

# New Corporate Forms: One Viable Solution to Advancing Environmental Sustainability

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**E**nvironmental sustainability will have a far greater impact on business than the internet, social media, and the “cloud” combined—a reality that should be recognized by boards, management, shareholders, and corporate lawyers alike. As Maurice Strong, the first Director General of the United Nations Environment Programme, explained, “After all, sustainability means running the global environment—Earth Inc.—like a corporation: with depreciation, amortization and maintenance accounts. In other words, keeping the asset whole, rather than undermining your natural capital.”<sup>1</sup> Investors have started to recognize the impact of social and environmental factors on the overall well-being of a corporation and, in some cases, to measure the “social return on capital.” And for their part, corporations are increasingly integrating corporate sustainability initiatives into their mainstream operations, with the understanding that there does not necessarily need to be a trade-off between environmental initiatives and profit maximization.

However, we believe that there is simply not enough time to watch and encourage the natural evolution of corporate board and management decisions. To be effective, many of the solutions to the pressing social and environmental problems facing our world today must be preventative rather than reactionary. While we are lawyers and not economists or scientists, we understand that institutionalized mispricing of natural resources and the continued failure to price externalities, combined with the progressive nature of climate change, requires the transformation of both business and law *as soon as possible*. And there is some good news on this front. In fact, there are actions that both are pragmatic and can serve to accelerate the necessary seismic shift toward sustainability. A recent report by Generation Investment recommends five critical areas on which business should focus to effect more rapid change: (1) identify and incorporate risks from stranded assets; (2) mandate integrated reporting; (3) end the default practice of issuing quarterly earnings reports; (4) align executive compensation structures with long-term sustainable performance; and

(5) encourage long-term investing with loyalty-driven securities.<sup>2</sup> Embedded in one of these recommendations is the need to change the corporate form.

When we refer to “corporate form,” we are really talking about the rules by which a company operates. The variations among corporate forms—sole proprietorships, partnerships, trusts, limited liability companies (LLCs), and corporations, to name a few—provide diverse financial and legal advantages. However, the vast majority of legal entities organize as corporations either in the state where they have primary operations or in Delaware.

When we advise our clients on what type of corporate form will best serve a particular business, three issues typically arise: liability, taxation, and access to capital. And 50 years after the publication of Rachel Carson’s *Silent Spring*<sup>3</sup> educated the world about the impact of humanity’s actions on the natural environment, corporate law has added a fourth threshold issue for consideration: the *purpose* of the entity beyond simply providing value for shareholders.

Over the last decade, a growing number of companies have started pursuing both returns for investors *and* the achievement of one or many social and environmental purposes. As a result, many non-profit and for-profit entities are “bending the arcs” of their respective corporate forms to achieve multiple or blended objectives. Although there have been some successes, many of the approaches adopted to date are unsatisfactory because they pose significant limitations and create risks and potential liability for boards and management.<sup>4</sup>

## Traditional Corporate Form and Sustainability

Corporations of all sizes have become increasingly engaged with social and environmental issues. Major consulting firms like McKinsey and BCG have now joined the ranks of boutique firms like BSR and GreenOrder in advising the *Fortune* 500 on how to become more environmentally sustainable. Voluntary reporting initiatives, such as the Carbon Disclosure Project,<sup>5</sup> have collected and made public

1. Michael de Pencier, “Interview with Maurice Strong,” *Corporate Knights: The Canadian Magazine for Responsible Business*, 2003, Vol. 2, No. 2, p. 15.

2. Generation Investment Management LLP (February 25, 2012) *Sustainable Capitalism*, p. 1.

3. Rachel L. Carson, *Silent Spring* (1962).

4. W. Derrick Britt, R. Todd Johnson, & Susan H. Mac Cormac (Sept. 2011) *Frequently Asked Questions, Proposed Amendments to the California Corporations Code*

for a New Corporate Form: *The Flexible Purpose Corporation and Senate Bill 201*, p. 2-4.

5. The Carbon Disclosure Project (CDP) is an independent not-for-profit organization working to measure, disclose, manage, and share environmental information in order to drive greenhouse gas emissions reduction and sustainable water use by business and cities. See, *Carbon Disclosure Project*, available at <https://www.cdproject.net/en-US/Pages/HomePage.aspx>.

company performance data on various environmental metrics. Most major corporations also produce Corporate Sustainability Reports, explaining their annual accomplishments with respect to environmental sustainability, community, and social benefit initiatives. There is a clear trend in corporate governance toward increased attention to the environmental and social impacts of business operations. In fact, shareholder resolutions on issues of environmental sustainability are now the fastest growing category of resolutions (replacing executive compensation).

Some critics believe that the traditional corporate form maximizes profit for shareholders at the expense of other stakeholders, including the company's employees, the local community, and the natural environment.<sup>6</sup> Others contend that making socially responsible decisions can create competitive advantage, lead to a greater market share, and increase consumer and employee goodwill.<sup>7</sup> Furthermore, while it is a useful shorthand default for directors and management on how to make daily decisions, the duty to maximize shareholder value is not legally required in all cases.

The primary guiding principles driving board decision-making are the duties of care and loyalty. In general, the duty of care requires directors to be well informed and to carefully consider the issues before making a deliberate decision. The directors may rely on experts and officers for their information and can help ensure compliance by developing a process to consider all viable options. The duty of loyalty requires directors and management to place the interests of the corporation ahead of their own personal interests or the interests of other organizations with which they are closely linked.

The primary fiduciary duties are evaluated by courts in light of the "business judgment rule," which creates a safe harbor for boards and management and generally affords them considerable flexibility when considering environmental or social factors in defining the long-term best interests of the corporation and its shareholders. It is generally held not to be malfeasance for directors to make decisions in the ordinary course of business that do not maximize short-term shareholder value, unless there is a evidence that the board's decision was uninformed or tainted by self-interest.

However, the business judgment rule does not afford sufficient protection and flexibility to consider social or environmental factors in *all* decisions. For example, the rule does not offer protection in change-of-control situations when boards and management generally have a fiduciary duty to act exclusively in the interest of maximizing shareholder value.<sup>8</sup> Further, because the scope of the business judgment rule is judicially created and interpreted, and because litigation in this area is prevalent, directors and their lawyers tend to apply risk-averse constructions even where judicial guidance favors an expansive interpretation. This risk avoidance is more acute given the thousands of plaintiffs' lawyers who troll the results of the exchanges every day, looking for precipitous drops in stock prices that could give rise to shareholder class action litigation. As a result, boards of directors are typically hesitant to pursue alternative purposes if they could have a negative impact on short-term stock price.

In addition, various market and regulatory forces generate a greater emphasis on short-term shareholder returns. The practice of issuing quarterly earnings reports both encourages and places excessive internal emphasis on short-term decisions. Executive compensation structures often give too much weight to short-term actions and provide limited accountability for the long-term ramifications of decisions. Further, stock market trading is characterized in significant part by short-selling and other short-term investment strategies, leading to a general instability that undermines executives seeking to create long-term value. These market forces and compensation structures combined with the real and perceived limitations of the business judgment rule contribute to a continued emphasis on shareholder value and lack of innovation around blended value.

Even if founders and initial shareholders embrace a social or environmental mission at a company's inception, the traditional corporate form presents risks for the entrepreneur who seeks to maintain the mission throughout the lifecycle of the company. Investors can shift the company away from the original mission over time in favor of increased profitability, particularly in a change-of-control situation.<sup>9</sup> Although there are mechanisms to help "anchor the mission"—particularly effective are the use of LLCs and intellectual property

6. As heard in the classic case of *Dodge v. Ford Motor Co.*, "A business corporation is organized and carried on primarily for the profit of the stockholders...The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes"; more modernly, this is still the rhetoric in recent speeches and legal articles. See, e.g., Senator Al Franken's speech at the Netroots Nation. "[I]t is literally malfeasance for a corporation not to do everything it legally can to maximize its profits." Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, Perspectives in Business Ethics, (P. Hartman Ed., 2<sup>nd</sup> Edition) p. 260-296.

7. McWilliams, A., & Siegel, D. (January 2001) Corporate Social Responsibility: A Theory of the Firm Perspective, *Academy of Management Review*, 26(1), 117-127.

8. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, a takeover case in which the court held that in certain limited circumstances when the "sale" or "break-up" of the company is inevitable, the fiduciary obligation of the directors of the target corporation are narrowed significantly to the singular responsibility of maximizing immediate

shareholder value by securing the highest price available. In this different frame, the conduct of the directors is not reviewed pursuant to the traditional business judgment rule. In this particular case, the target's board based some of their decisions out of a concern for the interests of creditors rather than shareholders, thus violating their fiduciary duties.

9. See, e.g., *eBay Domestic Holdings, Inc. v. Newmark*, C.A. No. 3705-CC, 2010 Del. Ch. LEXIS 187 (Del. Ch. Sept. 9, 2010). Although not under a traditional change in control situation, the court rescinded a "Rights Plan" deployed as a poison pill by Craigslist allegedly in order to stave off eBay's threat to Craigslist's "corporate culture." The decision is the first of its kind to examine whether the protection of a purportedly unique "corporate culture," divorced from any effort to promote shareholder value, can justify implementation of a poison pill. The court held that the "[d]irectors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law."

licenses, as opposed to the constituency statutes as referenced below—they can be too broad or unintentionally narrow. If too broad, the investors in the company are at risk from a “bad actor” director with too much power. On the other hand, if the mechanisms are too narrow, the mission may be ignored if they conflict with a director’s fiduciary duties, or can be diluted or deleted entirely by amendment.

In the case of the traditional corporate form, transparency with respect to the social mission is also problematic. Regulations governing the traditional corporation provide for disclosure of corporate financial data but do not require disclosure of social mission performance data unless they are material to operations. Increased transparency in this area is essential to protect investors from director actions that waste corporate assets under the auspices of a social mission without accountability. Voluntary reporting, a current trend, particularly in the environmental emissions area, lacks the rigor necessary to appropriately assess performance. Without required disclosure and regular auditing, investors will find it difficult to compare companies because there is too much variation in the types of information disclosed and the methods used to calculate it.<sup>10</sup>

Even with these hurdles, many traditional corporations are promoting corporate social responsibility with some measure of success, particularly from a marketing perspective. There are now corporate social responsibility departments at most large corporations that, in many cases, set high standards for environmental sustainability. These corporations have gained consumer and employee goodwill, have increased their market share, and are able to actually provide increased wealth to their shareholders. Private equity firms like Carlyle are joining forces with the Environmental Defense Fund to review Environmental, Social, and Governance (ESG) factors in their investments to create value and unlock opportunities. One firm’s comprehensive ESG analysis program led it to begin releasing Sustainability Reports on its Green portfolio, which claims to have achieved an estimated \$160 million in cost savings by eight of their program companies in 2010.

However, the fact remains that corporate structure is not designed to *promote* corporate social responsibility, but merely allows it to exist within the safe harbor of the business judgment rule. We believe that, without any changes to the rules by which they operate, corporations will naturally evolve—as they have over the past 100 years—to more fully embrace environmental sustainability. Unfortunately, with respect to many of today’s most pressing environmental problems—the result in large part of the mispricing of natural resources and failure to price certain externalities—time is of the essence. Continued failure to price environmental externalities has led to unsustainable use of natural resources and ineffective accounting for the costs of pollution.<sup>11</sup> For example, the American Society of Civil Engineers (ASCE) estimates a five-year shortfall of \$108.6 billion for water and wastewater infrastructure in the United States alone.<sup>12</sup> As Amir Peleg, the Founder and CEO of water monitoring company TaKaDu recently stated, “Water is not the new oil. Its value is greater than oil. Our mispricing of water leads to vulnerable water infrastructure and unsustainable water loss.”<sup>13</sup> This problem is exacerbated because many of the corporations that attempt to determine the true value of natural resources don’t disclose (or even verify) their findings, either for fear that disclosure will cause their stock prices to plummet or, if they share information with their competitors to spread the risk and ensure consistent reporting across an industry, they will lose trade secret protection.<sup>14</sup>

For these reasons, we came to the conclusion back in 2001 that a new alternative needed to be provided for the corporate form in the United States.<sup>15</sup>

## Emerging Alternatives

Discussion about changing and improving the corporate form to take into account social and environmental factors is *not* new. Some of the best corporate lawyers in the country came together in the late 1970s and labored for more than a decade to draft the American Law Institute’s *Principles of Corporate Governance: Analysis and Recommendations*.<sup>16</sup> This publica-

10. The need for integrated sustainability accounting standards has led to the creation of the new Sustainability Accounting Standards Board (SASB). The SASB will create industry-based key performance indicators suitable for disclosure in standard filings such as the Form 10-K, establishing standards for integrated reporting that are concise, comparable within an industry, and relevant to all 35,000 publically listed companies in the U.S. For more details, see <http://www.sasb.org>.

11. See, e.g., Nicolas Z. Muller, Robert Mendelsohn, and William Nordhaus (August 2011) *Environmental Accounting for Pollution in the United States Economy*, American Economic Review 101, p. 1649-1675.

12. American Society of Civil Engineers (ASCE) (2009) *2009 Report Card for America’s Infrastructure*, p. 7, 25, and 57, available at [http://www.infrastructurereportcard.org/sites/default/files/RC2009\\_full\\_report.pdf](http://www.infrastructurereportcard.org/sites/default/files/RC2009_full_report.pdf).

13. Tom Smith (September 30, 2011) *Low water prices lead to inefficient distribution and use*, available at <http://www.proudgreenhome.com/blog/6529/Low-water-prices-lead-to-inefficient-distribution-and-use>.

14. The U.S. Securities and Exchange Commission (SEC) provided companies with interpretive guidance on how existing disclosure requirements applied to climate change, but many corporations are still risk adverse to voluntary environmental disclosures. Securities and Exchange Commission (February 8, 2010) *Commission Guidance Regarding Disclosure Related to Climate Change*, 17 CFR Parts 211, 231, and 241, available at <http://www.sec.gov/rules/interp/2010/33-9106.pdf>.

15. Other countries have already taken enormous steps with corporate form and sustainability. In the United Kingdom, Community Interest Companies (known as C.I.C.’s) are quickly taking hold, with over 100 new CICs registered monthly, and over 6000 CICs on the Regulators’ register as of Jan 2012. See <http://www.cicassociation.org.uk/about/what-is-a-cic>. Belgium created Social Purpose Companies, a statutory label for companies that meet certain special criteria, including having a central social purpose and not being operated for shareholder profit. Rosemary E. Fei, *Beyond Taxation: A Guide to Social Enterprise Vehicles*, (January/February 2011) *Taxation of Exempts*, Vol. 22/Issue 4. France, Portugal, Spain, and Greece offer a form of cooperative society with multiple stakeholders (including its employees) and a social mission corresponding to local needs and other countries, such as Finland, have established special registers of companies organized as social enterprises. Jacques Defourny & Marthe Nyssens, *Social Enterprise in Europe: Recent Trends and Developments*, (August 2008), *Social Enterprise Journal* Vol. 4/No. 3. Outside of Europe, South Africa’s Johannesburg stock exchange now requires all companies, regardless of form, to issue integrated reports including their ESG factors for financial years starting on or after March 1, 2010 or explain why they are not doing so. See, *The Code for Responsible Investing in South Africa* (CRISA) (19 July 2011) available at [http://www.iodsa.co.za/Portals/0/library/documents/CRISA\\_19\\_July\\_2011.pdf](http://www.iodsa.co.za/Portals/0/library/documents/CRISA_19_July_2011.pdf).

16. *Principles of Corporate Governance: Analysis and Recommendations*, The American Law Institute at Washington, D.C., 1994, publ. American Law Institute Publishers.

tion contains an entire chapter on the limitations of current corporate forms on social issues and includes recommendations on how corporate forms can or should be changed to improve relations between a corporation, its employees, and the broader community (and since this was before the movement initiated by Rachel Carson's *Silent Spring* had fully matured, the environmental purposes were not mentioned).<sup>17</sup> Over the past 15 years, innovators have expanded on the work of these early thought leaders to create several innovative solutions, each with its own advantages and drawbacks. These new corporate forms are discussed below in the historical order in which they were introduced to the market.

### Hybrids

The first effort to address the limitations of existing corporate forms was the creation of "hybrid" structures, in which non-profit companies set up for-profit entities or vice-versa. There are various forms of hybrids. For example, a non-profit can establish a wholly-owned or majority-owned for-profit subsidiary, enter into a joint venture (typically in the form of a LLC) with a for-profit company, make a minority investment in a for-profit company, or establish a contractual relationship with a for-profit company. On the other hand, for-profit companies can set up non-profit foundations or otherwise contract with non-profits to provide products and services.

Hybrids have advantages in that they allow non-profits to enter into commercial activities via their for-profit affiliates and to receive revenues via services agreements, license revenues, or dividends. They can also attract funding from private, for-profit sources via their for-profit affiliates without jeopardizing the non-profit's charitable status.

However, there are significant constraints to the widespread adoption and use of these hybrid structures. For a non-profit to set up a majority-owned for-profit subsidiary, it must be a public charity (as opposed to a private foundation) with a broad funding base. In making minority equity investments, non-profits must comply with the complex project related investment (PRI) regulations. When it sets up a non-profit foundation, a for-profit company must navigate IRS rules that have evolved little during the past century or more. Moreover, all of these hybrid structures require additional resources such as fees for attorneys and other advisors that are sufficient to create and sustain two distinct

legal entities. Issues also arise in connection with the need to document all of the commercial relationships between the entities and the work of employees who provide services to both organizations. Hybrids that do not secure competent tax and legal advice at the time of formation find themselves facing fines and even potentially loss of tax-exempt status.

### Constituency Statutes

In response to the rash of corporate takeovers in the 1980s, states began to pass corporate constituency statutes that allowed managers and directors to consider the interests of a variety of stakeholders, and not just shareholders, in carrying out their fiduciary duties to the corporation. Currently, 33 states have passed "constituency statutes," which provide that boards and management "shall" or "may" take into account the interests of stakeholders such as employees, suppliers, consumers, and creditors, in addition to shareholders'.<sup>18</sup>

These statutes have been attractive to proponents of sustainability, and increasingly used as a means to integrate corporate social responsibility into the charter documents as well as the operational decisions of sustainable companies. However, the risks associated with this expanded use of constituency statutes are significant. First, their use by socially responsible companies has never been tested in court and there has been little or no attempt to reconcile the new duties with the traditional duties of care and loyalty owed to shareholders. Many believe that, if and when they are tested, these statutes will be found to be unenforceable, particularly in states like California that have long-arm statutes.<sup>19</sup> Second, there is no guidance with respect to how managers and directors should weigh the interests of varying constituencies. And there is no provision confirming that stakeholders representing such constituencies will have no cause of action to enforce their particular social or environmental interest. Finally, there are no means for companies that organize under the constituency statutes to report out or provide real accountability to shareholders on the socially responsible factors.

### Low-Profit Limited Liability Company ("L3C")

The low-profit limited liability company ("L3C") is another alternative for pursuing profitability together with a special

17. Part II discusses the "Objective and Conduct of the Corporation" and states in §2.01, "Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business...[m]ay take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and [m]ay devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes." *Id.* at p. 55.

18. See, e.g., 805 Ill. Comp. Stat. 5 / 8.85 (2010) (stating directors "may...consider the effects of any action...upon employees, suppliers and customers of the corporation or its subsidiaries, communities in which offices or other establishments of the corporation or its subsidiaries are located, and all other pertinent factors"); N.Y. Bus. Corp. Law § 717(b)(2)(i)-(v) (Consol. 2011) ("[Directors] shall be entitled to consider...the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following: (i) the prospects for potential growth, development, productivity and

profitability of the corporation; (ii) the corporation's current employees; (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation; (iv) the corporation's customers and creditors; and (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business."); and 15 Pa. Cons. Stat. Ann. § 1715(a)(1) (West 2011) ("[Directors may consider] [t]he 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.")

19. Cal. Corp. Code §2115.

purpose. The L3C is a statutory variant of the limited liability company that has been considered in 21 states and adopted in nine.<sup>20</sup> However, the L3C is principally designed to assist for-profit companies that have a *primarily* charitable purpose and want to attract PRI investments from foundations.

The statutory changes that create the L3C were specifically written to dovetail with the IRS regulations regarding PRI investments for foundations.<sup>21</sup> Currently, foundations commit less than 1% of their assets to PRIs,<sup>22</sup> due to restrictive and esoteric IRS requirements on what types of entities may receive these funds and how the investment must be structured. By requiring that “the primary purpose of the organization must be charitable, with the production of income permitted to be a secondary purpose,”<sup>23</sup> L3Cs can receive both foundations’ PRIs and investments from non-exempt parties to accomplish the L3C’s primary charitable purpose. An L3C may offer lower rates of return to member owners, but it should be noted that these entities cannot obtain tax exemptions under IRS 501(c)(3).<sup>24</sup>

The L3C has been billed as a simple answer to a very complex problem, yet these entities retain all of the limitations of the LLC from an investment perspective and arguably do not effectively solve many of the complications associated with PRIs.<sup>25</sup> Institutional investors are often unwilling to bear the burden of reviewing the diverse operating agreements of LLCs. In addition, LLCs and L3Cs have limited capital market acceptance and multiple tax concerns as pass-through entities. Furthermore, with the PRI concerns, there is no IRS ruling or attorney tax letter on PRIs for either regular for-profit LLC or L3C entities, so this new form does not help with the “private benefit” issue.<sup>26</sup>

Finally, although it could be addressed in the operating

agreement, the current drafts of model forms prepared for the L3C lack mission-anchoring mechanisms, decision-making protections for socially responsible management members, and transparency reporting obligations around the special purpose. There has been opposition from the ABA to the L3C; and many fear that because the characterization is definitional and not elective, any LLC that is set up traditionally and has a charitable purpose could be subject to the L3C requirements whether it intends to be or not.

### Flexible Purpose Corporation<sup>27</sup>

On October 9, 2011, Governor Brown signed into law California Senate Bill 201, creating a new division of the California Corporations Code to authorize and regulate the formation and operation of a new form of corporate entity known as a Flexible Purpose Corporation (FPC).<sup>28</sup> The law went into effect on January 1, 2012, and as of the date of publication, approximately 20 companies have established as FPCs. The FPC creates a new “safe harbor” in addition to the business judgment rule that requires boards and management to consider environmental and social factors in addition to shareholder value, in both the ordinary course of business and change-of-control situations, and protects boards and management from shareholder liability in connection with those actions.

The bill was drafted by the Working Group on New Corporate Forms, a group of ten corporate lawyers including partners from large and small firms, a law professor from Stanford, a general counsel of an impact investor and foundation, and members of the Corporations Committee of the State Bar.<sup>29</sup> Originally convened by the three co-chairs, the members of the Working Group were invited based on their corporate law experience as well as their ability to represent

20. Illinois (805 ILCS 180), Louisiana (HB1421/Act417), Maine (H-819), Michigan (MCL 450.4101 et seq.), North Carolina (H769/SB308), Rhode Island (H5279), Utah (Tit. 48, Ch. 02c), Vermont (tit. 11, Ch. 21), and Wyoming (Tit. 17, Ch. 15).

21. See, e.g., 805 ILCS 180/1-23(a) stating that “A low-profit limited liability company shall at all times significantly further the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. 170(c)(2)(B), or its successor, and would not have been formed but for the relationship to the accomplishment of such charitable or educational purposes,” and MCL 450.4101 (2)(m)(i) requires “[t]he limited liability company significantly furthers the accomplishment of 1 or more charitable or educational purposes described in section 170(c)(2)(B) of the internal revenue code, 26 USC 170, and would not have been formed except to accomplish those charitable or educational purposes.”

22. The Foundation Center tracks all PRI-makers identified via grantmaker surveys, reporting by foundations on their 990-PFs, and membership to the PRI Makers Network. Recently, the Foundation tracked 173 private and community foundations that made at least one PRI of \$10,000 or more in 2006 or 2007 and found that their program-related investments totaled \$742 million of the \$91.9 billion (approximately 0.8%) in overall charitable distributions provided by foundations during this two-year time frame. Steve Lawrence, *Doing Good with Foundation Assets, An Updated Look at Program-related Investments*, in The Foundation Center, *The PRI Directory: Charitable Loans and Other Program-related Investments by Foundations*, New York: Foundation Center, 2010.

23. Americans for Community Development, authors of the L3C legislation, available at <http://www.americansforcommunitydevelopment.org/faqs/faqs-significantportion.html>.

24. See, I.R.C. §501(c)(3). For additional U.S. tax regulations and exemptions governing organizations, see *id.* §§ 501–515. Because L3Cs are designed to facilitate PRIs by foundations, these investments are governed by the tax rules governing PRIs rather than the rules governing charitable contributions. In fact, there have been strong criticisms of the tax implications of L3Cs. See J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Opti-*

*mal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 274 (2010) (“[W]ithout changes to federal PRI [‘program-related investment’] provisions for private foundations] rules, the L3C construct has little or no value. Indeed, the existence of the state law form, without matching federal income tax substance, is dangerous since the ill-advised may assume value and use the form.”).

25. See generally Ann E. Conaway, *The Global Use of the Delaware Limited Liability Company for Socially-Driven Purposes*, 38 Wm. Mitchell L. Rev. 772 (2012) (discussing the creation and use of L3Cs and explaining “The Truth About L3C Legislation”) and Daniel S. Kleinberger, *A Myth Deconstructed: The “Emperor’s New Clothes” on the Low Profit Limited Liability Company*, 35 Del. J. Corp. L. 879 (2010).

26. William Callison, L3Cs: Useless Gadgets? *Business Law Today Volume 19*, Number 2 (2009).

27. One of the authors of this article, Susan Mac Cormac, was on the Working Group that drafted the FPC.

28. The State of Washington will likely soon adopt the “Social Benefit Corporation,” a corporate form very similar to California’s FPC. *Substitute Washington HB 2239*. The legislation was delivered to the Governor on March 6, 2012 and is expected to be signed into law. For current status of the bill, see <http://e-lobbyist.com/gaits/WA/HB2239>.

29. The members of the Working Group are W. Derrick Britt (Co-chair), Partner, Doty, Barlow, Britt, and Thomas, LLP; R. Todd Johnson (Co-chair), Partner, Jones Day; Susan H. Mac Cormac (Co-chair), Partner, Morrison Foerster; Keith Paul Bishop, Partner, Allen Matkins Leck Gamble & Mallory LLP; Edward A. Deibert, Director, Howard Rice Nemerovski Canady Falk & Rabkin; William P. Fitzpatrick, General Counsel, Omidyar Network; Steven K. Hazen, Retired, Former Vice-Chair for Legislation of the State Bar of California Business Law Section; David M. Hernand, Partner, Gibson Dunn & Crutcher LLP; Jay A. Mitchell, Director, Organizations and Transactions Clinic, Stanford Law School and former chief corporate counsel of Levi Strauss & Co.; and Robert A. Wexler, Partner, Adler & Colvin.

diverse perspectives and approaches to the various “friction points” encountered when creating hybrid organizations. Dedicated to creating a non-partisan and unbiased solution to the limitations of existing corporate forms, the Working Group worked by consensus and spent almost two years deliberating and drafting the proposed new division of the California Corporations Code.

The Working Group considered various possible names for the new corporate entity and, for a time, used the working name “H Corporation,” with the “H” referring to hybrids. Ultimately, the Working Group settled on “Flexible Purpose Corporation” because it most closely described the new corporate form’s differences from the traditional corporation formed under California’s General Corporation Law (GCL).

FPCs are required to specify in their Articles of Incorporation (Articles) at least one “Special Purpose”<sup>30</sup> that directors and managers may consider in addition to traditional shareholder economic interests when determining what is in the best interests of the company and its shareholders. In general, decisions and actions that consider the multiple and potentially competing purposes of the FPC are protected from claims of waste or other breaches of fiduciary duties. FPC disclosure and transparency requirements protect investors from abuse of this expanded liability protection.

More specifically, the Flexible Purpose Corporation is different from a traditional corporation organized in California under the California Corporate Code in six defining ways: (1) the Articles must include one or more social or environmental purposes; (2) directors are protected from liability for decision-making involving trade-offs between profitability and the special purpose(s); (3) the special purpose mission may not be altered without the approval of two-thirds of each class of voting shares; (4) change of corporate form requires a vote of at least two-thirds of each class of voting shares; (5) shareholders cannot be forced into or out of an FPC without dissenters’ rights; and (6) an FPC must provide annual reports communicating achievements toward its special purposes together with 8-K type reporting of actions that could have a material impact on economic or socially responsible returns.

One of the primary goals when developing the FPC

was to have it “look and feel” as much as possible like a traditional corporation organized under the California Corporations Code to enable for-profit companies with a social and/or environmental goals to access traditional capital markets as well as “socially responsible” investment without increased risk. Initially, funding for FPCs has and will continue to come from impact investors<sup>31</sup> and wealthy individuals focused on sustainability. Second, there is considerable attraction toward use of FPCs by public charities that want to establish for-profit subsidiaries or affiliates to house commercial activities, but want to “anchor” their charitable mission on equal par with such affiliate’s profit motive. In addition, private foundations have become increasingly interested in making socially responsible investments.<sup>32</sup> Some foundations that fund “mission-related investments” that are still prudent and lucrative, yet also seek to advance the foundation’s mission, are attracted to FPCs—and to L3Cs and Benefit Corporations as well. However, none of these new corporate forms provide tax advantages or temper the PRI regulations that govern the investments. Finally, private equity and venture funds with a focus on cleantech and/or sustainability have expressed interest in FPCs. Some GPs of these funds recognize the greater operational efficiencies and potential for overall value enhancement that can come with well-managed FPCs, but they must first gain greater comfort with the risks associated with any new form and the impact on exit strategies. GPs may also initially be constrained by their LPs, even those who publicly tout a socially responsible agenda. However, that is likely to change in the not too distant future. A report discussing the critical role of the \$20 trillion in assets held by institutional investors play in addressing the current environmental and social problems examined the practices of the largest U.S. institutional investors currently investing for both financial return and positive social and environmental impact. This report shows that these investors are earning a competitive rate of return and goes on to provide recommended policy changes to encourage institutional investors to embrace funding companies with a blended value.<sup>33</sup> Although the evolution of the spectrum will not happen overnight, we are confident that institutional investors will fund FPCs and see both financial and social returns.

The FPC has already been and will continue to be

30. The Special Purpose can be one or more charitable or public purpose activities that a non-profit public benefit corporation is authorized to carry out and/or promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of, the FPC’s activities upon its employees, suppliers, customers, creditors, the community and society, and/or the environment. Cal. Corp. Code §2602(b)(2).

31. “Impact investors” is a term used to describe any investors who include social and environmental factors in their investment decisions and require some measure of reporting on the social return on investment (SROI). Impact investors seek to enhance social benefits or environmental health as well as achieving financial returns.

32. For decades, many foundations have imposed negative screens on their investments to avoid investing in “bad actors” such as tobacco companies. See e.g., *The Rockefeller Foundation Social Investing Guidelines*, available at <http://www.rockefeller-foundation.org/uploads/files/af34dcb4-1000-4dde-9748-df58eafc7ae2.pdf>.

33. *Impact at Scale: Policy Innovation for Institutional Investment with Social and Environmental Benefit*, is a collaboration between InSight at Pacific Community Ventures and the Initiative for Responsible Investment at Harvard University and is funded by The Rockefeller Foundation. The report explores the role of public policy in impacting investing for institutional asset owners and reveals government strategies to encourage this funding into the future. When examining current practices, the report “clearly demonstrates that Institutional Investments that have social and environmental value are also earning a competitive rate of financial return, allowing institutions to maintain their fiduciary duty while simultaneously having a social impact.” Dr. Judith Rodin, President of the Rockefeller Foundation. *Impact at Scale: Policy Innovation for Institutional Investment with Social and Environmental Benefit* (February 2012).

adopted by several types of entities: small, socially responsible companies, subsidiaries of public companies, and for-profit subsidiaries of non-profit public charities. The authors' goal is to have FPCs eventually become a viable and well-used alternative form, capable of attracting mainstream capital, for both small sustainable companies as well as large publicly traded multi-nationals, to fundamentally shift the playing field in favor of environmental sustainability.

### Benefit Corporation

The Benefit Corporation as a new corporate form arose out of the "B Corporation" certification process developed and marketed by B Labs.<sup>34</sup> This statutory corporate form contains advantages for companies that wish to pursue special purposes, but is often confused with B Lab's private system of certification for socially responsible companies.

The "B Corporation" certification process claims to differentiate between "good companies" and those that are simply involved in "greenwashing"<sup>35</sup> their products or processes. B Lab promotes the "B Corporation" certification, which allows for-profit entities to self-audit their socially responsible practices under the B Lab standards and then pay a royalty to license the B Corporation mark for display on products and materials. There are several other certifications for companies that want to distinguish themselves as socially and environmentally responsible; many of these are more comprehensive<sup>36</sup> and have more robust means of verification.<sup>37</sup>

Several years after the Working Group on New Corporate Forms was established and the year after the FPC legislation was introduced in California, B Lab co-drafted separate legislation with Bill Clark, a Pennsylvania attorney, designed to codify the B Lab standards. The first Benefit Corporation bill was signed into law on April 13, 2010 in Maryland. Similar statutes have been supported by B Lab, and various versions of this new class of corporation now exist in seven states, with the most recent passed in California on October 9, 2011, which became law on January 1, 2012 with the FPC.<sup>38</sup>

Benefit Corporation legislation varies significantly among the states; in fact, the differences among Benefit Corporations in the various states are more significant than the differences

between the Benefit Corporation and the FPC in California. The Bar Associations in most of the states (including California) have opposed the legislation primarily on technical (but also on policy) grounds, reflecting the failure in many states to ensure that the new provisions do not conflict with other provisions of the corporation code.

In general, the Benefit Corporation is formed for the purpose of creating a "general public benefit," which is defined as "a material positive impact on society and the environment, taken as a whole, as assessed against a third-party standard..." This purpose is in addition to, and may be a limitation on, shareholder profits. Furthermore, a Benefit Corporation may also elect one or more enumerated "specific public benefits" that accomplish a particular benefit for society or the environment. The inclusion of additional specific public benefits does not limit the Benefit Corporation's obligations to create a general material public benefit. Unlike the FPC's broad Special Purpose language, the Benefit Corporation employs a "materiality" requirement for any benefit, an approach that may restrict larger corporations from converting into Benefit Corporations.

There are additional differences between the Benefit Corporation and FPC. One is that the third-party standards by which Benefit Corporations assess their annual sustainability actions. Although the definition of "third-party standard" has been strengthened over the various iterations of the legislation, Benefit Corporations must select a standard to compile their annual reports and have little ability to change the standard over time. In contrast, the FPC allows for its standards to evolve as the definitions and interpretations of common sustainability practices progress. Furthermore, perhaps the greatest difference between the two corporate forms is in their enforcement proceedings. The Benefit Corporation creates a new cause of action entitled a "benefit enforcement proceeding." This enforcement proceeding lacks clarity and contains a real possibility of third-party claims, as this new right of action can be initiated by stakeholders who own at least 5% of the equity interest in the Benefit Corporation's parent company or any other persons that are specified in the articles or bylaws of the Benefit Corporation.<sup>39</sup> Finally, at least in California,

34. "B Lab drives systemic change through three interrelated initiatives: 1. Building a community of Certified B Corporations...2. [Promoting the] use of B Lab's GIIRS Ratings & Analytics...[and] 3. Promoting legislation creating a new corporate form..." *B Lab—the non-profit behind B Corp.*, available at <http://www.bcorporation.net/The-Non-Profit-behind-B-Corps>.

35. "Greenwashing" is a term used to describe a form of public relations spin in which green marketing is deceptively used to promote the perception that an organization's aims and policies are environmentally friendly. See <http://en.wikipedia.org/wiki/Greenwashing>.

36. The Global Reporting Initiative (GRI) is one of the world's most prevalent standards for sustainability reporting, with over 3,500 companies from 60 countries participating to date. GRI's Sustainability Reporting Guidelines are technically robust and updated frequently, with G3 guidelines issued in 2006 and G4 guidelines currently in the public comment period and set to be released this year.

37. The ULE 880 uses a rigorous third-party audit of the organizational sustainability metrics, complementing existing self-reporting protocols and standards that address discrete sustainability issues. ULE 880: Sustainability for Manufacturing Organizations available at <http://www.ul.com/global/eng/pages/offering/businesses/environment/companyser/SQProgram/EnterpriseStandards/UL880/>.

38. Cal. Corp. Code §§ 14600–14631 (West 2011), S.B. 1462, 26th Leg., Reg. Sess. (Haw. 2011), Md. Code Ann., Corps. & Ass'ns § 5-6C-01 (West 2011), N.J. Stat. Ann. §§ 14A:18-1 to -11 (West 2011), N.Y. Bus. Corp. Law §§ 1701–1709 (Consol. 2011), VT. Stat. Ann. Tit. 11A, § 21.02 (2011), Va. Code Ann. § 13.1-782 (2011).

39. Cal. Corp. Code §1462.3(2)(C), (D).

the Benefit Corporation cannot be used by many categories of legal entities, including insurance companies, close corporations, and banks.<sup>40</sup> If the legislation is amended in California to address these and other technical issues, the Benefit Corporation may become a viable vehicle for small, socially responsible companies that do not need to avail themselves of mainstream capital.<sup>41</sup>

## Conclusion

While the traditional corporate form may and likely will evolve over time, in the absence of the FPC and the Benefit Corporation, there is still risk of director liability, no satisfactory mechanism to anchor social mission, and no standardized transparency reporting obligations with respect to critical (and many would argue *material*) social and environmental factors. Many states are considering the adoption of new corporate forms in an effort to support and encourage the convergence of business profitability and business sustainability. The federalist system of the United States permits this unique moment in time for innovation and experimentation by the states to accomplish this objective. Changing the corporate form is one of the few solutions that we believe can and will accelerate the adoption of environmental sustainability initiatives at a rapid enough speed to effectively address the pressing social and environmental issues facing the world today. As a recent statement by Generation Management noted, “Incremental change will prove insufficient to mainstream Sustainable Capitalism by 2020. So, like an artist at the easel, our goal is not to make superficial touch-ups...We are calling for a fresh canvas on which, together, we can paint a new picture of our future.”<sup>42</sup> We couldn’t have said it better ourselves.

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40. Insurance companies, close corporations, and banks are subject to additional requirements when setting forth their articles of incorporation. The FPC legislation incorporates those requirements in Cal. Corp. Code §2602(b)(4), (5), (7). However, there are no similar provisions in the Benefit Corporation code.

41. Some companies that have established as Benefit Corporations are Blessed Coffee in Maryland, Give Something Back, Inc. in California, Patagonia Inc. in California, Grey-

ston Bakery, Inc. in New York, and Farm Community Consultants in Virginia. See <http://www.benefitcorp.net/find-a-benefit-corp>.

42. *Sustainable Capitalism*, Feb. 15, 2012, Generation Investment Management LLP, p. 24.