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Law Alert

To: Firm Clients and Contacts

From: Niesar & Vestal LLP

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Re: **New California Social Enterprise Laws Create Benefit Corporation and Flexible Purpose Corporation**

On Sunday, October 9, 2011, California Governor Brown signed into law Assembly Bill 361 and Senate Bill 201 which create two new classes of for-profit corporations that are legally required to pursue a positive impact on society and the environment: the benefit corporation and the flexible purpose corporation. Such for-profit/nonprofit hybrid corporations widen the traditional corporate goal of profit maximization to include social and environmental benefits. Effective January 1, 2012, any new or existing company that wishes to define itself as a benefit or flexible purpose corporation may do so by writing its Articles of Incorporation in a way that supports a specific social mission alongside seeking shareholder profits.

California is the first state to pass the flexible purpose corporation model, but the sixth state to recognize benefit corporations (New Jersey, Virginia, Hawaii, Vermont and Maryland all officially allow benefit corporations, while similar legislation is pending in Michigan and New York).

Key Points of Assembly Bill 361 (Benefit Corporation)

Assembly Bill 361 authorizes and regulates the formation and governance of a new form of corporate entity known as a benefit corporation. The bill permits an existing corporation to become a benefit corporation by amendment to its Articles of Incorporation, adopted by at least a 2/3 shareholder vote, or through a merger, reorganization, or conversion.

Benefit corporations must be formed for the purpose of creating “general public benefit”, defined as a material positive impact on society and the environment, as assessed against a third party standard. The third party standard must be developed by an entity that has no material financial relationship with the benefit corporation and that has the necessary and appropriate expertise to assess overall corporate social and environmental performance, using a balanced multi-stakeholder approach, including a public comment period of at least 30 days to develop the standard. The criteria considered in developing the standard must also be made publicly available.

In addition to creating a general public benefit, benefit corporations may also identify specific public benefits as additional corporate purposes in their Articles of Incorporation, such as providing low-income communities with beneficial products or services, providing economic opportunity beyond creation of jobs, preserving the environment, improving human health, or promoting the arts and sciences.

Directors of a benefit corporation must consider the impact of any action of the corporation on not only shareholders, but also employees, beneficiaries of the public benefit, and the environment. Directors must prepare an annual benefit report relating to the public benefit purposes of the corporation. Fiduciary duties of officers and directors of a benefit corporation may only be enforced in special benefit enforcement proceedings defined in the bill.

Key Points of Senate Bill 201 (Flexible Purpose Corporation)

Senate Bill 201 enacts the Corporate Flexibility Act of 2011 and authorizes and regulates the formation and operation of a new form of corporate entity known as a flexible purpose corporation. The bill permits an existing corporation to merge or convert into a flexible purpose corporation upon approval of the transaction by a 2/3 shareholder vote. Dissenting shareholders must be given the right to cash out their holdings. A flexible purpose corporation may also convert into a nonprofit corporation, a corporation or other domestic business entity with the same 2/3 shareholder approval.

The Articles of Incorporation of a flexible purpose corporation must list the special purposes that the corporation shall engage in, which may include charitable and public purpose activities that could be carried out by a nonprofit public benefit corporation. Flexible purpose corporations must file regular public reports about the status of their stated special purposes. Officers and directors must specify objectives for assessing the corporation’s efforts to achieve its special purposes, and to include an analysis of those efforts in annual reports, together with specified financial statements, sent to shareholders.

Difference between Benefit Corporation and Flexible Purpose Corporation

The two new classes of hybrid corporations are similar in concept. The primary differences are that benefit corporations have less flexibility in choosing a purpose or mission than flexible purpose corporations, benefit corporations (but not flexible purpose corporations) must be certified by a third party as having a minimum standard of social and environmental impact, and fiduciary obligations of officers and directors of a benefit corporations are enforced differently.

Assessment of New Hybrid Structures

The key benefit of the new hybrid corporations is that they address entrepreneurs' fears that they will be sued by their own shareholders for failing to maximize profits and paying too much attention to a social and environmental mission. By removing the mandate that corporations only focus on shareholder profits, directors are freed up to use the market as a force for good without risking suit from their shareholders. By combining providing a social benefit with making profits, the new hybrid corporations may tap into both conventional capital markets as well as philanthropy and foundations for fundraising. Through these hybrid structures, investors and entrepreneurs may pursue social and environmental impact together with a certain level of financial performance.

These hybrid corporations will be taxed the same as for-profit corporations, although certain advocates may petition the Internal Revenue Service to consider future tax breaks for the hybrids.

The new hybrid structures do have their critics as well. Charities are concerned about increasing competition for limited philanthropic dollars. Some corporate lawyers and regulators argue that the new structures hold an inherent conflict of interest and that they will lower standards of director fiduciary duty. Some have described the structures as little more than slick exercises in marketing and have argued that existing laws offer sufficient options for social entrepreneurs, e.g. writing a special mission into a limited liability company's operating agreement, incorporating socially beneficial activities into core business strategies without abandoning the primary goal of making profits, launching nonprofit arms to segregate charitable work. Proponents of the new structures counter that such options may require costly legal work, whereas the new hybrid structures are simpler, more predictable, and cheaper to set up, operate and use as a shield against derivative suits from unhappy shareholders if on occasion the directors allow the social mission to trump shareholder value.

Opponents of the benefit corporation argue that requiring a minimum standard of social and environmental impact is more difficult to regulate and may encourage more potential shareholder lawsuits. For this reason, the flexible purpose corporation may be a more useful form by allowing the corporation to choose and maintain its own mission.

Companies should consider using one of these new hybrid forms if they are serious about operating a sustainable business and are comfortable allowing the public to see how well they are performing.