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## California's Flexible Purpose Corporation: A Step Forward, a Step Back, or No Step at All?

Christen Clarke

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# CALIFORNIA’S FLEXIBLE PURPOSE CORPORATION: A STEP FORWARD, A STEP BACK, OR NO STEP AT ALL?

*Christen Clarke\**

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## ABSTRACT

The roads of social welfare and commercial enterprise have come to an intersection in recent years. Laws governing corporations are expanding to make room for new forms of business entities that seek to satisfy both social and financial goals. The two most prominent “hybrid” business forms are the Low-

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Profit Limited Liability Company and the Benefit Corporation. The newest hybrid entity to take effect is the Flexible Purpose Corporation, which was introduced in California at the beginning of 2012. With the existence of hybrid organizations that already fit into the mold of Corporations and Limited Liability Companies, is there really a need for this new Flexible Purpose Corporation entity?

## I. INTRODUCTION

In 2009, a social entrepreneur in California sought to install solar panels at a local school.<sup>1</sup> Unfortunately, the businessman could not afford the venture himself, nor appropriately solicit sufficient funding.<sup>2</sup> He sought the help of a skilled lawyer to discover a manner in which to take on the project.<sup>3</sup> Jenny Kassan, an attorney who specialized in “sustainable economies,” developed such a solution.<sup>4</sup> Kassan’s idea created a club for donors to the solar panel project.<sup>5</sup> To attract donors, the club would provide discounts and other benefits for its members to local green businesses.<sup>6</sup> Kassan’s idea, in effect, created a social enterprise.<sup>7</sup> The underlying theory of social entrepreneurship is to identify social problems and form creative solutions. Some states have recently caught on to the concept of social enterprise, and are making an effort to assist entrepreneurs who are a part of the development.

This Comment will explore social enterprise and legislation backing the concept of social entrepreneurship. Specifically, it will unpack a new hybrid entity concept, the Flexible Purpose Corporation. Part II will present the difficulties traditional corporate sectors have experienced in satisfying social needs while remaining sustainable. It will then explain the steps that have been taken to overcome the obstacles. It will also examine different types of hybrid organizations which have been proposed and passed in several states. Part III will introduce a new type of hybrid entity in California: the proposed Flexible Purpose Corporation (FPC). Part IV will compare the FPC with existing hybrid entities. It will present arguments for the advantageous and disadvantageous components of each form. Part V will anticipate the impact this new legislation may have on California, and other states, if it is adopted.

## II. BACKGROUND AND HISTORY

### A. *The Nonprofit and For-Profit Sectors*

Nonprofit and for-profit entities are on opposite ends of the spectrum.

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<sup>1</sup> Bernice Yeung, *Profits with a Purpose*, CAL. LAW. (July 2010), <http://www.callawyer.com/clstory.cfm?pubdt=NaN&eid=910400&evd=1>.

<sup>2</sup> *Id.*

<sup>3</sup> *See id.*

<sup>4</sup> *See id.*

<sup>5</sup> *Id.*

<sup>6</sup> *See id.*

<sup>7</sup> The term “social enterprise” will coincide with the term “social entrepreneurship” throughout this Comment.

Nonprofit entities are required to promote public purposes and are forbidden from distributing profits to private owners.<sup>8</sup> In contrast, for-profit entities are required to maximize the profits of their owners, and have no duty to those with no interest in the business.<sup>9</sup> In the modern era, neither the nonprofit nor the for-profit sector has dominated the “market” of public service in the United States.<sup>10</sup>

Nonprofits have a fiscal incentive to provide for social welfare through the benefit of tax exemption.<sup>11</sup> In order to gain exemption from federal taxes, a nonprofit organization “must be organized and operated exclusively for exempt purposes set forth in [Internal Revenue Code] section 501(c)(3), and none of its earnings may inure to any private shareholder or individual.”<sup>12</sup> There are exceptions as to which activities of a nonprofit may be exempt.<sup>13</sup>

The central exception arises from unrelated business taxable income (UBTI).<sup>14</sup> Under the UBTI concept, income of a nonprofit is subject to an income tax if profit is gained from a regularly carried on trade or business that is “not substantially related to the nonprofit’s performance of its exempt function.”<sup>15</sup> Thus, it is important that nonprofit organizations strictly adhere to their mission. Despite the tax benefit, and because of the limits created by UBTI, nonprofits are limited in their ability to raise capital.<sup>16</sup> As a result, they are hindered in becoming fully sustainable.<sup>17</sup> In order to attract capital from private parties, many exempt

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<sup>8</sup> Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Non-For-Profit Hospitals*, 50 UCLA L. REV. 1345, 1377 (2003).

<sup>9</sup> Anthony Bisconti, Note, *The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?*, 42 LOY. L.A. L. REV. 765, 765 (2009).

<sup>10</sup> See WALTER W. POWELL & RICHARD STEINWELL, THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 151–52 (2d ed. 2006) (“In many markets, nonprofit providers of service function alongside for-profit and/or government providers.”). The authors go on to give statistics on the presence of each sector in several industries. *Id.* at 152.

<sup>11</sup> Horwitz, *supra* note 8, at 1382; Robert R. Keatinge, *LLCs and Nonprofit Organizations: For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 556 (2009).

<sup>12</sup> I.R.C. § 501(c)(3) (West 2010); *Exemption Requirements—Section 501(c)(3) Organizations*, IRS, <http://www.irs.gov/charities/charitable/article/0,,id=96099,00.html> (last updated Jan. 30, 2012) [hereinafter *Exemption Requirements*]. The exempt purposes are: “charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals.” *Exempt Purposes—Internal Revenue Code Section 501(c)(3)*, IRS, <http://www.irs.gov/charities/charitable/article/0,,id=175418,00.html> (last updated Jan. 10, 2012).

<sup>13</sup> Keatinge, *supra* note 11, at 566.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 560. The elements for UBTI are: “(1) . . . income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related to the organization’s performance of its exempt function.” *Id.* For a discussion on exempt organizations and unrelated business taxable income, see *id.* at 560–62.

<sup>16</sup> See Michael D. Gottesman, Comment, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 YALE L. & POL’Y REV. 345, 347–48 (2007).

<sup>17</sup> See M. Gregg Bloche, *Health Policy Below the Waterline: Medical Care and the Charitable Exemption*, 80 MINN. L. REV. 299, 321 (1995) (“Nonprofit organizations are not able to distribute profits to contributors of capital, diminishing their ability to raise capital.”); Gottesman, *supra* note 16, at 347–48; Michelle Scholastica Paul, *Bridging the Gap to the Microfinance Promise: A Proposal for a Tax-Exempt Microfinance Hybrid Entity*, 42 N.Y.U. J. INT’L L. & POL. 1383, 1395 (2010).

organizations are eligible to provide tax deductions for donors.<sup>18</sup>

On the other hand, for-profit entities generally have the potential to access unlimited capital.<sup>19</sup> However, their role in achieving social goals is hindered, in essence, because of the fiduciary duty that corporate directors have toward their shareholders.<sup>20</sup> Thus, when faced with a decision between an action that benefits the public or increases shareholder wealth, for-profits must choose the latter or risk legal action by the shareholders.<sup>21</sup> Another factor that contributes to the deficiency of for-profits promoting social welfare is the lack of a customary method to display their commitment to public good and accountability.<sup>22</sup> While the inadequacy of nonprofits results from tax implications, for-profits can only be as charitable as their shareholders allow.<sup>23</sup> In addition, the Internal Revenue Service (IRS) places a limitation on the amount of deductions a for-profit corporation can claim at ten percent of its taxable income.<sup>24</sup>

### B. Corporations and LLCs

Corporations<sup>25</sup> and partnerships<sup>26</sup> preceded Limited Liability Companies (LLCs) as business entities.<sup>27</sup> There was a gap between the original corporation and partnership entities, which some have called the “tax shield conundrum.”<sup>28</sup> This dilemma refers to the impossibility of having the “tax status of a partnership and the liability shield of a corporation”; a feat that was unachievable before the creation of the LLC.<sup>29</sup> Owners of a partnership are wholly liable for all debts of the entity.<sup>30</sup> On a positive note, the partnership is not taxable and tax liability

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<sup>18</sup> *Exemption Requirements*, *supra* note 12.

<sup>19</sup> Gottesman, *supra* note 16, at 346 (explaining that Google.org’s for-profit status allows it to raise equity capital).

<sup>20</sup> Alissa Mickels, Note, *Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with the Director Fiduciary Duties in the U.S. and Europe*, 32 HASTINGS INT’L & COMP. L. REV. 271, 282 (2009).

<sup>21</sup> *Id.*

<sup>22</sup> Gottesman, *supra* note 16, at 351.

<sup>23</sup> ALLEN R. BROMBERGER, SOCIAL ENTERPRISE: A LAWYER’S PERSPECTIVE 2 (2008), available at <http://www.perlmanandperlman.com/publications/articles/2008/socialenterprise.pdf>.

<sup>24</sup> I.R.C. § 170(b)(2)(A) (West 2010).

<sup>25</sup> At the heart of corporate structure are “a board of directors that oversees the management of the corporation, and shareholder decisions decided by majority rule.” Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 DEL. J. CORP. L. 377, 384 (2004).

<sup>26</sup> According to the Uniform Partnership Act, “[a] partnership is an association of two or more persons to carry on as co-owners a business for profit.” UNIF. P’SHIP ACT § 6(1) (1914). A formal written document is not needed for formation of a partnership, where one is required in other entity forms. Joseph S. Naylor, Note, *Is the Limited Liability Partnership Now the Entity of Choice for Delaware Law Firms?*, 24 DEL. J. CORP. L. 145, 147 (1999). This type of entity is typically best for very closely-held enterprises. Larry E. Ribstein, *LLCs: Is the Future Here?*, 13 BUS. L. TODAY 11, 11 (2003). “[T]he owners equally share control, profits, losses and partnership property.” *Id.*

<sup>27</sup> See Larry E. Ribstein & Bruce E. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 81 (2001).

<sup>28</sup> Daniel S. Kleinberger, *A Myth Deconstructed: The “Emperor’s New Clothes” on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 886 (2010).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 887.

passes through to the owners.<sup>31</sup> Conversely, shareholders of a corporation are shielded from total liability of debt.<sup>32</sup> They are liable only to the extent of their investment.<sup>33</sup> However, corporations are doubly taxed.<sup>34</sup> Double taxation causes the corporation to be taxed initially on its profits, while the shareholders are also taxed on their dividends.<sup>35</sup> As a for-profit entity, a corporation, under the management of its directors, is bound to pursue the greatest amount of wealth for its shareholders.<sup>36</sup> Failure to do so can result in directors being held personally liable in lawsuits filed by the shareholders.<sup>37</sup>

In order to close this gap, Wyoming became the first state to pass LLC legislation in 1977.<sup>38</sup> Now, every state has statutorily enabled LLCs.<sup>39</sup> LLCs have been considered a type of hybrid entity.<sup>40</sup> As a hybrid of corporations and partnerships, LLCs have appeal both in taxation and shielded liability.<sup>41</sup> Like a partnership, all of the income taxes on the revenue fall on its members;<sup>42</sup> the LLC itself is not liable.<sup>43</sup> Members are also able to “participate actively in the

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<sup>31</sup> *Id.*

<sup>32</sup> Catherine Ann Hilbert, Comment, *United States v. Bestfoods: Parent Corporation Liability Under CERCLA*, 24 DEL. J. CORP. L. 919, 922 (1999).

<sup>33</sup> *Id.* Hilbert explains the concept of piercing the corporate veil, which would open an investor up to total liability. *Id.* See generally Timothy P. Glynn, *Beyond “Unlimiting” Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329 (2004).

<sup>34</sup> Kleinberger, *supra* note 28, at 887.

<sup>35</sup> *Id.*

<sup>36</sup> Mickels, *supra* note 20, at 282.

<sup>37</sup> *Id.*

<sup>38</sup> Thomas M. Madden, *Do Fiduciary Duties of Managers and Members of Limited Liability Companies Exist As With Majority Shareholders of Closely Held Corporations?*, 12 DUQ. BUS. L.J. 211, 215 (2010).

<sup>39</sup> Kleinberger, *supra* note 28, at 886; Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW. 499, 499 (2001). The founders of an LLC must file articles of organization, rather than articles of incorporation as a corporation must do, with the state. Naylor, *supra* note 26, at 150. An LLC can generally “engage in any lawful business.” *Id.*

<sup>40</sup> *Great Lakes Chem. Corp. v. Monsanto Co.*, 96 F. Supp. 2d 376, 383 (D. Del. 2000) (“LLCs are hybrid entities that combine desirable characteristics of corporations, limited partnerships, and general partnerships.”); *Nw. Energetic Servs., L.L.C. v. Cal. Franchise Tax Bd.*, 159 Cal. App. 4th 841, 852 (Ct. App. 2008) (“An LLC is a hybrid entity that offers certain advantages over corporations and partnerships, by combining aspects of each.”); *Lieberman v. Wyoming.com LLC*, 11 P.3d 353, 357 (Cal. Ct. App. 2000) (“As a business entity, limited liability companies are a conceptual hybrid, sharing some of the characteristics of partnerships and some of corporations.”); Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 370 (2009); Kleinberger, *supra* note 28, at 886.

<sup>41</sup> Jonathan R. Macey, *F. Hodge O’Neal Corporate and Securities Law Symposium: Limited Liability Companies: The Limited Liability Company: Lessons for Corporate Law*, 73 WASH. U. L. Q. 433, 434 (1995) (“[T]he purpose of forming [an LLC] is to create an entity that offers investors the protections of limited liability and the flow-through tax status of partnerships.”); Murdock, *supra* note 39, at 499.

<sup>42</sup> Rather than partners or shareholders, owners of an LLC are called members. Kleinberger, *supra* note 28, at 888; Naylor, *supra* note 26, at 150.

<sup>43</sup> See Kelley, *supra* note 40, at 370; Kleinberger, *supra* note 28, at 886–87. LLCs have the tax status of a partnership. *Id.* at 886. Partnerships are not taxable entities and experience pass-through taxation. Kleinberger, *supra* note 28, at 887. Essentially, “[p]artnership profits . . . are deemed to pass through to the partners, at which level they are taxed but once.” *Id.*

management of the organization,” creating an advantage over corporations.<sup>44</sup> In addition, LLCs can create a mission of social good instead of maximizing profits.<sup>45</sup> Similar to a corporation, LLC members have limited liability, and are liable to the entity only to the extent of their investment.<sup>46</sup>

LLCs are considered to have several advantages over corporations, which have made them attractive to some entrepreneurs.<sup>47</sup> Among the biggest advantage is the ability to limit fiduciary duties through the articles of organization or a contract.<sup>48</sup> The corporation had long been the dominant business entity filed in the U.S., even before the first general corporation statute was enacted in 1811 by the state of New York.<sup>49</sup> In recent years, the LLC has been on the rise, and now surpasses the number of corporations formed in the country each year.<sup>50</sup> However, corporations are still the dominant structure of nonprofit organizations and publicly traded companies.<sup>51</sup>

### C. Constituency Statutes

Many states offer constituency statutes,<sup>52</sup> yet California is not one of those states.<sup>53</sup> Constituency statutes generally allow directors to “consider interests

<sup>44</sup> *Nw. Energetic Servs. L.L.C.*, 159 Cal. App. 4th at 852.

<sup>45</sup> Celia R. Taylor, *Carpe Crisis: Capitalizing on the Breakdown of Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. SCH. L. REV. 743, 752 (2009/2010).

<sup>46</sup> See Kleinberger, *supra* note 28, at 886; Macey, *supra* note 41, at 435.

<sup>47</sup> Taylor, *supra* note 45, at 751; see also Kelley, *supra* note 40, at 370–71.

<sup>48</sup> Taylor, *supra* note 45, at 751–52. The author asserts that “LLC organizers may contractually limit or eliminate fiduciary duties of owners and members to each other, to the entity, and to any third party to the LLC’s operating agreement.” *Id.* at 751. Other advantages include flexibility in management structure and exemption from federal regulations imposed upon publicly traded corporations. *Id.* at 751; see also Kelley, *supra* note 40, at 370.

<sup>49</sup> Rodney D. Chrisman, Essay, *LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2010).

<sup>50</sup> *Id.*; Kleinberger, *supra* note 28, at 886.

<sup>51</sup> Chrisman, *supra* note 49, at 462.

<sup>52</sup> Bisconti, *supra* note 9, at 780. Pennsylvania was the first state to pass a constituency law in 1983. *Id.* at 781. Pennsylvania’s statutory language served as a model for other states to follow. Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 27 (1992). It reads:

In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate: (1) The 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. (2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation. (3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation. (4) All other pertinent factors.

15 PA. CONS. STAT. § 1715(a)(1)–(4) (1995). For an in-depth analysis on the concept of constituency statutes, see generally Orts, *supra*.

<sup>53</sup> Bisconti, *supra* note 9, at 796 (addressing California’s failed attempt to pass a constituency bill).

other than those of their shareholders when exercising their corporate decision-making authority.”<sup>54</sup> The statutes facially look after the welfare of non-shareholders whose interests are taken into consideration by the corporation’s directors. However, the benefit is practically directed toward corporate directors, who are shielded from some personal liability if they consider non-shareholder interests in making decisions.<sup>55</sup>

Constituency statutes have been discredited because they merely permit, rather than mandate, directors to take non-shareholder interests into account.<sup>56</sup> Therefore, corporations can ignore non-shareholder interests altogether.<sup>57</sup> They have also been criticized for being limited in their application.<sup>58</sup> Enforcement of constituency statutes is a contended issue as well.<sup>59</sup>

#### *D. Social Enterprise and Hybrid Organizations*

Social entrepreneurship has been developing as a movement in recent years, aiming to create sustainable organizations that identify social problems and specific solutions.<sup>60</sup> A social enterprise can take many different forms, but is generally structured as either a mission-oriented, for-profit entity or a business-oriented, nonprofit entity.<sup>61</sup> The term “social entrepreneur” was coined by Bill

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<sup>54</sup> *Id.* at 781–82; *see also* BRYAN HARRIGAN, CORPORATE SOCIAL RESPONSIBILITY IN THE 21ST CENTURY: DEBATES, MODELS AND PRACTICES ACROSS GOVERNMENT, LAW AND BUSINESS 207 (2009).

<sup>55</sup> *See* Lynda J. Oswald, *Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause*, 24 J. CORP. L. 1, 3 (1998).

<sup>56</sup> Bisconti, *supra* note 9, at 783. *But see* CONN. GEN. STAT. ANN. § 33-756 (West 1994) (requiring directors to consider non-shareholder interests). Still, enforcement of the provision is lacking. Bisconti, *supra* note 9, at 783.

<sup>57</sup> Bisconti, *supra* note 9, at 783.

<sup>58</sup> Mickels, *supra* note 20, at 292 (“Most constituency statutes limit the definition of stakeholder constituents to include customers, suppliers, employees, creditors or the community around which a company’s office is located. This narrow definition does not include the international community, environmental concerns or broader human rights concerns. Consequently, decisions made in the interest of the broader local community are considerably risky in nature.”).

<sup>59</sup> Oswald, *supra* note 55, at 3 (“[T]he statutes make no provision for enforcement or monitoring by the constituency groups whose interests are presumably protected by the statutes.”); *see* Bisconti, *supra* note 9, at 784. Bisconti argues that courts have interpreted them “in such a way as to fit them into the well-established . . . traditional-duty analysis.” Bisconti, *supra* note 9, at 784. The traditional analysis to which he refers is that of requiring shareholder maximization. *See id.* at 780. Bisconti also asserts that constituency statutes will not affect decisions made by corporate directors. *Id.* at 798–99. His argument comes, in part, in response to the inability of constituents to bring a cause of action against corporate directors for failing to act in the constituents’ interests. *Id.* at 783. He states that “[t]he lack of an enforcement mechanism leaves directors little choice but to fall back on the traditional framework because there is only the risk of a breach of duty claim.” *Id.* at 799. Setting a value on constituency statutes, Bisconti states that they “function only to the extent that they do not conflict with shareholder primacy.” *Id.* at 784.

<sup>60</sup> It has been characterized as a profession, a field, and a movement. DAVID BORNSTEIN & SUSAN DAVIS, SOCIAL ENTREPRENEURSHIP: WHAT EVERYONE NEEDS TO KNOW 1 (2010). The authors define social entrepreneurship as “a process by which citizens build or transform institutions to advance solutions to social problems.” *Id.*

<sup>61</sup> *See* Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 59 (2010); Gottesman, *supra* note 16, at 345–46. *See also* BROMBERGER, *supra* note 23, at 1 (listing many forms including: “business corporations, nonprofit corporations, for-profit subsidiaries of nonprofit entities, ‘captive’ charities created by business corporations, [and] joint ventures”).



Drayton,<sup>62</sup> and became known more widely from its use by Ashoka, Drayton's nonprofit organization.<sup>63</sup> A common problem among social entrepreneurs is determining which legal form is best for their venture.<sup>64</sup>

A modern trend is to create a for-profit entity with a focus on the double or triple bottom-line.<sup>65</sup> The three bottom-line interests are "economic prosperity, environmental quality, and social justice."<sup>66</sup> This concept is commonly called a hybrid organization.<sup>67</sup> In theory, this type of organization treads against the very essence of the for-profit motive.<sup>68</sup> The traditional for-profit entity is generally bound to act in the best interest of the shareholders.<sup>69</sup> For the hybrid organization, the benefit to the stakeholder is the dominant purpose, and the company may not act if this purpose is not met.<sup>70</sup> In general, stakeholders include "employees, suppliers, the community, the environment, and shareholders."<sup>71</sup>

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<sup>62</sup> Caroline Hsu, *Entrepreneur for Social Change*, U.S. NEWS (Oct. 21, 2005), <http://www.usnews.com/usnews/news/articles/051031/31drayton.htm>.

<sup>63</sup> BORNSTEIN, *supra* note 60, at 18. Ashoka is an organization dedicated to the support and networking of social entrepreneurs, and expansion of the sector. See generally ASHOKA: INNOVATORS FOR THE PUBLIC, <http://www.ashoka.org> (last visited Mar. 28, 2012). The organization was founded in 1980. *Id.* It now supports over 2,000 fellows, financially and otherwise, who are social entrepreneurs in a variety of ventures. *Id.*

<sup>64</sup> BROMBERGER, *supra* note 23, at 2.

<sup>65</sup> One law journal article proposed a new type of entity, the not-for-loss corporation. Jay Milbrandt, Comment, *A New Form of Business Entity is Needed to Promote Social Entrepreneurship: The Not-For-Loss Corporation*, 1 J. BUS. ENTREPRENEURSHIP & L. 421, 422 (2008). Milbrandt also characterized this hypothetical entity as a hybrid of for-profit and nonprofit entities. *Id.* at 439. For the not-for-loss corporations, he proposed an expansion of the purposes in which nonprofits are now limited, to include "social purposes." *Id.* at 440. However, the "social purposes" definition would still be limited in scope. *Id.* "The not-for-loss corporation [w]ould return money to investors and reinvest the would-be-profit in itself," however the return on investment would be capped at some point. *Id.* at 439-40. Milbrandt proposed that equity investors would receive a tax break, creating incentive to invest in such a corporation. *Id.* at 439. Ultimately, the not-for-loss corporation would require a "primary social purpose." *Id.* at 440.

<sup>66</sup> Judd F. Sneirson, *Green is Good: Sustainability, Profitability, and a New Paradigm for Corporate Governance*, 94 IOWA L. REV. 987, 991 (2009). The interests are more commonly referred to as "people, planet, and profit." *Id.* at 991 n.12; Peter Madsen, *Professional, Business Practitioners, and Prudential Justice*, 39 MCGEORGE L. REV. 835, 840 (2008); Seema G. Sharma, *Corporate Social Responsibility in India: An Overview*, 43 INT'L LAW. 1515, 1529 (2009); Paulette L. Stenzel, *Free Trade and Sustainability Through the Lens of Nicaragua*, 34 WM. & MARY ENVTL. L. & POL'Y REV. 653, 658 n.20 (2010).

<sup>67</sup> Hybrid organization is a very suitable name. One entity, the L3C, has been referred to as a "for-profit [entity] with [a] nonprofit soul," thus a hybrid of for-profits and not-for-profits. *Frequently Asked Questions*, AMERICANS FOR COMMUNITY DEVELOPMENT, <http://www.americansforcommunitydevelopment.org/faqs.php> (last visited Mar. 28, 2012) (follow "1. What is the L3C?" hyperlink).

<sup>68</sup> "The social responsibility of business is to increase its profits." Rakhi I. Patel, *Facilitating Stakeholder-Interest Maximization: Accommodating Beneficial Corporations in the Model Business Corporation Act*, 23 ST. THOMAS L. REV. 135, 136 (2010) (quoting Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAGAZINE (Sept. 13, 1970), <http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>).

<sup>69</sup> Matthew F. Doeringer, Note, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291, 303-04 (2010) ("Once a company issues shares, its board and its officers are obligated to look after the interests of the shareholders over all other constituencies."). See also Mickels, *supra* note 20, at 282.

<sup>70</sup> Patel, *supra* note 68, at 146.

<sup>71</sup> *Id.* A Minnesota bill identifies stakeholders as shareholders, employees, customers, suppliers, and creditors. *Id.* at 150.

Hybrid entities do not receive any tax benefit,<sup>72</sup> but are able to gain capital through investments and distribute money to individuals.<sup>73</sup> They are also able to receive funding from nonprofit, grant-making organizations.<sup>74</sup> This opens the floodgates to hybrid organizations and allows financial support to come from countless avenues.<sup>75</sup>

Hybrid organizations have received some raised eyebrows from those who doubt that an entity whose primary focus is stakeholders, rather than shareholders, can generate capital from traditional investors.<sup>76</sup> There are others who consider it impossible for corporate decisions to have both positive societal and financial impacts without jeopardizing substantial capital.<sup>77</sup>

### *E. Related Hybrid Entities*

Some states have already adopted legislation in support of hybrid organizations, and many are considering such proposals.<sup>78</sup> California's

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<sup>72</sup> The city of Philadelphia will soon award a tax credit to a limited number of businesses, which include certified B Corporations, in the near future. City of Phila. B. No. 090119-A (Phila. 2009) (enacted), available at <http://www.bcorporation.net/resources/bcorp/documents/Philadelphia%20Certified%20Sustainable%20Business%20Ordinance.pdf>. B Corporations will be discussed *infra*, Part II.E.3. One scholar has argued that for-profit microfinance institutions should receive a tax break. Paul, *supra* note 17 (proposing a new hybrid entity, the Microfinance Limited Partnership). She recognizes that such institutions would be better served as for-profit entities to increase efficiency and capital. *Id.* at 1392. Paul also notes that a microfinance institution would perform essentially the same function whether it is for profit or not for profit: "provid[ing] public goods that governments would otherwise have to supply." *Id.* at 1393. Therefore, she contended that for-profit microfinance institutions should be entitled to the same tax treatment as their nonprofit counterparts. *Id.*

<sup>73</sup> See Doeringer, *supra* note 69, at 316 ("the L3C . . . allows the company to issue equity to raise capital"); Kelley, *supra*, note 40, at 344 n.21 (stating that hybrid entities may "distribute part of their profits to their owners"); Taylor, *supra* note 45, at 761 (explaining that L3Cs are able to distribute profits to investors). L3Cs will be discussed *infra*, Part II.E.2.

<sup>74</sup> Cassidy V. Brewer & Michael J. Rhim, *Using the "L3C" for Program-Related Investments*, 21 TAX'N EXEMPT 11, 11 (2009); Taylor, *supra* note 45, at 762 (stating that L3Cs may receive program-related investments).

<sup>75</sup> See Brewer & Rhim, *supra* note 74, at 11 ("The L3C was created to facilitate the flow of both private and philanthropic capital to ventures that provide a social benefit."); Doeringer, *supra* note 69, at 316 (stating that social enterprises can raise "a significant amount of capital").

<sup>76</sup> See Doeringer, *supra* note 69, at 303 ("Choosing to operate a business with a social purpose often involves making choices that can lower the potential to generate economic profits."). Doeringer concludes his article by arguing that "the L3C's value will only be realized if government policies stimulate capital flows to these organizations and build increased public awareness of the benefits the social-enterprise sector can provide." *Id.* at 324. See generally Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619 (2010). Reiser argues that the ability of hybrid organizations to gain sufficient capital will depend on a number of factors. *Id.* She references critics who suggest that the IRS is reluctant to issue a blanket ruling allowing L3Cs to pre-qualify for program-related investments. *Id.* at 647. If the IRS were to do so, this would eliminate the cost of obtaining a private letter ruling when investing in an L3C, potentially attracting more funding from foundations. *Id.* at 646-47. Addressing B Corporations, Reiser believes they are "unlikely to be able to gain broad access to donations." *Id.* at 650. She argues that their ability to increase capital "depends largely on the success of its branding efforts and the size of the market for [similar] investments." *Id.*

<sup>77</sup> See Friedman, *supra* note 68 (arguing that pursuing social good will only come at the cost of the business).

<sup>78</sup> See, e.g., ME. REV. STAT. ANN. tit. 31, § 1611 (2010); MD. CODE ANN., CORPS. & ASS'NS § 5-6C-06 (West 2010); H.B. 594, 151st Gen Assemb., Reg. Sess. (Ga. 2011); S.B. 3011, 2011 Leg., Reg. Sess. (N.Y. 2011).

prospective Flexible Purpose Corporation, however, will be the first of its particular kind.<sup>79</sup> The subsections that follow will detail other types of corporate structures that are similar in nature and purpose to the FPC.

### 1. Social Businesses

Muhammad Yunus, founder of Grameen Bank, has his own take on social enterprise.<sup>80</sup> He introduced the social business, which he classifies as a subset of social entrepreneurship.<sup>81</sup> Yunus describes a social business as a method of using the for-profit structure to satisfy social goals.<sup>82</sup> Like other hybrid entities, a social business would be required to be “created and run for the express purpose of pursuing specific, articulated social goals, rather than maximizing profit.”<sup>83</sup> Yunus distinguishes his idea from charities by asserting that social businesses must recover all costs.<sup>84</sup>

Yunus has presented two types of social businesses.<sup>85</sup> The first is a standard business, but with a social purpose.<sup>86</sup> This form he calls a “non-loss, non-dividend business.”<sup>87</sup> It can be more attractive to investors than making a contribution to a nonprofit organization because it provides them with a return equal to their investment.<sup>88</sup> However, it does not distribute dividends to its investors, so the return is strictly limited to the amount of the investment.<sup>89</sup> Any profits are reinvested into the company, thus providing more capital to carry out the social purpose of the business.<sup>90</sup>

The second type of social business that Yunus identifies puts the business in the hands of the poor or disadvantaged.<sup>91</sup> Here, the shares are owned by the poor or disadvantaged, so profits will be realized by that class of persons.<sup>92</sup> An example of this type of entity exists in Yunus’ own venture, Grameen Bank.<sup>93</sup> Grameen Bank was created in 1983 for the benefit of the poor population in Bangladesh.<sup>94</sup> It operates by providing members of the community with small

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<sup>79</sup> Kyle Westaway, *Flexible Purpose Corporation Bill Introduced in CA*, SOCENT LAW (Feb. 9, 2011), <http://socentlaw.com/2011/02/flexible-purpose-corporation-bill-introduced-in-ca/>.

<sup>80</sup> See Taylor, *supra* note 45, at 767.

<sup>81</sup> MUHAMMAD YUNUS, CREATING A WORLD WITHOUT POVERTY: SOCIAL BUSINESS AND THE FUTURE OF CAPITALISM 32 (2007).

<sup>82</sup> *Id.* at 21–22.

<sup>83</sup> Taylor, *supra* note 45, at 767.

<sup>84</sup> YUNUS, *supra* note 81, at 22.

<sup>85</sup> *Id.* at 28. Yunus notes that it is possible to maintain a social business in both forms simultaneously. *Id.* at 30.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 24.

<sup>88</sup> *Id.* In order to do so, the company may not incur losses indefinitely. *Id.* at 28. Thus, profit is still a goal, but takes a back seat to the social purpose.

<sup>89</sup> YUNUS, *supra* note 81, at 24.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* at 28. In other words, “a social business by virtue of its ownership structure.” *Id.* at 30.

<sup>92</sup> See *id.* at 29.

<sup>93</sup> *Id.* at 30.

<sup>94</sup> YUNUS, *supra* note 81, at 44–48. Poor Bangladeshi women were the target population. *Id.*

loans, which they can use in their own businesses, a practice of microfinance.<sup>95</sup> The loans were made available without the obstacles of collateral, credit history, or any legal documents.<sup>96</sup>

## 2. L3Cs

Robert Lang<sup>97</sup> introduced the Low-Profit Limited Liability Company (L3C) model in 2005 in an effort to increase and diversify capital of organizations pursuing a socially beneficial purpose.<sup>98</sup> Lang, along with Marcus Owens,<sup>99</sup> hoped to establish a for-profit entity that would attract more funding from private foundations.<sup>100</sup> One hurdle in the progression of L3Cs is the current refusal of the IRS to definitively recognize gifts by private foundations to L3Cs as a tax-free contribution.<sup>101</sup>

A foundation is compelled to invest in or grant money to organizations that further its primary purpose or suffer a tax penalty.<sup>102</sup> Program related investments (PRIs) allow foundations to make contributions that are not taxed by the IRS, and they allow the foundation an opportunity to make a return on its investment.<sup>103</sup> PRIs must meet the following requirements: (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.<sup>104</sup> If an exempt organization makes a distribution contrary to these requirements, any return will qualify as UBTI.<sup>105</sup> The L3C theoretically makes the decision for exempt organizations to invest in for-profits easier by placing the primary social purpose in its articles of organization, and holding the L3C to that purpose.<sup>106</sup> Private foundations may

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<sup>95</sup> *Id.* at 48–52.

<sup>96</sup> *Id.* at 48.

<sup>97</sup> Lang is the CEO of The Mary Elizabeth and Gordon B. Mannweiler Foundation. David J. Schwister, Note, *L3Cs: The Next Big Wave in Socially Responsible Investing or Just Too Good to Be True?*, 3 J. BUS. ENTREPRENEURSHIP & L. 1, 3 (2009).

<sup>98</sup> See Brewer & Rhim, *supra* note 74, at 11; Robert Lang & Elizabeth Carrott Minnigh, *The L3C, History, Construct, and Legal Framework*, 35 VT. L. REV. 15, 15–16 (2010).

<sup>99</sup> Lang sought the assistance of Owens to draft the L3C legislation in order to best align with IRS requirements. Owens worked for the IRS for ten years, as head of the Exempt Organizations Division. Gottesman, *supra* note 16, at 357; Keatinge, *supra* note 11, at 582.

<sup>100</sup> James R. Hines Jr., Jill R. Horwitz & Austin Nichols, *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1189 (2010). See also Kleinberger, *supra* note 28, at 883–85; Lang & Minnigh, *supra* note 98, at 25; *The Concept of the L<sup>3</sup>C*, AMERICANS FOR COMMUNITY DEVELOPMENT, <http://americansforcommunitydevelopment.org/concept.php> (last visited Mar. 28, 2012).

<sup>101</sup> See Kleinberger, *supra* note 28, at 908; see generally, J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273 (2010).

<sup>102</sup> See Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment By Proxy or Perversion?*, 63 ARK. L. REV. 243, 252 (2010).

<sup>103</sup> Brewer & Rhim, *supra* note 74, at 12; *The Concept of the L<sup>3</sup>C*, *supra* note 100. See Hines et al., *supra* note 100, at 1188 (“A PRI is a combination of a grant and an investment.”).

<sup>104</sup> Bishop, *supra* note 102, at 249.

<sup>105</sup> See Keatinge, *supra* note 11, at 560–62.

<sup>106</sup> Taylor, *supra* note 45, at 762.

then be more confident that their investments qualify as PRIs, and will not later be taxed.<sup>107</sup>

The L3C concept appeals primarily to profit-seeking investors by allocating different levels of risk and reward.<sup>108</sup> In the L3C model, foundations are generally expected to accept the highest risk, resulting in the lowest rate of return.<sup>109</sup> Instead of making a traditional grant, which will provide no return, they are able to have the possibility of a return on their invested capital.<sup>110</sup> Other investments are of normal market risk, and financiers can expect a higher return.<sup>111</sup>

The L3C was the first hybrid organization to become recognized by law.<sup>112</sup> Rather than creating a new and separate entity, the L3C has been classified as a subset of the traditional LLC.<sup>113</sup> Several state legislatures have amended their LLC statutes to define and regulate L3Cs.<sup>114</sup> One drawback for shareholders is that L3Cs are subject to tax in the same way as LLCs.<sup>115</sup> The L3C itself is not taxed.<sup>116</sup> Instead, the burden falls on the shareholders, whom are taxed according to their respective share of the L3C's income.<sup>117</sup>

Each state that recognizes L3Cs generally has the same basic statutory parts.<sup>118</sup> First, they require significant furtherance of a charitable or educational purpose as set forth in IRS provisions that generally govern nonprofit organizations, and that purpose must have caused the formation of the company.<sup>119</sup> Next, no significant purpose can be to produce income; however, substantial profit alone is insufficient to show that the production of income is a significant purpose.<sup>120</sup> The last of the basic requirements bans any political or legislative

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<sup>107</sup> *Id.*

<sup>108</sup> Bishop, *supra* note 102, at 263; *The Concept of the L<sup>3</sup>C*, *supra* note 100. See also Brewer & Rhim, *supra* note 74, at 11; Kleinberger, *supra* note 28, at 884.

<sup>109</sup> Bishop, *supra* note 102, at 263; *The Concept of the L<sup>3</sup>C*, *supra* note 100. See also Brewer & Rhim, *supra* note 74, at 11.

<sup>110</sup> See Kleinberger, *supra* note 28, at 885.

<sup>111</sup> Bishop, *supra* note 102, at 263; *The Concept of the L<sup>3</sup>C*, *supra* note 100. See also Brewer & Rhim, *supra* note 74, at 11.

<sup>112</sup> Hines et al., *supra* note 100, at 1189. Vermont, in 2008, was the first state to pass legislature recognizing L3Cs. Kelley, *supra* note 40, at 376. See VT. STAT. ANN. tit. 11, § 3001(27) (2010). Several other states have followed suit, including: Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, and Wyoming. *Laws*, AMERICANS FOR COMMUNITY DEVELOPMENT, <http://www.americansforcommunitydevelopment.org/laws.php> (last visited Mar. 28, 2012).

<sup>113</sup> Brewer & Rhim, *supra* note 74, at 11; Lang & Minnigh, *supra* note 98, at 20; *Laws*, *supra* note 112.

<sup>114</sup> Kelley, *supra* note 40, at 376.

<sup>115</sup> Brewer & Rhim, *supra* note 74, at 15.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* Lang recognizes two other problems with the L3C—"misinformation and [a] lack of information." Lang & Minnigh, *supra* note 98, at 29. However, he does hope that people will give the entity a chance to prove its worth. *Id.* at 30. He also suggests that people "do not stifle them before they have a chance to blossom." *Id.*

<sup>118</sup> Taylor, *supra* note 45, at 762 (noting that the Vermont statute is "representative of other jurisdictions").

<sup>119</sup> Bishop, *supra* note 102, at 247. See, e.g., 805 ILL. COMP. STAT. 180/1-26 (2010); ME. REV. STAT. ANN. tit. 31, § 1611 (2010); MICH. COMP. LAWS ANN. § 450.4102(2)(m) (West 2010); VT. STAT. ANN. tit. 11, § 3001(27)(C) (2010).

<sup>120</sup> See Bishop, *supra* note 102, at 247. VT. STAT. ANN. tit. 11, § 3001(27)(B) (2010) ("No

purpose from being a goal of the company.<sup>121</sup> These statutes also generally require that the L3C or purpose designation be stated in the articles of incorporation or its equivalent.<sup>122</sup>

### 3. *Benefit Corporations*

The nonprofit organization B Lab<sup>123</sup> is responsible for the recent additions to the business corporations statutes of Maryland, Vermont, and several other states.<sup>124</sup> B Lab was created in an effort to develop a new economic sector that “uses the power of business to solve social and environmental problems.”<sup>125</sup> Certification as a B Corporation has been attractive to some businesses because it brands them as a “good company.”<sup>126</sup>

Pennsylvania has not passed a state law recognizing B Corporations as a

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significant purpose of the company is the production of income or the appreciation of property; provided, however, that 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.”). *See also* 805 ILL. COMP. STAT. 180/1-26 (2010); ME. REV. STAT. ANN. tit. 31, § 1611 (2010); MICH. COMP. LAWS ANN. § 450.4102(2)(m) (West 2010).

<sup>121</sup> Bishop, *supra* note 102, at 247–48. *See, e.g.*, 805 ILL. COMP. STAT. 180/1-26 (2010); ME. REV. STAT. ANN. tit. 31, § 1611 (2010); MICH. COMP. LAWS ANN. § 450.4102(2)(m) (West 2010); VT. STAT. ANN. tit. 11, § 3001(27) (C) (2010). Note that these requirements are parallel to those of the PRI. *See supra* text accompanying note 104

<sup>122</sup> *See, e.g.*, 805 ILL. COMP. STAT. 180/1-26(b) (2010); MICH. COMP. LAWS ANN. § 450.4102(2)(m) (West 2010); VT. STAT. ANN. tit. 11, § 3023(a) (2010); WYO. STAT. ANN. § 17-29-102(a)(ix) (West 2010).

<sup>123</sup> Jay Coen Gilbert founded B Lab in 2006 along with Bart Houlahan and Andrew Kassoy. *Co-Founders*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/team> (last visited Mar. 28, 2012). Gilbert and Houlahan also established the AND 1 empire, a basketball apparel company, so they are no strangers to successful business operations. *Id.* B Lab certifies qualifying businesses as “B Corporations.” *What is a B Corp?*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/about> (last visited Mar. 28, 2012). To qualify, a company must “legally expand the responsibilities of the corporation to include the interests of its employees, suppliers, consumers, community, and environment.” *FAQ*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/faq> (last visited Mar. 28, 2012). In addition, a corporation must meet the standards set forth in the “B Impact Assessment.” *See id.* A sample report may be found at *B Impact Assessment 2010*, CERTIFIED B CORPORATION, [http://www.bcorporation.net/resources/bcorp/documents/2010-B-Impact-Assessment%20\(1\).pdf](http://www.bcorporation.net/resources/bcorp/documents/2010-B-Impact-Assessment%20(1).pdf) (last visited Mar. 28, 2012). The first section analyzes the company’s accountability through its governance and transparency. *Id.* at 3–4. The next step evaluates employee care in compensation and benefits, employee ownership, and work environment. *Id.* at 4–8. The next section considers any benefit to consumers through beneficial products and services. *Id.* at 9–10. Next, the community is examined, taking into account suppliers, local participation, diversity, and commitment to service. *Id.* at 10–15. Lastly, the environmental impact is taken into account, with consideration of facilities, energy usage, the supply chain, and manufacturing methods. *Id.* at 22–24.

<sup>124</sup> *See State by State Legislative Status*, BENEFIT CORP. INFORMATION CENTER, <http://www.benefitcorp.net/state-by-state-legislative-status> (last visited Mar. 28, 2012).

<sup>125</sup> *Why B Corps Matter*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/why> (last visited Mar. 28, 2012).

<sup>126</sup> *See FAQ*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/faq> (last visited Mar. 28, 2012). In addition, B Corporations receive discounts on products and services from some providers. *See id.* Depending on a B Corporation’s sales, the annual fee for certification is as menial as \$500 to as much as \$25,000. *Make it Official and Sign B Corp Documents*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/become/official> (last visited Mar. 28, 2012).

separate legal entity.<sup>127</sup> Nevertheless, the city of Philadelphia has taken its own initiative, and will give tax credit to a number of eligible B Corporations.<sup>128</sup> No other municipality thus far has legislation that specifically names B Corporations as eligible for tax breaks or other business advantages.<sup>129</sup>

It was not until April of 2010 that the first state, Maryland, signed into law a concept similar to the B Corporation.<sup>130</sup> The model legislation, advocated by B Lab, names such an entity as a Benefit Corporation, and is only applicable to those labeled as such.<sup>131</sup> It requires the purpose for formation of a Benefit Corporation to be for a “general public benefit.”<sup>132</sup> The statutory language defines general public benefit as “a material positive impact on society and the environment, taken as a whole, as assessed against a 3rd-party standard, as defined, that satisfies certain requirements.”<sup>133</sup> The corporation may indicate a specific public benefit, but still requires the general benefit as well.<sup>134</sup> In addition, the general and specific public benefits must be in the best interest of the corporation.<sup>135</sup>

Directors of a Benefit Corporation have a duty to consider all of the following when making decisions: (1) the interests of shareholders; (2) the interests of employees and workforce of the Benefit Corporation, its subsidiaries and suppliers; (3) the interests of customers as beneficiaries of the public benefit purposes; (4) community and societal considerations; and (5) the local and global environment.<sup>136</sup> Paralleling traditional corporations, directors of a Benefit Corporation can be held liable for failing to pursue the enumerated public

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<sup>127</sup> See *B Corp Legislation*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/publicpolicy> (last visited Mar. 28, 2012) (noting that the legislature is considering a draft of Benefit Corporation materials).

<sup>128</sup> The bill amended Philadelphia Code § 19-2604 to allow up to twenty-five businesses in the city to receive a tax credit of \$4,000. PHILA. CODE § 19-2604(13). To be eligible, a business must be certified by the Office of Sustainability as a Sustainable Business. *Id.* B Lab certification will serve as prima facie evidence of status as a Sustainable Business. *Id.*

<sup>129</sup> See *B Corp Legislation*, *supra* note 127 (“[T]he City of Philadelphia passed legislation creating the country’s first tax break for certified sustainable business.”).

<sup>130</sup> The governor signed the bill into law on April 13, 2010. S.B. 690, 2010 Leg., Reg. Sess. (Md. 2010), available at <http://mlis.state.md.us/2010rs/billfile/sb0690.htm>. Seven states now legally recognize Benefit Corporations: California, Hawaii, Maryland, New Jersey, New York, Vermont, and Virginia. See *State by State Legislative Status*, *supra* note 124.

<sup>131</sup> VT. STAT. ANN. tit. 11A, § 21.02(a) (2010); *Provisions Relating to The Incorporation and Governance of Benefit Corporations*, PENNSYLVANIA BAR ASSOCIATION, [http://www.bcorporation.net/resources/bcorp/documents/Draft\\_Pennsylvania-Legislation.pdf](http://www.bcorporation.net/resources/bcorp/documents/Draft_Pennsylvania-Legislation.pdf) (last visited Mar. 28, 2012). This document is found through a link for “Model Legislation” on the Certified B Corporation website.

<sup>132</sup> MD. CODE ANN., CORPS. & ASS’NS § 5-6C-06(a); VT. STAT. ANN. tit. 11A, § 21.08(a) (2010).

<sup>133</sup> H.R. 361, 2011 Gen. Assemb. Reg. Sess. (Cal. 2011), available at [http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab\\_0351-0400/ab\\_361\\_bill\\_20110830\\_enrolled.pdf](http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_0351-0400/ab_361_bill_20110830_enrolled.pdf); see also MD. CODE ANN., CORPS. & ASS’NS § 5-6C-01(c); VT. STAT. ANN. tit. 11A, § 21.03(a)(4) (2010).

<sup>134</sup> H.R. 361, 2011 Gen. Assemb. Reg. Sess. (Cal. 2011); see also MD. CODE ANN., CORPS. & ASS’NS § 5-6C-06(b) (West 2011); VT. STAT. ANN. tit. 11A, § 21.08(b) (2010).

<sup>135</sup> H.R. 361, at § 14610(c).

<sup>136</sup> H.R. 361, at § 14620(b); MD. CODE ANN., CORPS. & ASS’NS § 5-6C-07(a)(1); VT. STAT. ANN. tit. 11A, § 21.09(a)(1) (2010). The California bill also includes the duty of consideration of the short and long-term interests of the Benefit Corporation and the ability to accomplish the public benefit purposes. Assemb. B. 301 at § 14610(c)(6)–(7). It is important to note that under the Vermont statute, “[a] director is not liable for the failure of a [B]enefit [C]orporation to create general or specific public benefit.” Tit. 11A, § 21.09(c).

purposes.<sup>137</sup> Stakeholders with no ownership interest in the corporation, however, do not have the absolute right to bring such a claim.<sup>138</sup>

There are also reporting requirements to which a Benefit Corporation must adhere.<sup>139</sup> It must send an annual report to each shareholder within 120 days of the end of its fiscal year.<sup>140</sup> The report must include: (1) the means of pursuing the general public benefit and the extent that the general public benefit was produced; (2) the means of pursuing the specific public benefit, if any stated in the articles of incorporation, and the extent that the specific public benefit was produced; (3) any circumstances that have impeded the production of the public benefit; and (4) “an assessment of the societal and environmental performance of the Benefit Corporation prepared in accordance with a third-party standard applied consistently with the prior year’s benefit report or accompanied by an explanation of the reasons for any inconsistent application.”<sup>141</sup> The third-party standard refers to a “standard for defining, reporting, and assessing best practices in corporate social and environmental performance that: (1) [i]s developed by a person or entity that is independent of the [B]enefit [C]orporation; and (2) [i]s transparent because [certain] information about the standard is publicly available or accessible.”<sup>142</sup>

#### 4. California Assembly Bill 2944

The Benefit Corporation was not B Lab’s first attempt at influencing legislation.<sup>143</sup> In 2008, the state of California considered a bill that would allow corporate board members to take into account the impact on the environment and

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<sup>137</sup> VT. STAT. ANN. tit. 11A, § 21.13(2010). A traditional corporation, which seeks primarily profits, holds directors personally liable for failing to act in the best interest of the shareholders through pursuit of profit. W. DERRICK BRITT ET AL., FREQUENTLY ASKED QUESTIONS—PROPOSED AMENDMENTS TO THE CALIFORNIA CORPORATIONS CODE FOR A NEW CORPORATE FORM: THE FLEXIBLE PURPOSE CORPORATION (Feb. 23, 2011), *available at* <http://businessforgood.blogspot.com/2011/03/frequently-asked-questions-proposed.html>. A Benefit Corporation, which seeks primarily a public benefit, holds directors personally liable for failing to act in the best interest of the stakeholders through pursuit of the public purpose. *See* tit. 11A, § 21.13.

<sup>138</sup> *See* tit. 11A, § 21.13(b). The section reads:

A benefit enforcement proceeding may be commenced or maintained only by: (1) a shareholder that would otherwise be entitled to commence or maintain a proceeding in the right of the benefit corporation on any basis; (2) a director of the corporation; (3) a person or group of persons that owns beneficially or of record 10 percent or more of the equity interests in an entity of which the benefit corporation is a subsidiary; or (4) such other persons as may be specified in the articles of incorporation of the benefit corporation.

*Id.*

<sup>139</sup> *See* MD. CODE ANN., CORPS. & ASS’NS § 5-6C-08 (West 2011).

<sup>140</sup> *Id.* at § 5-6C-08(b).

<sup>141</sup> *Id.* at § 5-6C-08(a). The Vermont statute includes a few more reporting requirements. *See* VT. STAT. ANN. tit. 11A, § 21.14 (2010).

<sup>142</sup> MD. CODE ANN., CORPS. & ASS’NS § 5-6C-01(e) (West 2011). It is feasible that B Lab would satisfy the third party requirement.

<sup>143</sup> Amy Westervelt, *A New Corporation for a New Economy*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/resources/bcorp/documents/2009AP-New-Corporation.pdf> (last visited Mar. 28, 2012).



the community when making decisions.<sup>144</sup> The bill would essentially allow corporate directors to determine what is in the best interest of the corporation by considering “the long-term and the short-term interests of the corporation and its shareholders, the corporation’s employees, suppliers, customers, and creditors, community and societal considerations, and the environment.”<sup>145</sup>

Assembly Bill 2944 took the form of a conventional constituency statute.<sup>146</sup> After several amendments, the bill passed through both houses in just over six months.<sup>147</sup> However, California Governor Arnold Schwarzenegger vetoed the bill,<sup>148</sup> and social responsibility was not revisited in California until Senate Bill 1463—the Flexible Purpose Corporation.

### III. FLEXIBLE PURPOSE CORPORATIONS

After Schwarzenegger’s veto of Assembly Bill 2944, several lawyers came together in a fresh effort to “facilitate the organization of companies in California with greater flexibility for combining profitability with a broader social or environmental purpose.”<sup>149</sup> As a result, the California Working Group for New Corporate Forms (Group) was created in the summer of 2008.<sup>150</sup> The Group consisted of ten corporate attorneys of diverse backgrounds, in an effort to prevent bias by any particular subset of the corporate field.<sup>151</sup>

#### A. *The Profit—Social Gap*

The Group was concerned about the gap that caused a dilemma for businesses seeking to satisfy both social-benefit and profit-making missions: choosing between a for-profit and nonprofit form.<sup>152</sup> Under California’s General

<sup>144</sup> The California State Legislature introduced Assembly Bill No. 2944 on February 22, 2008. H.R. 2944, 2008 Gen. Assemb. Reg. Sess. (Cal. 2008), available at [http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab\\_2901-2950/ab\\_2944\\_bill\\_20080222\\_introduced.pdf](http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_2901-2950/ab_2944_bill_20080222_introduced.pdf). For the finalized version of the bill, see H.R. 2944 (amended), 2008 Gen. Assemb. Reg. Sess. (Cal. 2008), available at [http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab\\_2901-2950/ab\\_2944\\_bill\\_20080822\\_amended\\_sen\\_v95.pdf](http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_2901-2950/ab_2944_bill_20080822_amended_sen_v95.pdf).

<sup>145</sup> BRITT ET AL., *supra* note 137.

<sup>146</sup> See *supra* Part II.C.

<sup>147</sup> See *Complete Bill History*, [http://leginfo.public.ca.gov/pub/07-08/bill/asm/ab\\_2901-2950/ab\\_2944\\_bill\\_20080930\\_history.html](http://leginfo.public.ca.gov/pub/07-08/bill/asm/ab_2901-2950/ab_2944_bill_20080930_history.html) (last visited Mar. 28, 2012).

<sup>148</sup> *Id.*

<sup>149</sup> BRITT ET AL., *supra* note 137. This document was created by co-chairs of the Group in order to accompany the FPC proposal in the California legislature. *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> See *id.*

<sup>152</sup> See *id.*; see also Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105 (2010). Reiser acknowledges the gap and later analyzes the rising sector of hybrid organizations in bridging that gap. *Id.* To explain the problem, she expresses that:

Until recently, the law has compelled those who desire a blended enterprise to adopt either a charity or a business form of governance. Once formed, an entity’s leaders must attempt to use a single mission form to govern their blended enterprise. Yet, neither the traditional charity form . . . nor any of the traditional business forms . . . is particularly well-suited to doing so.

*Id.* at 106.

Corporation Law, in pertinent part, directors of a corporation have a duty to act in the best interest of the shareholders.<sup>153</sup> This generally includes a fiduciary duty, requiring directors to maintain the primary objective of maximizing shareholder value.<sup>154</sup> This creates potential problems for businesses that practice corporate social responsibility.<sup>155</sup> Often, practicing corporate social responsibility can only come at the expense of profit to the shareholders.<sup>156</sup>

If directors make a decision with stakeholders in mind, any negative effect can be attributed to those directors. Absent invocation of the business judgment rule,<sup>157</sup> directors are potentially liable in a lawsuit brought by shareholders.<sup>158</sup> However, courts tend to presume that the business judgment rule applies.<sup>159</sup> Therefore, the Group notes that corporations have some flexibility in considering special purposes for long-term advantages to the corporation and shareholders.<sup>160</sup>

A major difficulty the Group recognized was that when control of the company changes, there is no guarantee that the socially responsible aspect will continue.<sup>161</sup> The Group refers to the lack of a “mission anchor” when control changes hands.<sup>162</sup> The new owners may not have the enthusiasm nor the incentive to sustain a social mission.<sup>163</sup> In acknowledging this concern, the drafters of the

<sup>153</sup> CAL. CORP. CODE § 309(a) (West 2008).

<sup>154</sup> See BRITT ET AL., *supra* note 137; see also Bisconti, *supra* note 9, at 765 (asserting that the traditional corporate model “limits directors’ fiduciary duties to one simple goal: obtaining the highest value possible for shareholders”); Schwister, *supra* note 97, at 11.

<sup>155</sup> See Taylor, *supra* note 45, at 751 (“[T]o the extent that CSR proponents make inroads into the shareholder-primacy, profit-maximization model, their progress will always be constrained.”).

<sup>156</sup> In a rather outdated news article, Milton Friedman openly criticized businessmen who attempted to practice social responsibility. See generally Friedman, *supra* note 68. In his book, Friedman describes corporate social responsibility as such:

[in a free economic society], there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.

MILTON FRIEDMAN & ROSE D. FRIEDMAN, CAPITALISM AND FREEDOM 133 (40th ed. 2002); but see Elena F Pérez Carrillo, *Corporate Governance: Shareholders’ Interests and Others Stakeholders’ Interests*, 4 CORP. OWNERSHIP & CONTROL 96, 101 (2007), available at [http://www.virtusinterpress.org/additional\\_files/journ\\_coc/full-text-papers-open-access/Paper006.pdf](http://www.virtusinterpress.org/additional_files/journ_coc/full-text-papers-open-access/Paper006.pdf) (stating that “[c]orporations’ acknowledgement of their [s]ocial [r]esponsibilities can be very satisfactory for [s]hareholder’s long-term interests,” and “interests of most stakeholders may coincide with those of shareholders and the [c]ompany”).

<sup>157</sup> See CAL. CORP. CODE § 309 (West 2008). The code does not specifically set forth a “business judgment rule,” but it is widely known as such. Section 309(c) exempts a director from liability who has relied on information from a dependable source. Directors are also excused from liability for damages if the articles of incorporation set forth a provision satisfying section 204(a)(10). The rule creates a “presumption that in making business decisions the directors of a corporation acted on an informed basis, in good faith and in the honest belief that action taken was in best interest of the company.” Mickels, *supra* note 20, at 283.

<sup>158</sup> See Bisconti, *supra* note 9, at 773 (“[D]irectors can be held personally liable for breaching their fiduciary duties.”).

<sup>159</sup> BRITT ET AL., *supra* note 137.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> Reiser, *supra* note 152, at 106. “[T]he market creates serious practical pressure for business managers to maximize profits, rather than pursue social objectives. Failing to do so may result in

proposal note that: “The traditional corporate form also presents a risk for the entrepreneur seeking to maintain the mission of a [s]pecial [p]urpose during the life of an early-stage corporation because investors may shift the company away from the original Special Purpose over time in favor of additional profitability instead.”<sup>164</sup> The Group was insistent on creating a business entity in which its founders could have faith in knowing that their social mission would carry on.

### B. *The Dynamics of an FPC*

In November of 2009, the Group completed a draft of the proposal for a new corporate entity, the FPC, which it hoped would sufficiently combine profitability with a “special purpose.”<sup>165</sup> The proposal would “encourage and expressly permit companies to be formed[,] or converted from other forms[,] to pursue one or more purposes [while] creating economic value for shareholders.”<sup>166</sup> FPCs under this proposal would remain subjects of the General Corporation Law, but would adhere only to the extent required by the impending FPC statutory provisions.<sup>167</sup> The core component of an FPC is that its articles of incorporation must identify at least one special purpose to be considered in determining the best interest of the corporation and its shareholders.<sup>168</sup> By allowing consideration of the special purpose along with the shareholders’ financial interest, directors will be shielded from potential personal liability for a breach of fiduciary duty.<sup>169</sup>

On February 19, 2010, the FPC was introduced into the California Senate as Senate Bill 1463 by Senator Mark DeSaulnier.<sup>170</sup> Initially, the bill sought to add a new division to the California Corporations Code (Code).<sup>171</sup> It was amended on April 5, 2010 to add to and amend other sections of the Code as well.<sup>172</sup> Under California’s Senate Bill 1463, Title I of the Code would be expanded to include

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business reverses and loss of market share, undermine investor-confidence, and perhaps cause managers to lose their positions.” *Id.* at 106–07.

<sup>164</sup> *Flexible Purpose Corporations: Fact Sheet*, OFFICE OF SENATOR MARK DESAULNIER 1, 1 (Feb. 19, 2010), <http://sd07.senate.ca.gov/sites/sd07.senate.ca.gov/files/PDF/Legislation/2010/SB%201463%20Fact%20Sheet.pdf>.

<sup>165</sup> *Id.* The definition of “special purpose” for the sake of California Senate Bill 1463 will be discussed *infra* notes 180–81 and accompanying text.

<sup>166</sup> BRITT ET AL., *supra* note 137.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* at 5. This presents a second “bottom line” for the directors to focus on. See *infra* note 249.

<sup>169</sup> BRITT ET AL., *supra* note 137.

<sup>170</sup> S.B. 1463, 2010 Leg., Reg. Sess. (Cal. 2010) at 1, available at [http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb\\_1451-1500/sb\\_1463\\_bill\\_20100219\\_introduced.pdf](http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb_1451-1500/sb_1463_bill_20100219_introduced.pdf). Senator DeSaulnier is a Democrat and represents the Seventh District of California. See *Biography*, SENATOR MARK DESAULNIER, <http://sd07.senate.ca.gov/biography> (last visited Mar. 28, 2011). He is currently in his first term in the Senate, but previously served in the State Assembly. *Id.* The Group sponsored the bill. FACT SHEET, *supra* note 164, at 2.

<sup>171</sup> See Cal. S.B. 1463 at 1.

<sup>172</sup> S.B. 1463, 2010 Leg., Reg. Sess. (Cal. 2010) (amended) at 1, available at [http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb\\_1451-1500/sb\\_1463\\_bill\\_20100405\\_amended\\_sen\\_v98.pdf](http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb_1451-1500/sb_1463_bill_20100405_amended_sen_v98.pdf). To view the amended sections of the code regarding FPCs, see *id.* at 1–20. See *id.* for the entire text of Cal. S.B. 1463. The remainder of this Comment will focus on the new division proposed.

Division 1.5, the Corporate Flexibility Act of 2010.<sup>173</sup> The Division would only apply to corporations that were organized as an FPC under Division 1.5, or were appropriately converted into an FPC.<sup>174</sup>

Section 2602 sets forth the requirements of the articles of incorporation.<sup>175</sup> First, the term “Flexible Purpose Corporation” must be included.<sup>176</sup> Next, the articles must specify the general and special purposes in which the FPC is to be involved.<sup>177</sup> A special purpose is required to fall under at least one of the following umbrellas: (1) “[o]ne or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out”; or (2) “promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of, the flexible purpose corporation’s activities upon . . . the FPC’s employees, suppliers, customers, and creditors[,] the community and society[,] or the environment.”<sup>178</sup> The bill sets out two separate paragraphs in which to present the general purpose of the FPC, either of which must be included in the articles.<sup>179</sup> Both paragraphs emphasize a goal in producing both long-term and short-term benefits.<sup>180</sup>

When making executive decisions, Senate Bill 1463 would allow directors to consider “the short-term and long-term prospects of the [FPC], the best interests of the [FPC] and its shareholders, and the purposes of the [FPC] as set forth in its articles.”<sup>181</sup> This provision goes to the root of the problem that the Group sought to resolve; it requires that a public purpose be included in the articles of incorporation.<sup>182</sup> This provision would shield directors from potential personal liability for failing to act in the financial best interest of the shareholders while pursuing the public purpose of the FPC.<sup>183</sup>

Directors of an FPC, like those of a traditional corporation, would still be subject to personal liability if they do not act in the best interest of the corporation or its shareholders.<sup>184</sup> Also in conformity with a traditional corporation, an FPC’s articles of incorporation may not limit a director’s duty to act in the FPC’s best interest.<sup>185</sup> In the event that a director may be held personally liable for

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<sup>173</sup> See Cal. S.B. 1463 (amended) at 21.

<sup>174</sup> *Id.* at § 2502.

<sup>175</sup> See *id.* at § 2602.

<sup>176</sup> *Id.* at § 2602(a).

<sup>177</sup> *Id.* at § 2602(b).

<sup>178</sup> See S.B. 1463, 2010 Leg., Reg. Sess. (Cal. 2010) (amended), at § 2602(b)(2).

<sup>179</sup> See *id.* at § 2602(b)(1).

<sup>180</sup> *Id.* The remaining requirements of the articles of incorporation are beyond this discussion.

<sup>181</sup> *Id.* at § 2700(c).

<sup>182</sup> *Id.* at § 2602(b)(2).

<sup>183</sup> It is important to note that this will “not eliminate or limit the liability of a director for any act or omission occurring prior to the date on which the provision becomes effective.” S.B. 1463, 2010 Leg., Reg. Sess. (Cal. 2010) (amended), at § 2603(a)(10)(B).

<sup>184</sup> See CAL. CORP. CODE § 204 (West 2008); S.B. 1463, 2010 Leg., Reg. Sess. (Cal. 2010) (amended), at § 2603(a)(10)(A).

<sup>185</sup> Compare CAL. CORP. CODE § 204 (“[Provisions set forth in the articles of incorporation] may not eliminate or limit the liability of directors . . . for acts or omissions that a director believes to be contrary to the best interests of the corporation or its shareholders.”), with Cal. S.B. 1463 (amended), at § 2603(a)(10)(A) (“[Provisions set forth in the articles of incorporation] may not eliminate or limit the

unacceptable actions, section 2715 of Senate Bill 1463 identifies the parties that may bring a legal claim.<sup>186</sup> Under the bill, only creditors or shareholders may bring a legal action against a director of an FPC.<sup>187</sup>

Chapter 11 of Division 1.5 lays out the reporting requirements of an FPC.<sup>188</sup> Similar to a traditional corporation in California, an FPC must send an annual report to its shareholders within 120 days of the fiscal year end.<sup>189</sup> However, in addition to the cash flow and income statements, as required of traditional corporations, an FPC must also include a “management discussion and analysis . . . concerning [its] stated [special] purpose.”<sup>190</sup> This section of the report must include: (1) “an 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 special purpose objectives during the fiscal year”; (2) “an identification and discussion of the material actions taken . . . during the fiscal year to achieve its special purpose objectives, the impact of those actions . . . and the extent to which those actions achieved the special purpose objectives for the fiscal year”; (3) “identification of material actions [and their intended impact,] that the [FPC] expects to take in the short term and long term [to achieve] its special purpose objectives”; (4) “a description of the process for selecting, and an identification and description of . . . other measures used by the [FPC] during the fiscal year for evaluating its performance in achieving its special purpose objective”; and (5):

an identification and discussion of any material operating and capital expenditures incurred . . . in furtherance of achieving the special purpose objectives, [along with an] estimate of any additional material operating or capital expenditures the [FPC] expects to incur over the next three fiscal years in order to achieve its special purpose objectives, and other material expenditures of resources incurred by the [FPC] during the fiscal year . . . 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.<sup>191</sup>

The bill also requires a special purpose current report to be sent to shareholders in certain situations.<sup>192</sup> If an “expenditure has or is likely to have a material adverse impact on the [FPC]’s results of operations or financial condition for a quarterly or annual fiscal period,” such a report should include:

[an] identif[ication] and discuss[ion of] . . . any expenditure . . . , excluding

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liability of directors . . . for acts or omissions that a director believes to be contrary to the best interests of the flexible purpose corporation or its shareholders *and its corporate purposes as expressed in its articles.*”) (emphasis added).

<sup>186</sup> Cal. S.B. 1463 (amended) at § 2715(c).

<sup>187</sup> *Id.*

<sup>188</sup> *Id.* at 67.

<sup>189</sup> CAL. CORP. CODE § 1501(a)(1) (West 2008); S.B. 1463, 2010 Leg., Reg. Sess. (Cal. 2010) (amended), at § 3500(a).

<sup>190</sup> Cal. S.B. 1463 (amended), at § 3500(b).

<sup>191</sup> *Id.*

<sup>192</sup> See *id.* at § 3501(a).

compensation of officers and directors, made in furtherance of the special purpose objectives[;] whether [it is classified as] an operating expenditure, a capital expenditure, or some other expenditure of corporate resources, including employee time or otherwise[;] whether the expenditure was direct or indirect[;] and whether the expenditure was made to a person or entity outside of the flexible purpose corporation or was made internally.<sup>193</sup>

The bill did not survive the legislative term.<sup>194</sup> The FPC was reintroduced by Senator DeSaulnier on February 8, 2011 as Senate Bill 201—The Corporate Flexibility Act of 2011.<sup>195</sup> The remaining sections of this Comment will reference Cal. S.B. 201.<sup>196</sup>

#### IV. ANALYSIS

There are several components in each of the hybrid organizations that differ. Each type is composed of some factors that are more favorable than those in another hybrid type. This section will compare those factors, and determine which entity is most advantageous on that matter.

##### A. Organizational Structure

The most important place to start in the comparison of social enterprises is their entity classification. Both FPCs and Benefit Corporations are separate entities, which fall within the Code for Corporations.<sup>197</sup> L3Cs, on the other hand, are a subset of LLCs.<sup>198</sup> Despite their differences, all of these entities are subject to the same laws as their strictly for-profit counterparts.<sup>199</sup> The key difference, however, exists in the selection of either a corporation or LLC form. Each organizational structure has its advantages and drawbacks.<sup>200</sup>

Structurally, the FPC is identical to Yunus' Social Business concept.<sup>201</sup>

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<sup>193</sup> *Id.* at § 3501(b). The report must be distributed within forty-five days of the event, but distribution is not required if the information is included in the last annual report. *Id.* at § 3500.

<sup>194</sup> Allen Matkins, *The Flexible Purpose Corporation – Can It Serve Two Masters?*, CAL. CORP. & SEC. LAW (Feb. 10, 2011), <http://calcorporatelaw.com/2011/02/the-flexible-purpose-corporation-can-it-serve-two-masters/>.

<sup>195</sup> *Id.* See also 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>.

<sup>196</sup> S.B. 201, 2011 Leg., Reg. Sess. (Cal. 2011), available at [http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb\\_0201-0250/sb\\_201\\_bill\\_20110208\\_introduced.pdf](http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0201-0250/sb_201_bill_20110208_introduced.pdf).

<sup>197</sup> See BRITT ET AL., *supra* note 137; MD. CODE ANN., CORPS. & ASS'NS § 5-6C-06(a) (West 2011); VT. STAT. ANN. tit. 11A, § 21.08(a) (2010).

<sup>198</sup> Lang & Minnigh, *supra* note 98, at 20; *Laws, supra* note 112.

<sup>199</sup> See MD. CODE ANN., CORPS. & ASS'NS § 5-6C-02(a) (West 2011) (“The provisions of the Maryland General Corporation Law apply to benefit corporations . . . .”); Cal. S.B. 201, at § 2501 (“[T]he provisions of [the General Corporation Law] shall apply to corporations organized under [the Corporate Flexibility Act of 2010.]; Brewer & Rhim, *supra* note 74, at 14 (“[T]he L3C should be treated in the same manner as an LLC.”).

<sup>200</sup> See *supra* Part II.D.

<sup>201</sup> See *supra* Part II.E.1.

Specifically, the “non-loss, non-dividend” Social Business is comparable.<sup>202</sup> Both entities would be run as a profit-making business, and would recoup costs. The Social Business, however, would not adhere to a primary purpose of pursuing profit.<sup>203</sup> In fact, none of the shareholders would expect a profit; they would only expect to be distributed an amount equal to their investment.<sup>204</sup> The rest of the earnings would be reinvested back into the business.<sup>205</sup> The FPC is very different in this sense. Shareholders would hope to receive a profit from their investment, since the primary purpose can be pursuing profits. Based on this evaluation, the FPC would most likely be able to attract more capital from investors, because they will expect a return on their investment. However, if the owners of the business are more interested in pursuing a social goal, the Social Business would be a more appropriate choice of entity.

The FPC closely resembles constituency statutes that many states have enacted.<sup>206</sup> Both arrangements effectively shield corporate directors from personal liability in the event that a decision is made with consideration of factors other than shareholder maximization.<sup>207</sup> The major difference lies in the aspect of incorporation. Corporations governed by constituency statutes have the option to consider nonshareholder interests, which are generally not established in the articles of incorporation.<sup>208</sup> Inherently, such corporations can wholly overlook nonshareholder interests.<sup>209</sup> On the contrary, FPCs may not be formed without enumerating the public purpose in the incorporating document. This requirement may cause directors to more fully appreciate their commitment to benefiting stakeholders. California’s attempt to create a constituency statute may have extended further than other states have reached.

### *B. Profit Maximization*

In addition to maximizing profits, social enterprises generally consider other factors in corporate decision making that lead them to prefer one form over another.<sup>210</sup> This alternative consideration could result in a reduction in the potential profit. L3Cs actually preclude profit-making from being an objective of the entity.<sup>211</sup> In order to combat this potential downside, profit-maximization schemes are essential in assuring an enterprise’s sustainability.

L3Cs promote the grant of money from foundations in the form of PRIs.<sup>212</sup>

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<sup>202</sup> *See id.*

<sup>203</sup> Taylor, *supra* note 45, at 767.

<sup>204</sup> YUNUS, *supra* note 81, at 24.

<sup>205</sup> *Id.*

<sup>206</sup> Assembly Bill 2944 was more closely related to conventional constituency statutes. *See* H.R. 2944, 2008 Gen. Assemb. Reg. Sess. (Cal. 2008) (amended). Senate Bill 201 pushes California’s attempt at a constituency statute to a deeper level, discussed *infra*.

<sup>207</sup> *See* BRITT ET AL., *supra* note 137; HERRIGAN, *supra* note 54, at 206–08.

<sup>208</sup> Bisconti, *supra* note 9, at 783; HERRIGAN, *supra* note 54, at 207.

<sup>209</sup> Bisconti, *supra* note 9, at 783.

<sup>210</sup> *See* Reiser, *supra* note 152, at 108 (referring to the “dual mission” of hybrid organizations).

<sup>211</sup> *See, e.g.,* VT. STAT. ANN. tit. 11, § 3001(27)(B) (2010).

<sup>212</sup> *See supra* text accompanying notes 102–07.

L3Cs may appeal to grant-making foundations because their social purpose is presented in their articles of organization.<sup>213</sup> Similarly, FPCs would lay out their special purpose in the articles of incorporation.<sup>214</sup> The distinguishing characteristic is that the organizing requirements of an L3C mirror the requirements of a PRI.<sup>215</sup> In contrast, FPCs are incorporated in a more similar manner to a traditional corporation, specifically pursuing profits as a dominant goal. Thus, since PRIs are explicitly barred from allowing a significant purpose of the investment to produce income,<sup>216</sup> it is highly unlikely that an FPC will ever be able to receive foundation funding based in a PRI.

### C. Tax Treatment

Since hybrid entities do not hold tax exemption status, a favorable tax arrangement would be sensible in maximizing profits as well.<sup>217</sup> Adhering to the same laws as an LLC, the L3C would experience pass-through taxation.<sup>218</sup> Therefore, profits of the company would only be taxed once. Alternatively, the FPC and Benefit Corporation are subject to double taxation—once on the corporation's profits, and again on the dividends.<sup>219</sup> From the standpoint of maximizing profits by minimizing taxes, the L3C appears to be a more favorable selection.

### D. Degree of Importance and Specificity of the Social Benefit

Senate Bill 201 goes a step further than Assembly Bill 2944. Assembly Bill 2944 did not seek to create a new entity.<sup>220</sup> It simply would have allowed directors of corporations as a whole to take social interests into consideration when making executive decisions.<sup>221</sup> Therefore, *all* corporations would enjoy the benefit of the new bill.<sup>222</sup> However, Senate Bill 201 benefits would be limited to those companies that organize as an FPC.

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<sup>213</sup> Taylor, *supra* note 45, at 762.

<sup>214</sup> S.B. 201, 2011 Leg., Reg. Sess. (Cal. 2011), at § 2602(b).

<sup>215</sup> Compare *supra* text accompanying note 104, with *supra* text accompanying notes 119–21.

<sup>216</sup> Bishop, *supra* note 102, at 249.

<sup>217</sup> Some states have attempted to provide tax benefits to hybrid organizations. Kelley, *supra* note 40, at 368. In 2006, the Hawaii legislature considered a bill to create a hybrid entity called the Socially Responsible Business Corporation. *Id.* In its final draft, the bill sought to “create tax incentives for corporations that include a certain percentage of employees and members of the community on their boards of directors.” Tom Brandt, *Socially/Environmentally “Responsible” Business Incentives Not Bad Idea, Just New*, HONOLULU STAR-BULLETIN (Apr. 23, 2006), available at <http://cog.kent.edu/lib/BrandtSociallyRespBusiness.pdf>. It would provide “relief from state corporate income taxes for corporations formed under the law.” Kelley, *supra* note 40, at 368. The Responsible Business Corporation Act passed through both houses, but was rejected by the governor. *Id.*

<sup>218</sup> Kleinberger, *supra* note 28, at 886–87.

<sup>219</sup> *Id.* at 887.

<sup>220</sup> See H.R. 2944, 2008 Gen. Assemb. Reg. Sess. (Cal. 2008) (amended).

<sup>221</sup> *Id.*

<sup>222</sup> See BRITT ET AL., *supra* note 137. The benefit being referred to is the ability of directors to not be held personally liable for considering social, rather than just financial, effects of an executive decision.



In relation to the stricken Assembly Bill 2944, the FPC bill may have the effect of encouraging businesses to incorporate as a new entity. As an FPC, they would be required to have a special purpose in order to reap the benefit. For corporations as a whole, Assembly Bill 2944 would have been a better solution. They would not have to take any action to have the bill apply to them. For the state, the FPC is a better solution because corporations that are subject to the bill would be required to have a special purpose included in their articles of incorporation. If corporations take heed of the encouragement to incorporate as an FPC, the community will in turn benefit from the special purpose being carried out.

FPCs are a step back from existing hybrid entities. L3Cs and Benefit Corporations essentially require their primary purpose to be that of social welfare.<sup>223</sup> The L3C must have a charitable or educational purpose as the primary goal.<sup>224</sup> Furthermore, it bans such entities from having a significant purpose to produce income.<sup>225</sup> FPCs, on the other hand, would not only be permitted to produce income as a primary purpose, but it seems that it would be expected.<sup>226</sup> Other than inclusion of the special purpose, all other aspects of the articles of incorporation are to mirror traditional corporations. Similar to L3Cs, Benefit Corporations must have a general public benefit as the overarching reason for creation of the entity.<sup>227</sup> The FPC, however, takes a more particular stance than the Benefit Corporation on the requirements of its social purpose. Rather than placing a general benefit on society, FPCs are required to specify which social benefit they will work to satisfy.<sup>228</sup> This difference becomes important when measuring the effectiveness of a corporation in achieving a social benefit.<sup>229</sup>

A general public benefit is a very broad standard and may be difficult to evaluate. For instance, all corporations provide some sort of societal benefit in providing products or services. When a benefit is specifically identified, as would be required of an FPC, it seems more likely to be accurately measured. Benefit Corporations have the choice of identifying a specific public benefit, but again, only the general benefit is required. In consideration of the specificity of the social purpose, FPCs appear more equipped than Benefit Corporations to be accountable for achieving their purpose.

#### *E. Accountability and Enforcement*

Todd Johnson, a partner at Jones Day law firm and former advisor to B Lab,

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<sup>223</sup> See, e.g., ME. REV. STAT. ANN. tit. 31, § 1611 (2010); VT. STAT. ANN. tit. 11A, § 21.08 (2010).

<sup>224</sup> ME. REV. STAT. ANN. tit. 31, § 1611(1) (2010).

<sup>225</sup> Tit. 31, § 1611(2)(C).

<sup>226</sup> The bill only requires that “a purpose” of an FPC be social in nature. See S.B. 201, 2011 Leg., Reg. Sess. (Cal 2011), at § 2602(b)(2).

<sup>227</sup> VT. STAT. ANN. tit. 11A, § 21.08 (2010).

<sup>228</sup> See *id.* Benefit Corporations have the option of enumerating a specific public purpose, but are not required by statute. MD. CODE ANN., CORPS. & ASS’NS § 5-6C-02(b) (West 2011).

<sup>229</sup> See Lang & Minnigh, *supra* note 98, at 29 (“It is harder to measure social good.”).

addressed the accountability methods of FPCs.<sup>230</sup> In his blog post, Johnson asserts that “the ‘[B]enefit [C]orporation’ form seeks to create accountability (beyond reporting) through a system of greater liability, whereas the ‘[FPC]’ form seeks to unleash directors from the risk of liability.”<sup>231</sup> He states that the reduction of the risk of liability will allow directors to more broadly experiment with simultaneously “doing well and doing good.”<sup>232</sup> If the FPC bill is signed into law, time will tell if this freedom results in more overall success for FPCs.

Both FPCs and Benefit Corporations require an annual report, just as any traditional corporation.<sup>233</sup> However, because hybrids must have a social purpose, unlike traditional corporations, information regarding that social purpose must be included in their reports.<sup>234</sup> Benefit Corporations must report how they sought to produce a public benefit, and then what benefit, if any, resulted.<sup>235</sup> Likewise, FPCs would be required to disclose what actions were taken, and the outcome of those actions.<sup>236</sup>

Senate Bill 201 takes reporting requirements a step further. As proposed, FPCs would also be compelled to discuss the special-purpose-related objectives in the annual report, along with any changes made from the previous year.<sup>237</sup> They would also have to identify the ways in which they seek to provide a public impact in the future.<sup>238</sup> This requirement is an important tool for keeping businesses accountable.

Since the special purpose of an FPC is secondary to profit-making, it is hard to refrain from being suspicious of whether the special purpose will be achieved to a valuable degree. To tackle these suspicions, Senate Bill 201 would require the directors to specify objectives by which to measure the FPC's impact as it relates to the special purpose.<sup>239</sup> Nevertheless, with the directors being given the privilege of selecting the impact standard, it seems that FPCs would be capable of getting away with doing very little.

While the impact of some FPCs may be noticeable in a community, the social benefit of others may be virtually insignificant. How can it be ensured that an FPC's standard of measuring social impact is not negligible? Benefit Corporations are subject to an evaluation by a third-party standard in determining their social impact.<sup>240</sup> FPCs do not have this requirement, and all evaluation of the performance of the special purpose is done by the standard that the corporation sets

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<sup>230</sup> See R. Todd Johnson, *The Benefit Corporation: A Step In the Right Direction, But . . .*, BUSINESS FOR GOOD (June 12, 2010), <http://businessforgood.blogspot.com/2010/06/benefit-corporation-step-in-right.html>.

<sup>231</sup> *Id.*

<sup>232</sup> *Id.*

<sup>233</sup> Compare MD. CODE ANN., CORPS. & ASS'NS § 5-6C-08 (West 2011) and S.B. 201, 2011 Leg., Reg. Sess. (Cal. 2011), at 65, with CAL. CORP. CODE § 1501 (West 2008).

<sup>234</sup> See, e.g., MD. CODE ANN., CORPS. & ASS'NS § 5-6C-08 (West 2011); Cal. S.B. 201, at 65.

<sup>235</sup> MD. CODE ANN., CORPS. & ASS'NS § 5-6C-08(a)(1)(i) (West 2011).

<sup>236</sup> Cal. S.B. 201, at § 3500(b)(2).

<sup>237</sup> *Id.* at § 3500(b)(1).

<sup>238</sup> *Id.* at § 3500(b)(5).

<sup>239</sup> See *id.* at § 2516 & § 3500(b)(1).

<sup>240</sup> See MD. CODE ANN., CORPS. & ASS'NS § 5-6C-08(a)(2) (West 2011).

for itself.<sup>241</sup> FPCs are required to include their standard of evaluation in the annual report, but are not required to receive any input on the selection of that standard from a third party.<sup>242</sup> Obtaining an outsider's point of view on whether a corporation is, in fact, benefiting those who are "outsiders" of the corporation seems rational and essential.<sup>243</sup>

A follow-up to the issue of social impact is the means in which the social impact will be enforced. The social mission is to be included in the FPC's articles of incorporation, thus a component of the corporation's day-to-day business.<sup>244</sup> For the traditional corporation, because the primary component is profit maximization, shareholders are given standing to sue directors when they act outside of the shareholders' best interests.<sup>245</sup> Since FPCs have the added component of a social impact, the question remains whether stakeholders should have standing to sue?

As introduced, Senate Bill 201 does not allow stakeholders to bring a claim if directors do not follow through with the social mission.<sup>246</sup> Only shareholders and creditors may bring such a claim.<sup>247</sup> Excluding creditors from ever bringing this type of claim, the only way for a director to be personally liable for failing to pursue the special purpose is for the shareholders to take action.<sup>248</sup> Since shareholders are generally interested in maximizing their profits above all else, Bisconti's fear may carry over from typical constituency statutes to the FPC.<sup>249</sup> Without the ability of stakeholders to bring a legal claim for disregarding the special purpose, directors can avoid the heat. However, the special purpose of an FPC is at the heart of the organization. Shareholders will know that when choosing to invest.<sup>250</sup> It seems likely that if the bill passes, many investors in an FPC will do so because of their own commitment to the special purpose. This would create a check on the directors, given the probability that a shareholder may just bring a claim regarding the directors' ignorance of the special purpose.

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<sup>241</sup> Cal. S.B. 201, at § 3500(b)(4).

<sup>242</sup> *See id.*

<sup>243</sup> I will note that sometimes the stakeholder may be an employee, thus an "insider," but the general idea of hybrids is that they positively affect those who have no stake in the corporation.

<sup>244</sup> *See* S.B. 201, 2011 Leg., Reg. Sess. (Cal. 2011), at § 2602(b)(2).

<sup>245</sup> *See* CAL. CORP. CODE § 316(c) (West 2008).

<sup>246</sup> Cal. S.B. 201 at § 2715(c) (allowing only shareholders and creditors to bring a claim against directors).

<sup>247</sup> *Id.*

<sup>248</sup> However, it is unlikely that a lawsuit against a director for failing to pursue the special purpose would succeed; although the special purpose must be included in the articles of incorporation, directors may consider a number of factors when making decisions—more than just the advancement of the public purpose. *Id.* at § 2700(3)(c).

<sup>249</sup> *See supra* Part II.C.

<sup>250</sup> S.B. 201, 2011 Leg., Reg. Sess. (Cal. 2011), at § 2602(a) (requiring the articles of incorporation to contain the words, or an abbreviation of, "flexible purpose corporation").

## V. IMPACT

### A. *The Future for California*

Governor Schwarzenegger was the hurdle that hindered California's last attempt at a constituency statute. He will not have the opportunity to veto the current bill, as there is new governor in office.<sup>251</sup> The state will have to rely on Governor Jerry Brown, a Democrat, to have a high regard for the possibility of a hybrid entity in California. Susan MacCormac, who was a member of the Working Group that initially pushed the bill into existence, says the possibility of the bill passing is "looking good."<sup>252</sup> She does realize, however, that it is not a sure thing.<sup>253</sup>

### B. *Will Other States Follow?*

Many states have been receptive to the idea of hybrid organizations; some have already passed legislation and others have bills in consideration.<sup>254</sup> For those states that are reluctant, the FPC may appeal as a happy medium. FPCs have much more similarity to traditional corporations than other hybrids presented. They would provide much incentive to corporations with little required from the state itself. In general, corporate directors would be shielded from personal liability for making decisions that consider interests other than shareholder maximization, resulting in no burden to the state.

### C. *Tax Breaks in the Future?*

Tax treatment is a major concern for business and nonprofit entities. One can only wonder whether the FPC, and other hybrids, would receive favorable tax treatment in the future. It seems unlikely that FPC will receive any tax breaks. The L3C and Benefit Corporation, which are already in existence, do not yet enjoy tax advantages.<sup>255</sup> These two business entities are skewed to the side of public benefit rather than profit-making, where the FPC fits. Being that the FPC is essentially a for-profit corporation, it is highly unlikely that the entity will receive any favorable tax treatment.

### D. *Dwindling Nonprofit Sector?*

With the freshness of hybrid organizations, even in their constant growth it is

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<sup>251</sup> William M. Welch, *California: Jerry Brown Wins Costliest Governor Race in U.S.*, U.S.A. TODAY (Nov. 3, 2010), [http://www.usatoday.com/news/politics/2010-11-02-ca-governor\\_N.htm](http://www.usatoday.com/news/politics/2010-11-02-ca-governor_N.htm).

<sup>252</sup> Makower, *supra* note 195.

<sup>253</sup> *Id.*

<sup>254</sup> See, e.g., 805 ILL. COMP. STAT. 180/1-26 (2009); MD. CODE ANN., CORPS. & ASS'NS § 5-6C-06(c) (West 2011); ME. REV. STAT. ANN. tit. 31, § 1611 (2010); VT. STAT. ANN. tit. 11A, § 21.08(c) (2010); S. 2170, 214th Leg., Reg. Sess. (N.J. 2010), available at [http://www.njleg.state.nj.us/2010/Bills/S2500/2170\\_I1.PDF](http://www.njleg.state.nj.us/2010/Bills/S2500/2170_I1.PDF); *State by State Legislative Status*, *supra* note 124.

<sup>255</sup> Brewer & Rhim, *supra* note 74, at 11.

difficult to tell whether they will survive the test of time. If they endure, it appears likely that the nonprofit sector, and perhaps the traditional for-profit sector, will shrink. This effect occurred with the creation of another hybrid—the LLC.<sup>256</sup> Corporations, which were the major business entity only decades ago, have now been surpassed by LLCs in the creation of new ventures.<sup>257</sup> It seems probable that nonprofit organizations will experience the same downfall, because hybrid organizations draw from the best assets of its predecessors just as LLCs did.

Although this may occur overall, the FPC will likely not have much of an effect on the fading nonprofit sector. FPCs are skewed much farther to the wing of traditional corporations rather than nonprofit entities. Unlike Benefit Corporations and L3Cs, FPCs are not required to primarily pursue a public benefit. FPCs are more closely aligned with socially responsible corporations, but have the incentive of avoiding director liability for considering impacts identified in their articles other than finances.

#### *E. New Liability Component for Breach of Social Duty?*

Hybrid entities to date excuse directors from a duty to ensure that their social component is satisfied. Although Benefit Corporations require directors to pursue a general public benefit, the legislation specifically states that directors cannot be held liable if the business fails to achieve its social goal.<sup>258</sup> It also expressly states that directors “[do] not have any duty to a person that is a beneficiary of the public benefit purposes.”<sup>259</sup> One can only wonder as the hybrids continue to grow, whether their social benefits will grow likewise. If not, then perhaps legislators will have to take another look at directors’ duties.

### VI. CONCLUSION

At the rate new hybrid entities are springing up, at some point the number of corporate entities may become overwhelming. However, California has taken action at the top end of the hybrid emergence. Before California’s introduction of the FPC, L3Cs and Benefit Corporations were the only separate hybrid entities recognized by U.S. law, and the FPC is substantially different from both. The distinctions between the three entities are great enough to merit independent recognition. In the words of John Fogerty, the states “better get while the getting’s good,”<sup>260</sup> and that is just what California has done.

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<sup>256</sup> Chrisman, *supra* note 49, at 460; Kleinberger, *supra* note 27, at 886.

<sup>257</sup> Chrisman, *supra* note 49, at 460; Kleinberger, *supra* note 27, at 886.

<sup>258</sup> MD. CODE ANN., CORPS. & ASS’NS § 5-6C-07(c) (West 2011).

<sup>259</sup> *Id.* at § 5-6C-07(b).

<sup>260</sup> JOHN FOGERTY, UP AROUND THE BEND (Fantasy Records 1970).