Entrepreneurs and Investors Get Legislative Support for California Corporations that Stress Social Measures over Maximizing Profits

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Two new bills recently introduced in the California legislature would allow socially conscious entrepreneurs to form either a "flexible purpose corporation" or a "benefit corporation." These two new forms of corporate entities would serve to not only maximize financial returns to shareholders but also advance a broader social and environmental purpose (known as a "special purpose"). The "flexible purpose corporations" and the "benefit corporations" will continue to be subject to all other provisions of California's General Corporations Law, except as specifically noted in the new law.

The Problems with Traditional Corporate Structures

Socially conscious entrepreneurs looking to form new business ventures that further a "special purpose" currently have limited options in structuring their corporate entities. Traditional corporations have proven to be problematic structures for advancing social and environmental measures because corporate executives and board members must make decisions based on maximizing financial returns for shareholders rather than those on the basis of a "special purpose." Although directors of a corporation are normally protected by the "business judgment rule" (i.e. protection offered to directors who act in good faith, in a manner reasonably believed to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances), California corporations and its directors can still be sued by shareholders for negatively impacting shareholders' returns. The legal issue of fiduciary responsibility has long been seen as a barrier to companies taking more proactive social and environmental measures. In many cases, it has given both privately held and publicly traded companies an excuse to avoid taking on social measures.

Other forms for corporate entities such as limited liability companies which are not specifically required to be a profit-seeking enterprise are also limited in that they are better suited for smaller ventures given their tax-pass through and partnership like qualities. Finally, the option of a nonprofit corporation, a hybrid model championed by social entrepreneurs, has been generally rejected by capital markets given its operational restrictions. And although groups of socially responsible investors, social and environmental activists, and others in California and other states have tried unsuccessfully for years to influence progressive change in publicly held companies, getting publicly held companies to change has been all but impossible.

Senate Bill 201, known as the Corporate Flexibility Act of 2011, would enable a new form of for-profit corporation which would permit companies to pursue environmental and/or social measures instead of simply making money.

Flexible Purpose Corporations

Senator Mark DeSaulnier introduced Senate Bill 1463 in the California State Senate in 2010 and reintroduced Senate Bill 201 on February 8, 2011. Senate Bill 201 does not currently include any substantive changes from the original Senate Bill 1463. Senate Bill 201 would authorize and regulate the formation and operation of a new form of corporate entity known as a "flexible purpose corporation." Senate Bill 201 would permit flexible purpose corporations to be formed or converted from other entities to pursue a "special purpose" in addition to maximizing shareholder wealth.
The Articles of Incorporation of a flexible purpose corporation must include a statement that a purpose of the flexible purpose corporation is to engage in one or more of the following:

1. One or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out; or
2. The purpose of 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 any of the following:

a. The flexible purpose corporation's employees, suppliers,
customers, and creditors;
b. The community and society; or
c. The environment.

By adding this statement to the Articles of Incorporation, existing and potential shareholders will be put on notice that the corporation's directors will consider the "special purpose" of the corporation when taking corporate actions, which actions may or may not align with the goal of maximizing financial returns to shareholders. Directors of a flexible purpose corporation will be protected by a standard similar to the existing business judgment rule, but which will additionally provide that in discharging his or her duties, a director may consider and give weight to those factors as the director deems relevant, including the short-term and long-term prospects of the flexible purpose corporation, the best interests of the flexible purpose corporation and its shareholders, and the purposes of the flexible purpose corporation as set forth in its Articles of Incorporation.

Benefit Corporations

On March 4, 2011, Assembly Member Jared Huffman of the 6th Assembly District introduced legislation establishing a new type of corporation in California. Assembly Bill 361 would create a "benefit corporation", which is not as "flexible" as the "flexible benefit corporation" because it may only pursue a specified "general public benefit", as defined in great detail by the legislation. A "general public benefit" is "a material positive impact on society and the environment, taken as a whole, as measured by a third-party standard, from the business and operations of a benefit corporation." This "third-party standard" must be developed by an organization that is independent of the benefit corporation and meets a litany of specified requirements. For example, one of the requirements is that not more than 1/3 of the members of such organization's governing body may be representatives of either an association of businesses operating in a specific industry, the performance of whose members is measured by the standard, or businesses whose performance is measured by the standard. Also, the "third-party standard" must access necessary and appropriate expertise to asses overall corporate social and environmental performance and use a balanced multistakeholder approach.

In addition, the Articles of Incorporation of a benefit corporation may identify one or more "specific public benefits" which the benefit corporation may pursue. These specific public benefits include providing low-income or underserved individuals or communities with beneficial products or services, promoting economic opportunity for individuals or communities beyond the creation of jobs in the ordinary course of business, preserving the environment, improving human health, promoting the arts, sciences or advancement of knowledge, increasing the flow of capital to entities with a public benefit purpose, and the accomplishment of any other particular benefit for society or the environment.

The relevant statutes will specify a list of interests that the directors of a benefit corporation are required to take into consideration when discharging their duties as directors, as well as a list of interests that directors are permitted to take into consideration. For example, directors must consider the impacts of any action upon the following: shareholders, employees, the workforce, customer interests, community and social considerations, the local and global environment, the short-term and long-term interests of the benefit corporation, and the ability of the benefit corporation to accomplish its general and specific benefit purposes. However, directors are not required to give priority to the interests of any particular person or group set forth in this list unless the benefit corporation has stated its intention to give priority to interests related to a specific public benefit purpose.

Furthermore, no person may bring an action or assert any claim against a benefit corporation or its directors or officers with respect to the duties of directors and officers or with respect to the general or any specific public benefit purpose of the benefit corporation except in a "benefit enforcement proceeding", defined as a claim or action brought directly by a benefit corporation or derivatively on its behalf against a director or officer for failure to pursue the general or specific public benefit purpose or for violation of a duty or standard of conduct imposed by the benefit corporation statutes.

Monitoring the Process From Bill to Law

By the introduction of Senate Bill 201 and Assembly Bill 361, California joins a growing list of states to consider allowing the formation of corporate entities which place social and/or environmental considerations over maximizing financial returns for its shareholders. Should either Senate Bill 201 or Assembly Bill 361 pass, companies will be able to pursue environmental and social goals as aggressively as they do financial ones.

Senate Bill 201 has cleared both the Senate Banking & Financial Institutions Committee and the Senate Judiciary Committee. The Senate Appropriations Committee will hear the bill in early May. Assembly Bill 361 is scheduled for hearing in the Assembly Judiciary Committee on May 3.

We will continue to monitor the status of Senate Bill 201 and Assembly Bill 361. In the event they are signed into law, we will update you and let you know when they will become effective. If you would like to learn more about forming a flexible benefit corporation or benefit corporation or about converting an existing entity into corporate entity into one of these new entities, the attorneys in Nossaman's Corporate Practice Group are available to assist you.