

California's New Entities: Benefit Corporations and Flexible Purpose Corporations

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As of January 1, 2012, two new subtypes of traditional business corporations may be organized under the California Corporations Code – benefit corporations (§§14600-14631) and flexible purpose corporations (§§2500-3503). Both free their directors from having to manage strictly for the economic benefit of shareholders, enabling them to address social objectives such as preserving the environment, promoting the interests of the underserved and improving human health. Patagonia, the outdoor apparel company, became California's first benefit corporation on January 3rd. It remains to be seen whether the new corporate forms will be popular entity choices, whether they will be effective in promoting socially desirable goals, and whether unexpected problems will arise for early adopters as a result of their untested nature. While these types of entities are new, and as a result certain tax issues associated with their use may be unclear, there does not appear to be any obvious tax benefit to the use of either structure.

The directors of business corporations have a fiduciary duty to manage their corporations for the economic benefit of their shareholders. Corporations often make charitable contributions and take other socially beneficial actions. These are justified by the proposition that they enhance shareholder value by improving the image of the corporation and its brands. If the directors get too carried away with good works, they can be sued for violating their fiduciary duty to shareholders by wasting corporate assets to pursue social objectives. The charters of both benefit corporations and flexible purpose corporations expressly include social objectives among the purposes that they may pursue, even if the pursuit reduces the economic benefits provided to shareholders.

The legislation authorizing benefit corporations and flexible purpose corporations is part of a movement among business owners and managers to use their companies to pursue social objectives and, for competitive purposes, to portray their companies in that light. Another part of this movement is the certification of "B Corporations" - a designation meaning that the corporations do not focus exclusively on shareholder profits and meet certain standards of social and environmental performance, accountability and transparency. Organizing a business as a benefit corporation or flexible purpose corporation is different from seeking B Corporation

certification, but those entities are well suited to such certification. There is doubt as to whether traditional California business corporations can meet the criteria generally associated with B Corporation status because of the priority assigned to profits by the California General Corporation Law ("CGCL").

As of January 1, 2012, California law permits business corporations that qualify as benefit corporations or flexible purpose corporations to manage themselves not only with a view to the bottom line but also to achieve social objectives. The new entity types are described briefly below. The description is not intended to be complete or a substitute for advice from counsel.

Benefit Corporations

A benefit corporation is a corporation organized as a business corporation under the CGCL that has in its Articles of Incorporation the sentence: "This corporation is benefit corporation." Newly formed corporations may be organized as benefit corporations, and existing corporations or other entities may become benefit corporations by amending their Articles of Incorporation or by converting to, or merging into, benefit corporations. Benefit corporations are subject to newly enacted §§14600-14631 of the Corporations Code and, to the extent not inconsistent with those sections, the CGCL. As a result, benefit corporations are the same as other California corporations except that they have certain rights and obligations under §§14600-14631 that are not applicable to business corporations.

Every benefit corporation has the purpose of creating "general public benefit." The term 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." In addition to the general public benefit, a benefit corporation may adopt as its purposes one or more "specific public benefits" by identifying them in its Articles of Incorporation. Specific public benefits mean six specifically listed benefits such as "preserving the environment" and "improving public health" and "the accomplishment of any other particular benefit for society or the environment." The identification of a specific public benefit does not limit a corporation's purpose to create general public benefit. The purpose of creating general public benefit is in addition to, and may be a limitation upon, the corporation's purpose under the CGCL and the Corporation's purposes to create any identified specific public benefits.

The directors of benefit corporations have the freedom to pursue the creation of general public benefit and any identified specific public benefits without concern that they will be accused of straying from the exclusive goal of creating economic benefits for the shareholders. The later goal does remain a purpose of the corporation which, presumably, the directors may not entirely ignore.

The new law authorizes “benefit enforcement proceedings” by which benefit corporations, either directly or through derivative actions brought by shareholders, may enforce the obligations of the corporation to seek to pursue the general and any identified specific public benefit purpose. The Articles of Incorporation may entitle other specifically named persons to bring these proceedings. No director shall be liable for monetary damages for a failure by the corporation to create a general or specific public benefit.

Benefit corporations will have to strike a balance between pursuing the public benefit purposes of the corporation and its purpose of providing economic benefits to the shareholders. If controlling shareholders are dissatisfied with the balance struck by the directors, they may simply replace the directors. Minority shareholders who are dissatisfied with the balance struck by directors, with the approval of the controlling shareholders, will have little recourse. This issue may be a focus of controversy in the future, in cases where investors with at least some profit motivation feel that the corporation is being operated largely as a charity.

The directors of a benefit corporation are required by law, in connection with every action or proposed action, to consider the impacts of the action on shareholders, employees, customers, the local and global environment, community and societal considerations and various other factors. The law contains complex provisions limiting the liability of directors. There are parallel but different provisions imposing obligations on the officers of benefit corporations and addressing their potential liability.

Benefit corporation status brings with it significant accountability and transparency obligations. Compliance will require significant corporate resources. Each benefit corporation must select a “third-party standard” developed by an independent entity. Third party standard means a “standard for defining, reporting, and assessing overall corporate, social and environmental performance” meeting extensive requirements. Each year, the corporation must deliver an annual benefit report to its shareholders addressing such issues as the process by which its third-party standard was selected, the ways in which the corporation pursued a general public benefit and any specific public benefit during the year and the success of such pursuits, an assessment of the overall social and environmental performance of the corporation prepared in accordance with the third party standard, the names of all persons known to own 5% or more of its shares, a statement indicating whether in the opinion of the Board of Directors the corporation failed to pursue its general, and any specific, public benefits during the year and a statement regarding certain factors that might affect the credibility of the objective assessment of the third party standard. If the corporation has a website, it must post the annual benefit report on the public portion of the website, although it may redact certain information such as the compensation of directors and financial and proprietary information.

Given the compliance obligations imposed on benefit corporations, it seems likely that benefit corporation status will be selected only by companies whose equity holders are either passionately devoted to the use of company resources for the benefit of the public or who perceive that benefit corporation status will provide their company with a compelling competitive advantage in its industry.

Flexible Purpose Corporations

Flexible purpose corporations are corporations organized under §§ 2500-3503 of Corporations Code, the Corporate Flexibility Act of 2011. Except as otherwise expressly stated in the Act, the CGCL applies to flexible purpose corporations. The Act is more extensive than §§ 14600-14631 of the Corporations Code, which govern benefit corporations. Consequently, lawyers familiar with California business corporations have more work to do to figure out how flexible purpose corporations work than they do in the case of benefit corporations. Flexible purpose corporations may be formed as new entities under the Act, and existing legal entities may convert to, or merge into, flexible purpose corporations.

The name of a flexible purpose corporation must contain the words “flexible purpose corporation” or an abbreviation of those words. The Articles of Incorporation must contain a statement that the corporation is a flexible purpose corporation. The Articles must also satisfy length statutory provisions requiring statements concerning the purposes of the corporation, including that the corporation is to engage in business for the benefit of the long-term and short-term interests of the corporation and its shareholders and, generally speaking, that a purpose of the corporation is to engage in one or more activities that involve public benefits.

Fewer hard public benefit requirements are imposed on flexible purpose corporations than on benefit corporations. Flexible purpose corporations do not have to have the purpose of creating general public benefit, they do not need to prepare assessments based on third party standards, their directors are not required to consider any particular public benefit related factors when addressing proposed actions, and there are no provisions authorizing benefit enforcement proceedings. Furthermore, flexible purpose corporations are not subject to any comparable requirements. For this reason, it has been suggested that the flexible purpose corporation structure is more susceptible to use by persons seeking to create a false impression that their companies are devoted to the public good, when in fact they are not - a strategy referred to as “greenwashing” in the field of environmental preservation. Nevertheless, the fact that the flexible purpose corporation structure could be used for a dishonorable purpose does not mean that it cannot also be used advantageously by persons legitimately wishing to fulfill both public benefit purposes and traditional corporate goals in a single entity.

Flexible purpose corporations are required to deliver extensive annual reports to their shareholders. Each report must contain a management discussion and analysis (special purpose MD&A) concerning the corporation's purpose or purposes as set forth in its Articles of Incorporation. The corporation is required to post the special purpose MD&A on its website or to provide it through other similar electronic means. As mentioned, the report does not need to contain an assessment based on an independently developed standard.

It was not so many years ago that states first passed legislation permitted the formation of limited liability companies. Now, apparently, more LLCs are formed every year than corporations. While in a few years many states will probably have authorized entities like benefit corporations and flexible purpose corporations, it seems unlikely that these hybrid entity types will ever achieve the popularity of traditional structures. Nevertheless, for the right company, like Patagonia apparently, they can represent just the right approach to balancing the traditional profit motive with the desire to provide public benefits and to observe principles of accountability and transparency.

Given the complexity of the statutes and the fact that they have been untested in the courts and hardly even in practice, even socially minded entrepreneurs should move cautiously when deciding whether to organize, or reorganize, their companies as benefit corporations or flexible purpose corporations.