

California Creates Two New Types of Corporations: Understanding the Benefit Corporation and Flexible Purpose Corporation

BY ROB R. CARLSON AND LISA M. TRAN

On January 1, 2012, two California bills became effective that create new forms of California corporate entities. AB 361, authored by Assemblyman Jared Huffman, creates the benefit corporation or B-corp, while SB 201, authored by Senator Mark DeSaulnier, creates the flexible purpose corporation or FPC. Unlike the traditional corporation, B-corps and FPCs now allow for-profit businesses to serve a socially-minded purpose without having to maximize shareholder return.

The Need for Change

Prior to the passage of AB 361 and SB 201, corporations were reluctant to advance objectives not aimed solely at improving a corporation's bottom line. Actions taken by a corporation to act in an environmentally friendly or socially conscious manner were justified only in the context of maximizing long-term shareholder value. Directors of for-profit corporations avoided advancing "not for profit" objectives too strongly for fear of breaching their fiduciary duty to act in the best interests of the corporation's shareholders. The experience of popular ice cream maker, Ben and Jerry's, illustrates this conflict of interest when it was forced to accept a buyout bid from corporate giant, Unilever. Despite fears that a Unilever takeover could harm Ben & Jerry's longstanding commitment to social responsibility, the Ben & Jerry's board of directors felt forced to accept the offer under threat of a shareholder lawsuit. On the other end of the spectrum, non-profit corporations, required to serve the public interest, are restricted by their charters, Internal Revenue Service regulations governing tax-exempt entities and by the oversight of states' attorneys general from engaging in activities solely for the purpose of profit generation. Because the earnings of a nonprofit corporation cannot inure to the benefit of any private individual or entity, a nonprofit organization cannot seek capital from equity investors in order to fund its operations. Instead, nonprofit corporations must rely on the charitable donations of philanthropic donors who must have no financial interest in its organization. As a result of these funding restraints, nonprofit corporations have struggled to finance their activities, particularly during a sluggish economy.

Choosing Between the B-corp and the FPC

Benefit corporations (governed by California Corporations Code Section 14600 et. seq.) and flexible purpose corporations (governed by California Corporations Code Section 2500 et. seq.) offer a solution for California corporations that wish to operate for a profit while also advancing socially-conscious values. Although both types of entities appear to accomplish the same purpose, a careful review of the

characteristics of each reveals key distinctions which should be taken into consideration when creating or converting an existing company into a B-corp or FPC. Existing corporations may convert into either the B-corp or the FPC by obtaining the proper approval of the shareholders, and shareholders who vote against the conversion have standard dissenter's rights. After conversion into the B-corp or FPC, the articles of incorporation of both corporate forms must include a statement attesting to the purpose of the resulting corporation. The articles of incorporation of the B-corp must state that it was formed for the purpose of "creating a general public benefit" which is defined in the California Corporations Code as a "material positive impact on society and the environment, taken as a whole, as assessed against a third party standard." On the other hand, the articles of incorporation of the FPC must state that it was formed for the purpose of (i) engaging in one or more charitable or public purpose activities that a nonprofit public benefit corporation is normally authorized to carry out or (ii) promoting positive effects of the corporation's activities on the corporation's employees, suppliers, customers, creditors, community and society and the environment. Unlike the B-corp, FPCs are not required to pursue a "general public benefit" that will be judged according to a third-party standard. Instead, FPCs may focus on more specific purposes. Shareholders who are passionate about a particular cause may prefer the FPC approach over the general benefit approach of the B-corp. On the other hand, the B-corp structure may be more favorable because it may be viewed by the public as more credibly providing a general benefit to society as a whole, particularly because its actions are assessed against a third-party standard. In addition, while B-corps are required to state a general public benefit purpose, it may also enumerate specific purposes as well. Depending on the specific mission of the corporation, one corporate form may be more advantageous over the other.

When performing their duties to the corporation, directors must act in the best interest of the company and its shareholders. While directors of traditional for-profit corporations must only consider the interests of the shareholders when evaluating these decisions, directors of B-corps and FPCs are authorized to take into account other interests. B-corp directors have a duty to consider the impact of a proposed action on a corporation's shareholders, employees, customers, community and environment. Additionally, a B-corp director must also take into account the ability of the B-corp to accomplish its general public benefit purpose and any enumerated specific purposes. In discharging their respective duties, however, B-corp directors shall not be required to give priority to any particular factor unless the articles of the B-corp expressly state an intention to do so. On the other hand, FPC directors, when evaluating a potential corporate action, *may* consider and give weight to those factors as they deem relevant, such as the short- and long-term prospects of the FPC, the interests of its shareholders and the specific purposes of the FPC. Thus, while the general purpose of the B-corp may be viewed as more broad, its directors are required to take into consideration the impact of a proposed corporate action on several constituent groups whereas directors of the FPC are allowed to, but are not required to, account for the impact of a proposed action on these groups. Even then, directors of the FPC need only consider the action in the context of the specific purpose of the FPC. In either case, directors of both corporate forms are shielded from liability so long as they perform their duties as directors in a proper manner and in accordance with the law. Thus, companies who wish to give their directors greater discretion to consider certain interest groups may want to opt for the more relaxed standard that the law governing the FPC affords.

The statutes governing both the B-corp and FPC impose a reporting and disclosure duty on its directors. Directors of both types of corporations are required to (i) produce annual reports assessing the company's performance and (ii) make such reports publicly available. However, the required content of the reports differs between the two corporations. Directors of the B-corp must assess the performance of the company against a third-party standard and whether it successfully accomplished

its general benefit purpose (and any specific purposes that may have been stated in the company's charter). The third-party standard, by definition, must be developed by an independent entity that has no material financial relationship with the B-corp. Benefit Labs, a nonprofit organization and one of the sponsoring entities of AB 361, along with a handful of other nonprofit entities such as Global Reporting Initiative, Green Seal, Green America, and others provide various standards against which the B-corp may be evaluated. While some of these third-party organizations offer free assessment tools, the overall process of evaluating the company's performance against a third-party standard could result in increased time and expense to the B-corp.

Directors of the FPC, on the other hand, need not evaluate the company's performance against any third-party standard. Instead, the annual report for the FPC only requires a special management and discussion analysis section that evaluates whether the FPC achieved its special purpose. While this self-reporting may appear to simplify the disclosure process, the management of the FPC must ensure the disclosures that are made are complete and accurate and do not withhold material information from the company's shareholders. This requirement places a greater responsibility on FPC directors to use their best judgment when determining the appropriate amount and level of disclosures. Furthermore, FPCs are also required to deliver a special purpose current report to its shareholders within 45 days of (i) the incurrence of an expense likely to have a material adverse effect on the operations of the company, (ii) any withholding of any planned expense that is likely to have a material adverse effect on the company or (iii) a determination that the special purpose of the corporation has been satisfied or should no longer be pursued. The additional periodic reporting requirement of the FPC provides for more timely delivery of material information to its shareholders, but it also imposes a greater reporting burden on the company. It is important to note, however, that an exception to the annual and periodic reporting requirements of the FPC exists if the FPC has fewer than 100 shareholders and two-thirds of the outstanding shares authorized to vote waives such disclosure. Thus, corporations with a smaller number of shareholders may want to consider the FPC structure; whereas corporations with a larger shareholder base may opt for the B-corp structure, but only if it is willing to be judged against a third-party standard.

Concluding Thoughts

Companies who wish to differentiate themselves from purely profit-driven companies should determine whether adopting either the benefit corporation or flexible purpose corporation structure makes strategic sense. Increasingly, consumers are drawn more towards socially-conscious companies. According to a survey conducted by McKinsey & Company, 49% of Americans stated that they would boycott companies whose behavior they perceive is not in the best interest of society. In addition, mission investing, which is the discipline of investing both for financial return and social or environmental benefit, has become increasingly popular. A JP Morgan report from November 2010 valued the size of the socially-conscious consumer market at between \$400 billion and \$1 trillion. Companies who are willing to take on a more socially-minded mission may want to consider whether converting to the FPC or B-corp structure would help differentiate it from the competitive landscape. While California is the only state to adopt the flexible purpose corporation structure, seven states (including California) have adopted the B-corp structure, and B-corp legislation has been proposed in four additional states. California companies who are willing to accept a higher standard of public accountability in exchange for the ability to pursue socially-minded objectives must carefully identify the attributes of the type of corporate entity that best fits their needs.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Rob R. Carlson
1.213.683.6220
robcarlson@paulhastings.com

Lisa M. Tran
1.213.683.6393
lisatran@paulhastings.com
