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Benefit Corporations and Flexible Purpose Corporations in California:

New State Legislation Permits Socially Responsible Corporate Formations

As of January 1, 2012, California corporations have two new options for organization under the California Corporations Code: the benefit corporation[1] and the flexible purpose corporation (FPC).[2] In a traditional corporation, directors and officers owe a fiduciary duty primarily to the shareholders of the corporation. Both new forms of California corporations obligate directors and officers to consider the social and environmental impact of their actions on "stakeholders," i.e., employees, consumers and the environment, as well. This legal alert will discuss the advantages and disadvantages, as well as the legal requirements and potential liabilities, of both the benefit corporation and the FPC.

I. BENEFIT CORPORATIONS[3]

California is one of the newest states to enact benefit corporation legislation. This legislation creates a new type of corporation in California that: 1) will have a material positive impact on society and the environment; 2) has an expanded fiduciary duty that requires consideration of non-financial interests; and 3) reports on its overall social and environmental performance assessed against a third-party standard. To create the statutorily-required material positive impact on society and the environment, a benefit corporation must pursue the "general public benefit," and may additionally name a specific public benefit to pursue.

The benefit corporation legislation is a response to the demands of consumers, investors, and businesses for legal corporate structure options that allow for-profit endeavors to integrate social and environmental purposes into their business models. Consumers are increasingly aware of the social impact of businesses, and seek companies that are aligned with their social and environmental interests. As a result, investors and entrepreneurs are also becoming increasingly interested in pursuing social and environmental interests in their businesses. Benefit corporation legislation allows socially and environmentally conscious companies to consider stakeholder interests by providing certain protections to directors and officers when considering non-financial social and environmental interests.

A. The Law

A benefit corporation is a corporation formed under the California Corporations Code, with the additional requirement that the corporation's articles of incorporation state that "This corporation is a benefit corporation."[4] The three main legal requirements that characterize a benefit corporation are: (1) the public purpose requirement, (2) accountability considerations, and (3) specific transparency procedures.

1. <u>Three Legal Characteristics Specific to Benefit Corporation</u>

a. *The Public Purpose Requirement*

A benefit corporation is formed with the purpose of creating a "general public benefit." A benefit corporation is deemed to be pursing the general public benefit if its business and operations create a "material positive impact on society and the environment," as assessed against a third-party standard. This broad definition of "general public benefit" is intended to give corporations flexibility and encourage innovation by not being overly prescriptive.[5] The vagueness of the definition is balanced by the third-party standard discussed below. Until the courts interpret the new legislation, however, the practical meaning and application of the phrase "material positive impact" is unclear.

In addition to the **general** public benefit, a benefit corporation may name one or more **specific** public benefits to pursue. The specific public benefit can include[6]:

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; and/or
7. The accomplishment of any other particular benefit for society or the environment.

b. *Accountability Considerations*

A benefit corporation's directors and officers **<u>must</u>** consider the non-financial interests of the following stakeholders[7]:

1. The shareholders of the benefit corporation;
2. The employees and workforce of the benefit corporation, its subsidiaries, and its suppliers;
3. The customer interests as related to the general or specific public benefit purpose of the corporation;
4. Community and societal consideration, including the communities or societies housing the offices or facilities of the benefit corporation, its subsidiaries, or its suppliers;

5. The local and global environment;
6. The short-term and long-term interests of the benefit corporation, including benefits that may accrue to the benefit corporation from its long-term plans and the possibility that these interests may be best served by retaining control of the benefit corporation rather than selling or transferring control to another entity; and
7. The ability of the benefit corporation to accomplish its general and specific public benefit purposes.

Directors and officers **may** also consider the impact on[8]:

1. The resources, intent, and conduct (past, stated, and potential) of any person seeking to acquire control of the corporation; and
2. Any other pertinent factors or the interests of any other person or group.

A person may assert a claim under the benefit corporation legislation against a benefit corporation, its directors, or its officers only though a "benefit enforcement proceeding." The benefit enforcement proceeding limits the types of claims arising from the statute to the following[9]:

1. Failure to pursue the general public benefit purpose or any specific public benefit purpose of the benefit corporation;
2. Violation of a duty or standard of conduct imposed on a director under the benefit corporation legislation; or
3. Failure of the benefit corporation to deliver or post its annual benefit report.

A benefit enforcement proceeding can only be brought by the benefit corporation, or derivatively by a shareholder, a director, a person or group that owns 5 percent or more of the equity of the benefit corporation's parent, if any, or any other entities specified in the benefit corporation's articles or bylaws. This ensures the benefit corporation's reduced liability against third parties, including beneficiaries of the general or specific public benefit.

Injunctive relief is the sole remedy available for the above claims against a benefit corporation; the purpose of this remedy is to ensure that the corporation will fulfill the obligations it voluntarily undertook. A benefit corporation and its directors and officers will not be liable for monetary damages for any failure of the benefit corporation to create a general or specific public benefit. Further, benefit corporation directors and offers will not be liable for monetary damages for any alleged failure to discharge any obligations required of them by the benefit corporation legislation. A court may also award any reasonable costs incurred in connection with the benefit enforcement proceeding, including attorney's fees.

c. *Transparency Procedures*

A benefit corporation must prepare an annual report based on a third-party standard that complies with several provisions of the law discussed below. In general, the report must include a description of the selection of the third-party standard, how the benefit corporation pursued the general and any specific public benefit, and any circumstances that hindered the creation of the general or specific public benefit. More specifically, the annual report must include all of the following provisions[10]:

1. A narrative description of:

    a. The process and rationale for selecting the particular third-party standard used to prepare the benefit report;
    b. How the benefit corporation pursued a general public benefit during the year, and the extent the general public benefit was created;
    c. How the benefit corporation pursued its specific public benefit, if any, and the extent the specific public benefit was created; and
    d. Any circumstances that hindered the creation of a general or specific public benefit by the benefit corporation.

2. An assessment of the overall social and environmental performance of the benefit corporation based on the third-party standard selected by the benefit corporation.

3. The name of all entities that own at least 5% of the outstanding shares of the benefit corporation.

4. A statement indicating whether, in the opinion of the board of directors, the benefit corporation failed to pursue its general and specific public benefit purpose in all material respects. If the benefit corporation has failed to do so, the report must include a description of the ways in which the benefit corporation failed to pursue its general and specific public benefit purpose.

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

The annual report must be delivered to shareholders within 120 days after the end of each fiscal year and be posted on the benefit corporation's website, if the benefit corporation has one. Although the report must be accessible for public viewing, the benefit corporation can omit the compensation paid to directors and any financial or proprietary information listed in the report.

2. The Third-Party Standard

A benefit corporation must use an independent, third-party standard in preparing its annual benefit report. The third-party standard is a standard for defining, reporting, and assessing the overall corporate social and environmental impact of the benefit corporation's actions. The benefit corporation's directors and officers may choose the third-party standard so long as it meets the following criteria[11]:

1. The third-party standard must be a comprehensive assessment of the business's impact on:

    a. The employees and workforce of the benefit corporation, its subsidiaries, and its suppliers;
    b. The customer interests as related to the general or specific public benefit purpose of the corporation;
    c. Community and societal considerations, including the communities or societies housing the offices or facilities of the benefit corporation, its subsidiaries, or its suppliers; and
    d. The local and global environment.

2. The standard must be developed by an entity that has no material financial relationship with the benefit corporation or any of its subsidiaries and meets the following criteria:

    a. Not more than one-third of the members of the entity are representatives of:
        i. Associations of businesses operating in a specific industry, whose members are measured by the standard;
        ii. Businesses from a specific industry or an association of businesses in that industry; and
        iii. Businesses whose performance is assessed against the standard.

    b. The entity must not be materially financed by an association described in part a. above

3. The standard is developed by an entity that:

    a. Accesses necessary and appropriate expertise to assess overall corporate social and environmental performances; and
    b. Uses a balanced multi-stakeholder approach, including a public comment period of at least 30 days to develop the standard.

4. All of the following information about the standard must be publicly available:

    a. The criteria considered when measuring the overall social and environmental impact of the business;
    b. The relative weightings of the criteria used;
    c. The identity of the directors, officers, any material owners, and the governing body of the entity that developed and controls revisions to the standard;
    d. The process by which revisions to the standard and changes to the membership of the governing body are made; and
    e. An accounting of the sources of financial support for the entity, with sufficient detail to disclose any relationships that could reasonably be considered to present a potential conflict of interest.

In addition to adhering to the above requirements, the third-party standard should also use criteria specific to the operations of the benefit corporation. For example, manufacturing standards may not be applicable to a benefit corporation that focuses on service.

B Lab (http://www.bcorporation.net/) offers a free reporting and assessment tool for benefit corporations, the "B Impact Assessment." Companies are assessed in categories such as Governance, Transparency, Workers, and the Environment. The B Impact Assessment asks questions relating to each category, ranging from employee health insurance to greenhouse gas emissions. Once the company completes the assessment, a "B Impact Report" is generated, providing a score for each category, plus an overall score.

The Global Reporting Initiative (http://www.globalreporting.org/) also provides a free reporting and assessment tool. For a more extensive list of third-party standards available, visit http://benefitcorp.net/selecting-a-third-party-standard/list-of-standards.

B. The Advantages and Disadvantages of the Benefit Corporation Structure

Advantages:

- Reduced legal liability for directors and officers when considering non-financial interests of the company, environment, and community
- Ability to attract more investors due to the social impact of the corporation and increased accountability
- More marketing opportunities and the ability to distinguish a company as committed to social and environmental good
- Increased customer base due to the positive impact of the business

Disadvantages:

- Potential legal liability for failing to adequately pursue a general and specific public benefit
- Uncertainties in application of the law until courts interpret the legislation
- Possible issues arising from doing business in states that do not have benefit corporation legislation
- No tax benefit as compared to traditional nonprofit organizations
- Increased reporting requirements

C. Forming a Benefit Corporation

A benefit corporation is formed the same way a general corporation is formed, with the exception that the articles of incorporation of a benefit corporation must state that "This corporation is a benefit corporation."

A benefit corporation may also be formed by converting a general corporation. This is achieved by amending the corporation's articles of incorporation to include the language above. The amendment must be approved by the "minimum status vote" – at least two-thirds of the votes of outstanding shares of each class or series, or greater vote if required in the articles of incorporation. Shareholders that do not wish the corporation to convert to a benefit corporation may exercise dissenters' rights. When a shareholder exercises dissenters' rights, the corporation is required to purchase at fair market value the shares owned by the dissenting shareholders.

D. Case Studies

1. <u>California</u>

Patagonia, an outdoor clothing and gear company, was the first company to register to become a benefit corporation in California. Patagonia has been supporting environmental groups since the 1986 induction of its program to donate 1% of its sales, or 10% of its profits, to grassroots environmental groups. The new benefit corporation legislation has enabled Patagonia to continue its mission to support sustainable business, without fear of third-party liability for considering stakeholder interests.

Patagonia completed a B Impact Report in January 2012.[12] Patagonia's B Impact Report highlights the company's efforts to promote social and economic benefits; for example, the company subsidizes child care and counseling services for workers, and publishes the names of all its suppliers on its website.

2. Other States

California is the seventh state to enact benefit corporation legislation, joining the movement in Maryland, Vermont, Virginia, New Jersey, Hawaii, and New York. These states based their benefit corporation legislation on model legislation drafted by the nonprofit B Lab. California altered the model legislation; for example, unlike the model statute, California requires a description of the process and rationale for selecting a specific third-party standard, as well as a narrative statement by the directors indicating whether the benefit corporation failed to pursue its general and any specific public purpose in all material respects.

Benefit corporations that conduct business in multiple states or wish to model their business on corporations in other states should pay particular attention to state-by-state departures in legislation.[13] Once a court in any state interprets that state's benefit corporation legislation, the decision will serve as guidance for benefit corporations in California and throughout the country.

II. FLEXIBLE PURPOSE CORPORATIONS

The Corporate Flexibility Act of 2011 created a new subset of corporate structure called the flexible purpose corporation (FPC). The FPC was created to provide a safe harbor to corporations wishing to promote one or more specific special purposes in addition to creating economic value for shareholders.[14] The new legislation provides protection to directors and officers of the FPC by expanding the corporation's fiduciary duty to include consideration of the FPC's special purpose(s). The permissive nature of the statute also allows the FPC to prioritize the economic interests of the shareholders when appropriate. The FPC legislation's two major provisions concern the FPC's special purpose and reporting requirements.

A. The Law

An FPC is managed as a general purpose corporation under the California Corporations Code, except as expressly stated in the new legislation. The two major provisions that govern an FPC relate to the FPC's special purpose and reporting requirements.

1. Special Purpose

At the heart of the FPC legislation is the special purpose(s) that the corporation wishes to consider in addition to the economic interests of the shareholders. An FPC must list one or more special purposes in its articles of incorporation. The different special purposes that an FPC may pursue include[15]:

1. One or more charitable or public purpose activities; or
2. Promoting short-term or long-term effects or minimizing adverse short-term or long-term effects of the FPC's activities on any of the following:
    a. The FPC's employees, suppliers, customers, and creditors;
    b. The community and society; or
    c. The environment.

2. Reporting Requirements

An FPC is required to prepare a **special purpose management and discussion analysis** (the "special purpose M&DA"), an annual report on the impact of the FPC's actions toward the special purpose. The special purpose M&DA serves as a discussion about actions taken to further the FPC's stated purpose(s) throughout the fiscal year. The report must be publically available on the FPC's website, if the FPC has a website, or by other electronic means. The report must include[16]:

1. Identification and discussion of the short-term and long-term objectives of the FPC relating to its special purpose or purposes, and an identification and explanation of any changes made in those objectives during the fiscal year.

2. Identification and discussion of the material actions taken by the FPC during the fiscal year to achieve the special purpose objectives, the impact of those actions, and the extent to which those actions achieved the objectives for the fiscal year. This must also include a discussion of the causal relationships between the actions and the reported outcomes.

3. Identification and discussion of material actions, including the intended impact of those actions that the FPC expects to take in the short term and long term with respect to achievement of its special purpose objectives.

4. A description of the process for selecting, and an identification and description of, the financial, operating, and other measures used by the FPC during the fiscal year for evaluating its performance in achieving its special purpose objectives, including an explanation of why the FPC selected those measures and identification and discussion of the nature and rationale for any material changes in those measures made during the fiscal year.

5. Identification and discussion of any material operating and capital expenditures incurred by the flexible purpose corporation during the fiscal year in furtherance of achieving the special purpose objectives, a good faith estimate of any additional material operating or capital expenditures the flexible purpose corporation expects to incur over the next three fiscal years in order to achieve its special purpose objectives, and other material expenditures of resources incurred by the flexible purpose corporation during the fiscal year, including employee time, in furtherance of achieving the special purpose objectives, including a discussion of the extent to which that capital or use of other resources serves purposes other than and in addition to furthering the achievement of the special purpose objectives.

In addition to the special purpose M&DA, an FPC may be required to create a **special purpose current report** in some circumstances. Unless previously reported in the FPC's most recent M&DA, the board must make a special purpose current report available publicly by posting it on the FPC's web site or through similar electronic means within 45 days of one or more of the following[17]:

1. The special purpose current report must identify and discuss, in reasonable detail, any current or planned expenditure, excluding compensation of officers and directors, made in furtherance of the special purpose objectives, whether an operating expenditure, a capital expenditure, or some other expenditure of corporate resources. The special purpose current report should detail, for example, employee time spent on the special purpose, the nature of the expenditure (direct or indirect), and the categorization of the expenditure (overhead or otherwise) where the expenditure has or is likely to have a material adverse impact on the FPC's operation or financial condition.

2. Any decision by the board or action by management to do either of the following:

    a. Withhold expenditures, whether temporarily or permanently, that were to have been made in furtherance of the special purpose as contemplated in the most recent annual report, where the planned expenditure was likely to have had a material positive impact on the FPC's special purpose objectives.

    b. Determine that the special purpose has been satisfied or should no longer be pursued, whether temporarily or permanently.

The annual M&DA and the current special purpose report do not need to detail or itemize every relevant expenditure or action by the FPC in working towards meeting the special purpose objectives. The management and board of the FPC must use their discretion in providing relevant information, including information that a reasonable investor would consider important in understanding the corporation's objectives, actions, impacts, measures, rationale, and results of operations as they relate to the nature and achievement of the special purpose objectives.[18]

3. Accountability and Enforcement

The FPC legislation is permissive; in directing the operations of the company, the directors and officers of the FPC **may** consider the special purposes of the FPC as set forth in its articles. The legislation only requires that directors and officers serve in good faith, acting in a way that they believe to be in the best interests of the FPC and its shareholders.

The FPC legislation does not include a provision for enforcement of the FPC's special purpose, but does expressly state that "a director shall not be responsible to any party other than the flexible purpose corporation and its shareholders."[19] The FPC's special purpose is incorporated into the fiduciary duties of the directors and officers.

Consequently, the FPC's special purpose will likely be enforced through a shareholder's suit for breach of fiduciary duty.

B. The Advantages and Disadvantages of the FPC Structure

Advantages

- Ability to attract more investors due to the social impact of the corporation
- More marketing opportunities and the ability to distinguish the company as one committed to social and environmental good
- Boost sales from customers because of the positive impact of the business
- Ability to attract more investors than an LLC with a special purpose (see below)

Disadvantages

- Possible misuse and "greenwashing"[20] due to the permissive nature of the statute
- Uncertainty in application of the laws at this time
- No tax benefit as compared to traditional nonprofit organizations

C. Forming an FPC

1. Forming a New FPC

Generally, a new FPC is formed by filing articles of incorporation that include the following language[21]:

1. The name of the FPC, which must contain the phrase "flexible purpose corporation" or an abbreviation.

2. Either one of the following statements:

    a. "The purpose of this flexible purpose corporation is to engage in any lawful act or activity for which a flexible purpose corporation may be organized under Division 1.5 of the California Corporations Code, other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code, for the benefit of the long-term and the short-term interests of the flexible purpose corporation and its shareholders and in furtherance of the following enumerated purposes_____."

    b. "The purpose of this flexible purpose corporation is to engage in the profession of (with the insertion of a profession permitted to be incorporated by the California Corporations Code) and any other lawful activities, other than the banking or trust company business, not prohibited to a flexible purpose corporation engaging in that profession by applicable laws and regulations, for the benefit of the long-term and the short-term interests of the flexible purpose corporation and its shareholders."

3. A statement of the purpose the FPC will pursue.

4. A statement that the FPC is organized as an FPC under the Corporate Flexibility Act of 2011.

The FPC may be required to include additional language in its articles of incorporation depending on the type of corporation. For example, if the FPC is subject to the Insurance Code as an insurer, the articles of incorporation must additionally state that the business of the FPC is to be an insurer. For additional requirements based on the type of corporation, see California Corporations Code Section 2602(b)(4)-(7).

2. <u>Converting a Traditional Corporation into an FPC</u>

Rather than create a new FPC, an existing corporation can convert to an FPC.[22] The conversion must be approved by at least a two-thirds vote of each class of shareholders, or a greater vote if required in the articles, or outstanding shares of that converting corporation. The shareholders of the converting corporation will have all of the obligations under Chapter 13 (commencing with Section 1300) of a corporation involved in a reorganization.

Shareholders that do not wish the corporation to convert to an FPC may exercise dissenters' rights. When a shareholder exercises dissenters' rights, the corporation is required to purchase at fair market value the shares owned by the dissenting shareholders.

D. FPC Compared with Other Similar Corporate Entities

1. <u>Benefit Corporation</u>

The major difference between an FPC and a benefit corporation is that the benefit corporation is required to pursue the general public benefit and any special public benefit listed, whereas the FPC is not subject to such a requirement. An FPC is never required to pursue the general public benefit, and is *permitted*, but not required, to consider its specific purposes. This variance makes the FPC a better choice for companies that wish to make only specific or small changes in their actions.

Another difference is that an FPC is not required to use a third-party standard for reporting. However, the FPC still must use best practices when preparing its special purpose M&DA.

Finally, the FPC legislation does not create a special enforcement proceeding to enforce the special purpose(s) of the FPC. The FPC's special purpose will likely be enforced through a shareholder's suit for breach of fiduciary duty.

2. LLC

A limited liability company (LLC) can also be formed similar to an FPC. Since an LLC is formed by contract law, companies can write a special purpose into the operating agreement. However, this form of LLC is less attractive to investors due to tax consequences.[23]

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Please feel free to contact JDC's Community Organization Representation Project (CORP) at corp@sfbar.org to apply for pro bono legal assistance with business law matters (i.e. intellectual property, contracts, real estate, employment, corporate governance and structuring, and tax), and for assistance with incorporating a 501(c)(3) organization.

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[1] Assembly Bill 361.
[2] Senate Bill 201.
[3] A benefit corporation is not the same as a "Certified B Corporation." Even before the benefit corporation legislation was enacted in California, many California companies were "Certified B Corporations." Certified B Corporations are entities (including LLCs, corporations, and partnerships) in all 50 states that have been given the certification from the nonprofit B Lab for meeting a high standard of overall social and environmental performance, similar to the performance required by the benefit corporation legislation. While a benefit corporation may elect to receive certification form B Lab as a Certified B Corporation, the certification does not carry with it any of the protections provided by benefit corporation legislation, such as expanded fiduciary duty.
[4] Cal. Corp. Code Section 14610(b).
[5] William H. Clark, et. al., *White Paper*, *The Need and Rationale for the Benefit Corporation*, at 22 (2011), available at http://benefitcorp.net/for-attorneys/benefit-corp-white-paper.
[6] Cal. Corp. Code Section 14601(e).
[7] Cal. Corp. Code Section 14620(b).
[8] Cal. Corp. Code Section 14620(c).
[9] Cal. Corp. Code Section 14600(b).
[10] Cal. Corp. Code Section 14630.
[11] Cal. Corp. Code Section 14601(g).
[12] For Patagonia's full B Impact Report, *see* http://www.bcorporation.net/patagonia
[13] For a complete list of variations from the model legislation, *see* J. Haskell Murray, *Benefit Corporations: State Statute Comparison Chart* (2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988556.
[14] S.B. 201, Bill Analysis, Assembly Committee on Judiciary (2011).
[15] Cal. Corp. Code Section 2602(b)(2).
[16] Cal. Corp. Code Section 3500(b).
[17] Cal. Corp. Code Section 3601.
[18] Cal. Corp. Code Section 3502.

[19] Cal. Corp. Code Section 2700(f).

[20] "Greenwashing" is a public relations or marketing tactic whereby companies deceptively represent themselves as socially and environmentally responsible.

[21] Cal. Corp. Code Section 2602.

[22] Cal. Corp. Code Section 1152(d).

[23] For more on this topic, see W. Derrick Britt, et. al., *Frequently Asked Questions*, available at http://businessforgood.blogspot.com/2011/03/frequently-asked-questions-proposed.html.