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Corporate Form and Social Entrepreneurship: A Status Report from California (and Beyond)

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Abstract: In January 2012, amendments to California’s corporate code permitted a new type of corporate form designed around for-profit entities also wishing to commit to serving a broader “social purpose” (or purposes). Although not the first state to embrace such reforms, California’s experiment is unique, in that it allowed companies to opt for one of two different social benefit entity forms: the “Benefit Corporation” (BC) and the “Flexible Purpose Corporation” (FPC). This essay summarizes the reforms and presents basic descriptive data about the rate at which business organizations have embraced them. Thus far, both forms have had relatively modest take-up rates; those social enterprises that have opted for one of the two forms have generally favored the BC over the FPC, though its market share narrowed consistently during 2012. Although it is premature to conclude whether social enterprise statutes will prove successful, I argue that now is an ideal time to put the infrastructure into place for collecting, organizing and analyzing data in this arena as it becomes available.

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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
Capitalism and Freedom (1962).*

The purpose of the corporation must be redefined as creating shared value, not just profit per se. This will drive the next wave of innovation and productivity growth in the global economy. It will also reshape capitalism and its relationship to society. Perhaps most important of all, learning how to create shared value is our best chance to legitimize business again.

*Michael Porter & Mark Kramer
Harv. Bus. Rev. (2011).*

Few propositions of modern corporate law have proven as persistent – or as debatable – as *shareholder primacy*: the maxim that corporate entities (and managers who control them) should focus telescopically on the goal of maximizing the wealth of shareholders (a.k.a., the corporation’s “residual claimants”). This core tenet (as well as variations and violations of it) occupies a prominent position in myriad modern debates concerning (*inter alia*) corporate governance, fiduciary duties, takeover defenses, mergers and acquisitions, proxy contests, securities regulation, and even criminal law.

Skeptics of shareholder primacy – particularly those concerned with the broader role of sustainable business practices – have openly questioned the wisdom of the judicial commitment to the shareholder welfare end, arguing that it unjustifiably subordinates considerations both of (extra-corporate) societal actors and of (intra-corporate) stakeholder actors to those of shareholders, whose capital stake represents a narrow tranche of the economic interests that incorporated entities produce. Moreover, they argue, in

modern corporate capital structures – rife with options, convertible debt, derivatives, leverage, and thin equity cushions – shareholders can hardly claim distinction as the corporation’s sole “residual claimants” (and thus the focal beneficiaries of its activities). Finally, skeptics assert, even if one assumed that maximizing shareholder *welfare* should take precedence over other intra- and extra-corporate goals, that objective does not necessarily equate to maximizing shareholder *wealth*, particularly for shareholders who have preferences broader than wealth maximization (e.g., they care about public goods, environmental sustainability, wealth distribution, and so forth). Our continued obsession with shareholder primacy, critics conclude, makes little economic, political, or philosophical sense.

Defenders have rejoined that the shareholder primacy norm *does* (or at least can) make policy sense, at least for the vast majority of corporations where shareholders still bear the lion’s share of economic risk. Moreover, they assert, even if shareholder primacy does not entirely square with the way risks are actually distributed within (and outside of) the firm, shareholder welfare provides a useful

criterion for holding managers accountable – a task that would become hopelessly elusive were managers given wide discretion to pick and choose which constituency (or combination thereof) their actions or inactions are meant to serve. Finally, defenders argue, if broader social purposes were important to shareholders (or other corporate constituencies), a profit maximizing firm would have a natural profit incentive to commit contractually to pursuing such purposes as a way to make the corporation more attractive as a supplier, trading partner or target for capital investment.

By all indications, this now-century-old debate will continue to rage on for some time, and I do not aspire to resolve it here. A fair reading of the current state of play, however, suggests that while the shareholder primacy norm continues to be a valuable organizing theme for some (or even most) corporate entities, it is not categorically so: Numerous businesses – particularly those in environmental sustainability industries – would plausibly benefit (in a variety of ways) from choosing an entity form that commits them to broader social purposes alongside profit generation. Accordingly, perhaps, reform-minded lawyers have endeavored over time to conjure up mechanisms by which firms might plausibly embrace such goals in a credible and durable fashion. These reforms include initiatives to encourage corporate social responsibility, innovations to judicial doctrine (such as a highly protective business judgment rule), and – in a number of states – corporate “constituency statutes” (which provide legal protection for corporate directors who wish to weigh stakeholder considerations alongside shareholder return).

Recently, however, a different, more tailored governance innovation has taken hold in a handful of states: the creation of alternative corporate forms that require the incorporated entity to articulate a broader social goal (or goals) against which – alongside profitability – corporate performance is to be gauged. These alternative forms are designed to provide a concrete means by which a corporation can bind itself to a broader set of purposes, without also having to go “all in” with non-profit (or low-profit) status. To date, a dozen states have implemented legislation creating these new corporate forms (See Table 1 below!), and many others are in various stages of promulgation. A national experiment is decidedly underway.

What we still lack, however, is reliable information about the experiment’s results. This paper attempts to make a modest contribution to that enterprise, offering a status report on statutory innovations across states, and drilling down to focus on the data currently available from California’s own social enterprise experiment, eight months after its effective date.

Why California? After all, its statutory reforms are relatively new, coming almost two years after Maryland became (in early 2010) the first state to embrace for-profit social purpose entities. California’s experience is still relatively developmental compared to other states with a longer track record. That said, the scope of California’s reform is notable and worthy of our considered attention for at least two reasons. First, California is big, geographically and economically, comfortably ranking first in the country in number of registered firms (incorporated or not), employees, and payroll.² Adding in the home-state incorporation bias of non-

public companies (one that is particularly salient in California³), the Golden State's reform decisions simply matter more. And second, California's reforms are tantalizingly unique, in that they provide (unlike other states) a menu of social enterprise forms, allowing the choice among two new alternative business forms for social-purpose oriented corporations. California corporations now have an option between incorporating as a "benefit corporation" (BC) a "flexible purpose corporation" (FPC),⁴ or any of the preexisting forms. The intervening months have provided an intriguing window for assessing not only the extent of demand for such new business forms *writ large*, but revealed preferences among them.

The Backstory

Before delving into these statutes and their effects, however, one must first understand why proponents of reform thought them necessary in the first instance. Prior to the enactment of California's recent legislation, if a for-profit business located in California wished to pursue a social benefit mission alongside maximizing shareholder returns, it faced limited options. Although many states' statutes permit corporate entities great freedom to tailor their corporate purpose (as articulated in the charter), including social benefit goals,⁵ an odd quirk in California corporate law does not permit that type of drafting flexibility.⁶ Nor, for that matter, has California heretofore embraced the notion of "constituency" statutes that have the effect of permitting / requiring directors to weigh costs and benefits of their decisions across a large number of constituencies (including

shareholders, corporate stakeholders and society).⁷ While incorporating in another state (e.g., one allowing tailored corporate purposes or offering a constituency statute) may be an option, it is not always an attractive one for California-based firms, who remain beholden to many of the California's corporate provisions anyway, by "virtue" (using that term advisedly) of its infamous long-arm statute.⁸ Similarly, embracing other socially-oriented business forms, such as non-profit status, or L3Cs, posed myriad issues related to the explicit subordination (or elimination) of profit motive, tax considerations, and the difficulty of attracting third-party capital investments.

Consequently, prior to the new statutory innovations, many (if not most) socially-minded California businesses tended to incorporate as "plain vanilla" C-corporations, falling back (perhaps optimistically) on their managerial discretion and the (so-called) business judgment rule ("BJR") – a legal presumption that grants great deference to fiduciaries in weighing the costs and benefits of business decisions, without fear of judicial second guessing. While the deference embodied in the BJR is comforting, it is also limited in a major respect: While the rule grants fiduciaries discretion about *how* to serve their shareholder interests, it does not give discretion about *whether* to do so. Consequently, for decisions that obviously sacrifice shareholder welfare for the benefit of other considerations (including social purposes), the BJR provides no protection. Such clear tradeoffs are often manifest at "watershed" junctures in the life of a corporation, such as when a corporate entity enters "*Revlon*" mode, putting itself up for sale or reorganization in a fashion

that will cause (usually public) shareholders to surrender their ability to extract a control premium for their shares.⁹ Here, the dictates of corporate law tend to give corporate fiduciaries little choice but to take appropriate steps to maximize shareholders' short term value and accept the highest offer reasonably available. Many other concerns (including social benefit goals) tend to fade quickly when scrutinized against this simple judicial calculus.

Finally, even assuming away all the above constraints, many reform proponents perceived existing corporate structures as inadequate means for making credible, long-term commitments to a social purpose that remains immune to “mission creep.” In other words, if market conditions became too tempting or the demands of short-termism too pressing, they argued, the corporation could too easily re-define its mission through charter / bylaw amendments, restructurings, dissolutions, asset sales or acquisitions, abandoning any purpose that did not contribute directly to attractive quarterly P&Ls.

Legal reform advocates therefore perceived this *status quo ante* to be inadequate for the needs of at least some socially-motivated entrepreneurs, their employees, and their prospective investors, who wished to pursue profitable ventures *without* having to sacrifice their company's defining commitment to a broader social goals, such as environmental sustainability, public health, and poverty elimination. Drawing momentum from the preexisting efforts at reform in other states, the California BC and FPC statutes were soon to follow.

Although some reform in California seemed inevitable, the state's ultimate decision to embrace of two distinct social

enterprise corporate forms was somewhat more surprising. Although a working group focused on stimulating social entrepreneurship in California originally began drafting unified legislation, the group eventually split into two camps. This divide persisted, ultimately leading to two bills that – while substantially similar in many respects – differed in some important ways.

The California Reforms

As noted above, both the BC and FPC statutes in California require the corporation to articulate in its charter a public purpose (or purposes), and to issue annual reports on the corporation's fealty to that articulated purpose. Moreover, both statutes require a super-majority vote of shareholders (set by default at 2/3) to alter, repeal, reorganize out of, or otherwise jettison the special purpose provision. Nevertheless, the two forms differ in a few important respects. First, FPCs give somewhat of a greater freedom to tailor and articulate special purposes in the charter, while the BC purpose is somewhat more structured around a broad social purpose, defined as “a material positive impact on society and the environment, taken as a whole...”¹⁰ In addition, the statutes differ in the process by which fidelity to the broader social purpose is measured and assessed. While both require annual reports, assessment within a BC must be in accordance with an established, documented and measurable third-party standard; the FPC form, in contrast, permits greater latitude in analyzing performance. Third, embedded in the BC statute is also a form of traditional constituency statute, requiring the directors to consider the impacts of any action or proposed action upon various stakeholders

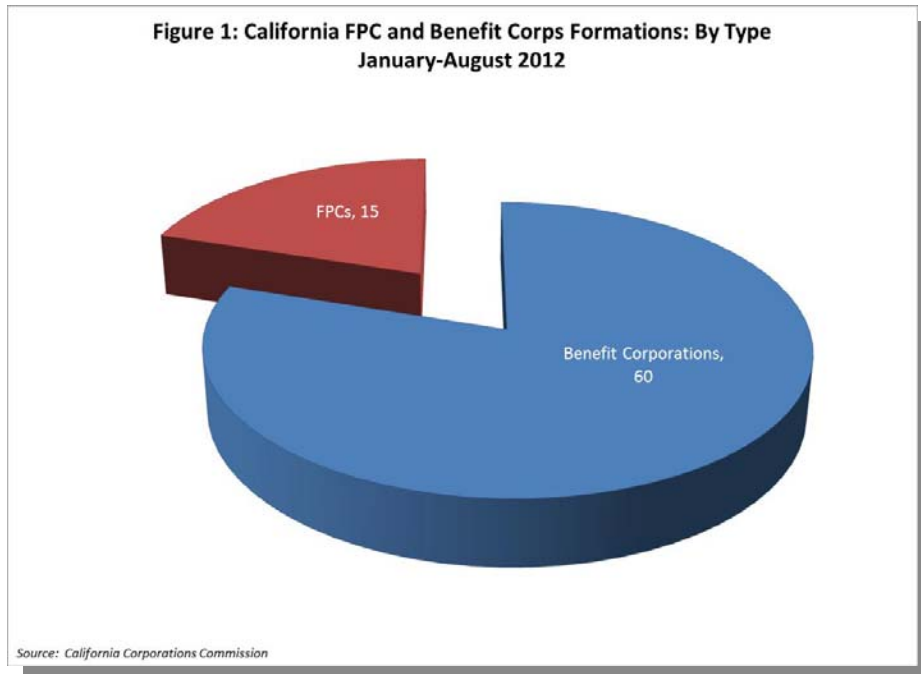
of the corporation, such as customers and employees.¹¹ The FPC statute does not contain a like provision. Furthermore, the BC statute creates a new type of “Benefit Enforcement Proceeding” (filed by a director, shareholder, or significant equity holder) while the FPC statute relies on traditional enforcement rights (and in particular the derivative action). Moreover, many of the core attributes typifying the California BC structure also carry over to other states’ benefit corporation statutes (albeit with some exceptions¹²) – a similarity generated by the national scope of reform-minded companies like B-Lab.

By most accounts, the FPC entails a somewhat greater degree of (for want of a better term) flexibility on organizational / governance dimensions than does the BC form, and it therefore represents the more modest departure from the traditional corporate form. Such flexibility likely brings about both benefits and costs. As to the former, FPCs are more likely to have a ‘look and feel’ similar to other for-profit start-ups, an affinity that may (in some circumstances) attract more financing interest from sources who value legal predictability and familiarity with existing corporate legal standards.¹³ On the other hand, by committing to independent third-party accountability standards and creating a new enforcement action, the BC form makes an arguably more concrete commitment that may (in some circumstances) be less susceptible to

“mission creep.” A disadvantage that both forms face is their novelty, and the lack of a well settled jurisprudence clarifying the interpretation and application of the legislative reforms, as well as the development of best practices in the operation and management of both firms. In this respect, it seems plausible that the BC form – by virtue of its relatively more established presence other states – is likely to generate a more robust quantity of judicial opinions in the short to medium term.¹⁴ Only time will tell, of course, which of these relative costs and benefits will win the day (and for what type of firm).

Current State of Affairs

Interesting as all the above speculations might be, they will remain speculations until we have meaningful data on how prospective new businesses have responded to legal reforms. We are now only at the cusp of being able to collect, organize and analyze this information. That said, data provided by the State of California permit some preliminary windows into the current state of play.¹⁵ What follows is a short overview of those data. I remind readers that the social entrepreneurship experiment is likely to be in a state of change and flux for some time, and accordingly the trends identified below are almost certain to change as practitioners, judges, and business perspectives evolve.

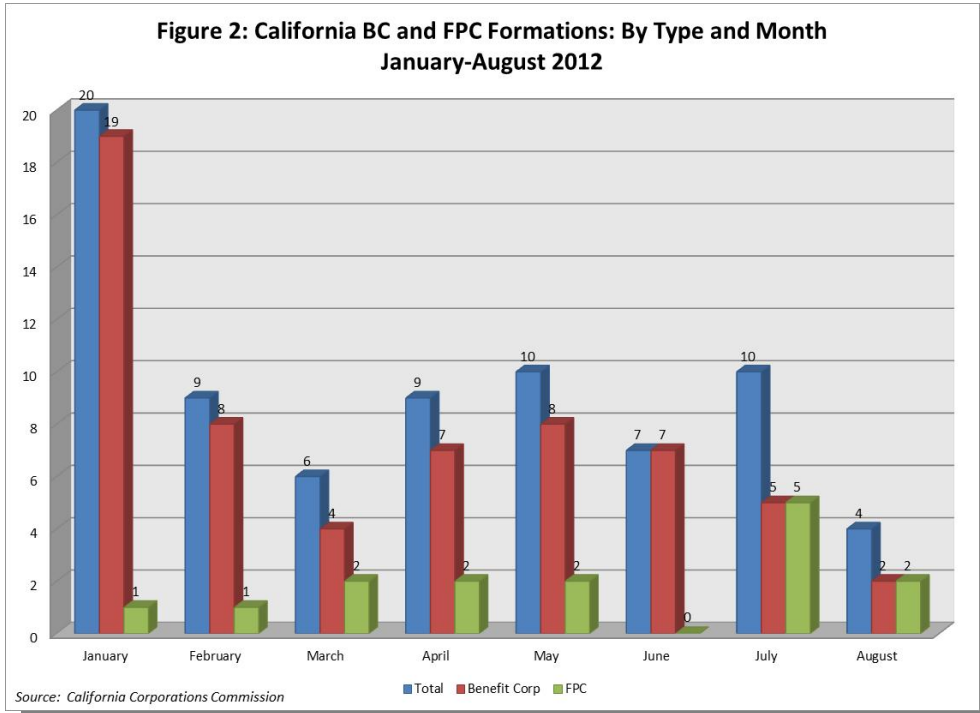


to-one basis over the FPC. The reasons behind this preference are as yet unclear, as is the question of whether this preference will persist over time. Figure 2 perhaps provides a small window into this question, tracking incorporations on a monthly basis. The figure suggests that the strong preference for the BC over the FPC was particularly marked during the first few

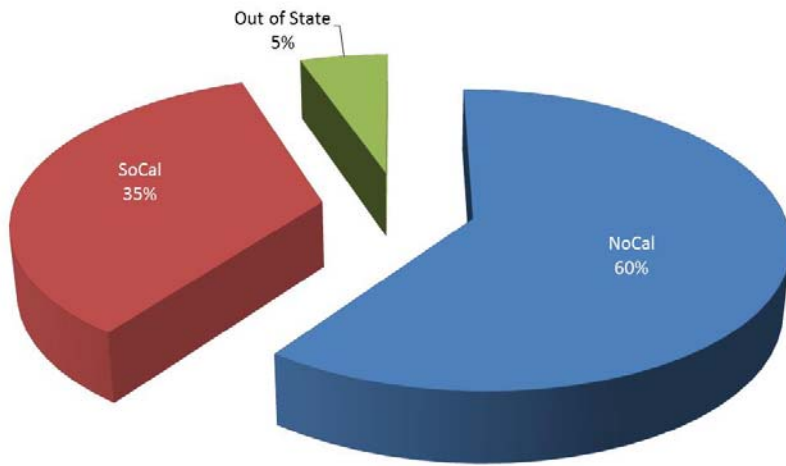
Figure 1 provides a count of BC and FPC incorporations filed in California between January 1 and mid-August, 2012. As illustrated by the figure, a total of 75 corporate entities were organized under one of the two new statutes. Although large enough a group to be analyzed statistically, this is still an extremely small number in the greater scheme of things, massively dwarfed by the roughly 60,000 new incorporations occurred overall during the same period of time in California.

months in which the statutes were effective, possibly suggesting an “inventorying” phenomenon, in which prospective BCs were already organized and lined up for incorporation before the statute’s effective date.¹⁶ In later months, while the BC still appears to be keeping a

As Figure 1 further shows, entities that chose to file under one of the two new statutory forms preferred the BC form on a four-



**Figure 3: California BC and FPCs: By HQ Location
January-August 2012**



Source: California Corporations Commission

narrow advantage, the FPC has largely increased in popularity while the BC has remained somewhat stable.

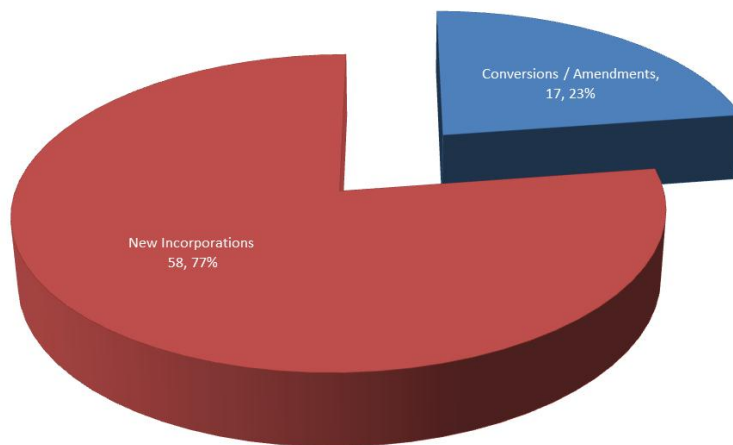
Geographic dispersion within (and outside of) California is also provides an interesting insight into demand for alternative forms. Figure 3 separates the new business entities by the geographic location of their headquarters. As the figure demonstrates, the vast majority of incorporations (95 percent) involve companies whose business is headquartered in California. Of those, Northern California companies outnumber Southern California by almost a two-to-one ratio. This greater popularity in Northern California may be due

to the large concentration of renewable / alternative energy and clean-tech companies located in the Bay Area.

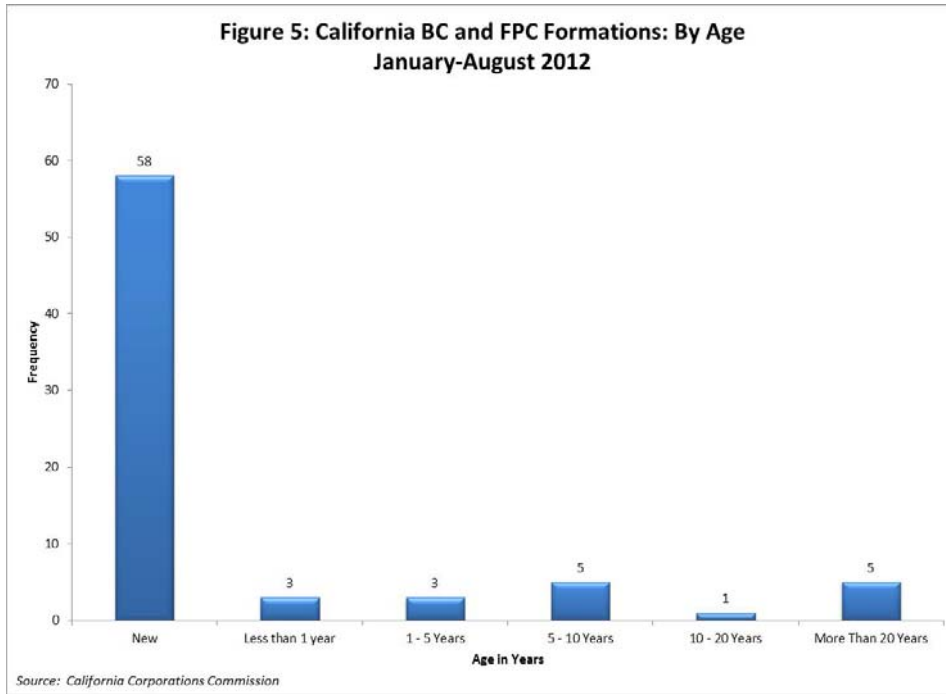
Given the nature of social enterprise oriented businesses, and their concentration in emerging industries, one would expect that FPC and BC incorporations would be heavily represented by new companies rather

than existing ones. Consistent with this prediction, Figure 4 shows that over three-quarters of the BC/FPC incorporations in California during 2012 represent what appear to be new corporations rather than corporations that either amended their

**Figure 4: California BC and FPC Formations: By Means of Formation
January-August 2012**



Source: California Corporations Commission



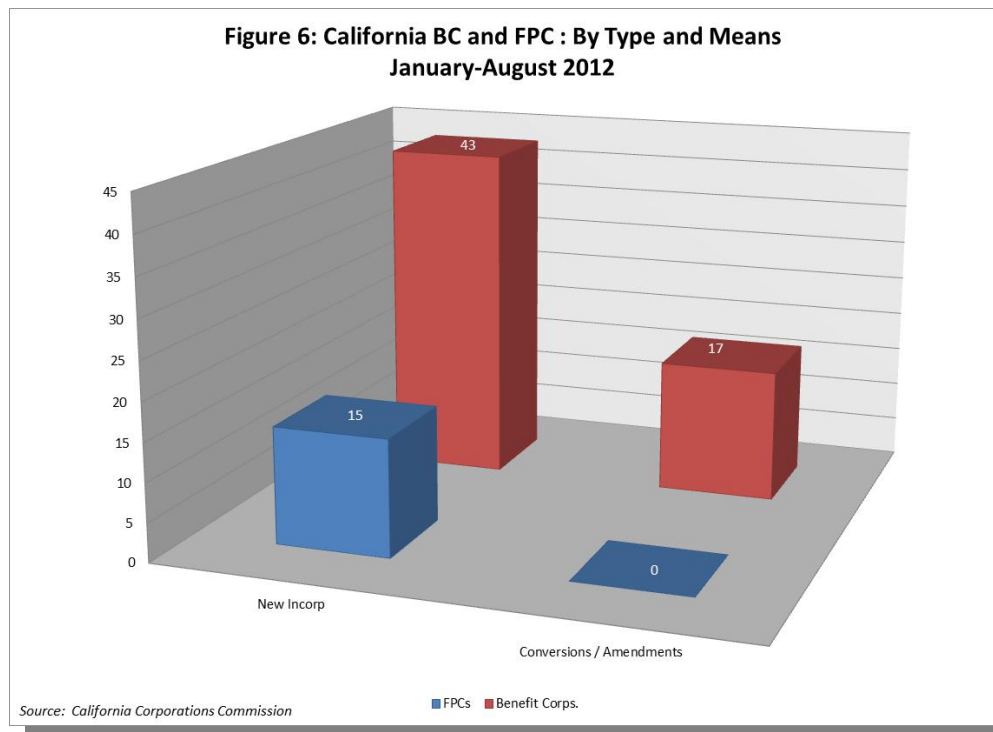
between. Although the numbers are admittedly small, it is interesting to note that at least some well established firms find it worthwhile to adopt the BC/FPC status.

An interesting and unanticipated oddity about the firms who adopted FPC/BC status by converting or amending their charters is their evidently strong

preference for the BC form over the FPC form, as illustrated by Figure 6. As the figure shows, *none* of the converting / amending firms appears to have opted for a FPC approach. This is a bit surprising,

charter in accordance with the statute, or when through the formal conversion process. It is important to note, however, that the new incorporations number may be biased upwards, as it plausibly captures existing firms that – while newly created – actually succeeded to the business of preexisting firms through the asset sale or acquisition process. That said, as Figure 5 demonstrates, the amending and/or converting firms tended to vary considerably in age, ranging from 2 months to 37 years, with a relatively uniform distribution in

preference for the BC form over the FPC form, as illustrated by Figure 6. As the figure shows, *none* of the converting / amending firms appears to have opted for a FPC approach. This is a bit surprising,



given the impression that the FPC is widely perceived to be a relatively modest departure from a traditional corporate form than is the BC. Although this evident regularity may be due to the possibility that new firms are more likely than established ones to want to attract investments from outsiders, or greater marketing visibility of BC proponents,¹⁷ at this stage the drivers behind this trend are unclear, and – as with all these data – the trend itself may well change or even reverse over time.

So, What Now?

Thus far, California’s and other states’ legislative experiments in social enterprise business forms remain decidedly a work in progress. While there is obviously interest in these new corporate forms, judging by California’s experience, uptake rates have thus far been modest. In many respects, this observation should not be too surprising, given the novelty of the area, the absence of developed case law, the lack of developed best practices in administering these sorts of business entities, and the understandable aversion that many have to being the first canary to fly into a new statutory cave. Fully appreciating the implications of this new “wave” in corporate organization, as well as course adjustments that may be necessary, will obviously require more time to let the experiment percolate.

As the experiment plays out, a number of unresolved issues are likely to receive considerable attention. The first is one of measuring and assessing individual firms’ performance in fulfilling their articulated social purposes. Unlike the standard measures for profitability (EPS, ROA, etc.), the markers of success in “enhancing sustainability” or “improving educational

opportunities” (or other typical forms of commonly articulated purpose) are significantly less concrete, and they are thereby prone to more indeterminacies. Although reference to established third-party standards might plausibly offer some discipline in the assessment process, that discipline is only as good as such standards are reliable – a factor that is still unknown.

A second potential obstacle concerns the nature of the financial returns (and thus investment potential) from social entrepreneurship enterprises. On first glance, a business organization’s simultaneous pursuit of a social goal alongside profit necessarily implies that the firm will (and indeed must) make marginal tradeoffs between profits and *something else*. It naturally follows that such a firm’s earnings would likely fall short of its for-profit peers, resulting in a market discount. While the various reputational attractions that social enterprises promise (among employees, customers, creditors, and suppliers of capital) might go some distance to counteract that discount, it seems wildly optimistic to expect such factors to reverse it completely.

That said, it is important to remember that capitalization discounts are not concomitant with investment returns. In fact, once a market discount (whatever its size) is fully incorporated into company valuation, it need not follow that the *risk-adjusted returns* on that investment will lag behind similarly situated for-profits. This is a significant consideration for social enterprises attempting to attract capital from institutional investors, which themselves are under an assortment of legal duties to maximize risk-constrained yields for their beneficiaries.

Moreover, although it is often overlooked, it is important to keep in mind

that FPCs and BCs *retain a real option to convert* into for-profits (upon a 2/3 shareholder vote), should the prevailing market environment become too unwelcoming. This conversion option can build in a type of internal safety net for firm’s capital claimants, a factor that would be reflected in lower downside equity Betas, smaller credit spreads, and reduced values-at-risk than for similarly situated for-profit organizations. Consequently, it is at least plausible that social entrepreneurship organizations would be *more* (not less) appealing investment targets on systematic risk grounds.

Of course, much of this discussion (at least at present) is little more than idle speculation. Testing, verifying, and/or falsifying these conjectures will demand more systematic access to (and analysis of)

real-world data, across states, over time, and along numerous dimensions. Thus far, there is little concentrated effort to collect, organize, and warehouse such data across (or even within) states. Because such information itself has significant public benefits, moreover, it would seem imprudent to leave its collection and analysis to private entities (with private motives) or partisan advocates (with ideological commitments). Respected academic institutions or non-partisan research centers are far more likely to be reliable and credible source for data, best practices, and policy relevant research on corporate form, social purpose, and entrepreneurship. The task of installing that infrastructure is something that we can (and should) work to accomplish today.

	Non-Shareholder Stakeholder Standing to Enforce?	Dissenting Shareholder Rights Protection?	Min. Status or 2/3 Vote (Default) Requirement to Change Purpose?	Creates New Officer or Director Oversight Position?	Third-Party Accountability Standards Required?	Enforcement Through Special Actions or Proceedings?	General Social Purpose Required?	Special Social Purpose Required?	Stock Certificate Notification Requirement?
California FPC	No	Yes	Yes	No	No	No	No	Yes	Yes
California BC	No	Yes	Yes	No	Yes	Yes	Yes	No	Yes
Hawaii BC	Unclear	No	Yes	Yes	Yes	No	Yes	No	No
Illinois BC	No	No	Yes	Yes	Yes	Yes	Yes	No	No
Louisiana BC	No	No	Yes	Yes	Yes	Yes	Yes	No	Yes
Maryland BC	No	No	No	No	Yes	No	Yes	No	Yes
New Jersey BC	Unclear	No	Yes	Yes	Yes	Yes	Yes	No	No
New York BC	No	No	Yes	No	Yes	No	Yes	No	Yes
South Carolina BC	No	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Vermont BC	No	No	Yes	Yes	Yes	Yes	Yes	No	No
Virginia BC	No	No	Yes	No	Yes	Yes	Yes	No	No
Washington FPC	No	Yes	Yes	No	No	No	No	Yes	Yes

Table 1: Major attributes of Enacted FPC/Benefit Corporation Statutes

Endnotes

¹ These include California, Hawaii, Illinois, Louisiana, Maryland, New Jersey, New York, North Carolina, South Carolina, Vermont, Virginia and Washington.

² See 2000 Census Bureau, County Business Patterns survey.

³ As explained below, California's unique long arm statute makes it particularly attractive for private corporations to incorporate in California, enhancing this home state bias.

⁴ AB 361, codified in California Corp. Code §§ 14600-14631 (Benefit Corporations) and SB 201, codified in Cal. Corp. Code §§ 2500-3508. The competing bills were introduced and passed on parallel tracks, and both were signed into law by California Governor Brown in October 2011, with simultaneous effective dates of January 1, 2012.

⁵ See, e.g., Del. Gen. Corp. Law §§ 101-102.

⁶ Cal. Corp. Code § 202, which prescribes specific language for a general corporate purpose, and specifically prohibits expansions of that purpose.

⁷ Although thirty states currently have such statutes, they are absent from both the California and Delaware corporate codes. For a state-by-state accounting, see Jonathan Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 Ann. Surv. Am. Law 85 (1999).

⁸ Cal. Corp. Code § 2115. The Delaware Supreme Court declared Section 2115 to be unconstitutional on commerce clause grounds in *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005). Since the *VantagePoint* holding, no California court has recognized it as binding on California courts, though some recent decisions have acknowledged it in passing. E.g., *Lidow v. Superior Court*, 141 Cal. Rptr. 3d 729 (Cal. Ct. App. 2012).

⁹ See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). Although California courts are sometimes said to have "rejected" the *Revlon* doctrine, the evidence for this claim is questionable. Indeed, there appears to be no published opinion by a California state court at any level that rejects the doctrine, and the handful that cite *Revlon* appear to do so approvingly.

¹⁰ Compare Cal. Corp. Code § 2602(b) to § 14610(b). BCs may also adopt specific social purposes in addition to a broad one. *Id.*

¹¹ Cal. Corp. Code § 14620(b).

¹² For example, many other states (but not California) include requirements for director seats or officer titles dedicated to the pursuit of the public benefit.

¹³ See, e.g., Susan Mac Cormac and Heather Haney, *New Corporate Forms: One Viable Solution to Advancing Environmental Sustainability*, 24 *J. App. Corp. Fin.* 49-58 (2012).

¹⁴ It bears noting, however, that FPC-like statutes have also recently been proposed in a number of states.

¹⁵ Many thanks to the California Corporations Commissioner's office for assistance in collecting this data.

¹⁶ Many of the 19 BCs incorporated in January, for example, appear to have been executed by a small number of attorneys, which may be a byproduct of concerted marketing efforts by BC proponents. (This is but one of many possibilities, however, and the data does not currently permit testing of it).

¹⁷ See note 16, *supra*.