferation of one-off, non-comparable, narrowly-tailored, self-reporting. This goes against the current trend, particularly in the public capital markets and among policy makers and large public corporations serious about sustainability, to encourage integrated sustainability reporting using credible third-party standards. As noted above in Section I.C, according to Institutional Shareholder Services, the largest shareholder proxy organization in the world, this trend is also true for institutional investors who "appear to be increasingly incorporating social and environmental considerations into their proxy voting decisions, as demonstrated by voting trends and institutional investor initiatives.[98]

As regards the second accountability mechanism (a right of action based upon failure to pursue the public purpose), the FPC statute does not create a procedure through which directors and officers can be held accountable, other than that which already exists for traditional corporations (namely the right to vote directors off the board). Shareholders of FPCs do not have a right of action for failure to pursue the FPC's "special purpose." This likely stems from the fact that FPC directors and officers would not be required by statute to pursue the "special purpose," but would simply be permitted to do so.

The FPC's expansion of a safe harbor for directors without a corresponding expansion of accountability could exacerbate director entrenchment, particularly in private companies. For example, directors could successfully attract private equity investors by declaring a broad "special purpose," report that they have done little toward achieving that purpose, and be comfortable that these minority shareholders have no legal recourse.

Perhaps most importantly, the FPC does not meet the needs of most of the entrepreneurs advocating for a new corporate form. These needs include market differentiation and mission protection. The challenge of market differentiation of FPCs is clear from the above examples regarding the potential existence of "bad actors" among the population of FPCs and how their potential existence would make becoming an FPC less desirable among leading sustainable businesses. The challenge of mission protection is an important one to these entrepreneurs. The entrepreneurs building mission-driven businesses want to maintain their mission as they bring in outside capital to grow. They fear losing control of their mission when they lose financial control and would benefit from the expanded right of action offered in benefit corporation legislation. Unlike benefit corporation legislation, FPC legislation does not offer these entrepreneurs the accountability tools they need to ensure that their businesses have the opportunity to grow in impact as they grow in size.

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[98] Carolyn Mathiasen & Erik Mell, Institutional Shareholder Serv., *Corporate Social Issues: A 2011 Proxy Season Preview: United States* 1 (2011).

The FPC has particular limitations: (i) because of its narrow approach, the FPC does not address the fundamentally broad concerns on the minds of the consumers, investors, and entrepreneurs described in Section I; (ii) because of its lack of accountability, the FPC does not address the fundamental legal issues important to both entrepreneurs and investors regarding the expansion of directors' fiduciary duties described in Section II; and (iii) because of its limited transparency mechanisms, the FPC could lead to abuse and additional market confusion, ultimately undermining efforts to serve the needs of the consumers, investors, and policy makers most interested in using the power of business to solve social and environmental problems by creating a clear, distinct marketplace of corporations meeting higher standards of corporate purpose, accountability, and transparency.