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## Social Entrepreneurship and Uncorporations

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# SOCIAL ENTREPRENEURSHIP AND UNCORPORATIONS

Jesse Finfrock\*

Eric Talley\*\*

*Larry Ribstein’s pioneering analysis of alternative business forms during the late twentieth century highlighted the contractarian freedom that these forms provided. The rise of the LLC model was of particular interest to Ribstein, who assessed how this model brought greater freedom to those who held duties and obligations within the corporate structure. This Article takes up Ribstein’s mantle by assessing the development the alternative “social enterprise” business forms manifested in benefit corporations (BC) and flexible purpose corporations (FPC). Both forms allow an incorporated entity to articulate and pursue a social benefit alongside the maximization of shareholder returns. Despite its utility, the uptake of the social enterprise corporation, as assessed through a case study of California, appears underwhelming. Yet, by using the arc of the LLC uptake path as a comparative historical benchmark, the authors argue that there is hope that these new social enterprise corporations will see an increasing rate of uptake in the future.*

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## I. INTRODUCTION

Few modern corporate law scholars will ever come close to matching the intellectual breadth and depth of the late Larry Ribstein. In his countless interactions with academics, practitioners, and policymakers over three decades, Ribstein invariably added something new and insightful. In this Article, we celebrate Ribstein’s storied and rich career by drawing inspiration from one dimension of his scholarship that has proven enormously influential and is durable to this day: the rise of the so-called “unincorporation.” Over the course of a decade, Ribstein and coauthors documented the growth and role of new business forms that dominated the late twentieth century, including LLCs, LLPs, S Corporations, Limited Partnerships, and other permutations. These statutory innovations, he successfully argued, facilitated tremendous contractarian benefits to entrepreneurs, affording them a “menu” of choices from which to select in an effort to tailor their own legal and governance traits to their peculiar business circumstances. Their prevalence today is, in part, a testament to his insights.

It is perhaps no surprise that at approximately the same time as Ribstein’s passing, several states began to promulgate more tailored governance innovation that further expands contractarian freedom over the duties and obligations residing within a corporate structure: the creation of alternative “social enterprise” business forms, which require the incorporated entity to articulate a broader social goal (or goals) against which—alongside profitability—corporate performance is to be assessed. Often operating under names such as the “Benefit Corporation” (“BC”) or “Flexible Purpose Corporation” (“FPC”), 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 nonprofit (or low-profit) status. As of this writing, approximately half the states and the District of Columbia have implemented legislation creating these new corporate forms, and many others are in various stages of promulgation. A national experiment is decidedly underway.

In the pages below, we follow Ribstein’s pioneering lead with other unincorporated forms to provide a preliminary empirical assessment on the results of the social enterprise experiment. While most who knew him would readily agree that the social enterprise sector was not Ribstein’s particular cup of tea (a likely understatement), for this same reason we view our analysis of this type of alternative business form as a fitting homage to Ribstein’s persuasive influence and breadth in the field.

Although our discussion is national in scope, we focus our sharpest attention on California. This focus is partially based on the granular data available to us, but we also have chosen California because of the state's economic prominence, its current position as the state with the most unincorporated entities already in existence, and the unique "mini-experiment" that California undertook: the simultaneous passage of two different types of social enterprise business forms (BC and FPC) in 2012. We find that both in California and overall, there have been a (numerically) modest number of companies that have embraced these alternative business forms. At the same time, however, we argue that it is far too early to declare the experiment stalled or unsuccessful. Indeed, the rate of statutory diffusion as well as firm-level adoption of these forms has thus far outstripped one of the most prominent historical benchmarks: the rise of the Limited Liability Company during the 1980s and 1990s, documented so comprehensively by Ribstein himself. By this historical comparison, in fact, we demonstrate that social enterprises have enjoyed significant success thus far. Only time (and additional empirical attention) will fully reveal the ultimate value added of these innovations, of course; we nevertheless conjecture (even on the basis of what is currently available) that the experiment has been almost certainly worthwhile.

The remainder of this Article proceeds as follows. Part II provides a general overview of social entrepreneurship forms, contrasting them with what was possible under other business organizational choices. Part III gives a brief empirical overview of the California experiment (the reader is directed to another recent article for more granular details<sup>1</sup>). Part IV endeavors to assess the empirical data, particularly in relation to other benchmarks (such as LLCs). Part V concludes.

## II. OVERVIEW OF SOCIAL ENTREPRENEURSHIP FORMS

Before delving into our empirical enterprise, we begin by providing some backstory, focusing on why such business entity forms were thought (at least by some) necessary to begin with.

### A. *The Status Quo Ante*

Prior to the enactment of social enterprise legislation, traditional corporations in California faced a troublingly limited set of options if they wished to articulate and pursue a social benefit mission alongside maximizing shareholder returns.

The first limitation was the state's enabling statute setting the formal requirements for corporate formation. Although many statutes (such as Delaware's) permit corporate entities great freedom to tailor their articulated corporate purpose (in the charter), including social ben-

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1. Eric Talley, *Corporate Form and Social Entrepreneurship: A Status Report from California (and Beyond)* (UC Berkeley Pub. Law Research Paper No. 2144567, 2012), available at <http://ssrn.com/abstract=2144567>.

efit goals,<sup>2</sup> others (including California's) are less generous. Due to an odd quirk in California corporate law, the state does not permit flexibility in the statement of a corporate purpose within a corporate charter, constraining incorporators instead to utilize a stock set of phrases that do not clearly admit social entrepreneurship goals.<sup>3</sup> In addition, California never adopted a (so-called) "constituency" statute, which would permit (or even require) directors to weigh costs and benefits of their decisions across a large number of constituencies, including shareholders, corporate stakeholders, and society.<sup>4</sup> These immutable prescriptions of the statute essentially made it impossible for a for-profit California-incorporated firm to embrace social entrepreneurship goals in its core governing constitution.

For aspiring California social entrepreneurs, incorporating in another state (i.e., one allowing greater flexibility in articulating corporate purposes or offering a constituency statute) could provide a partial route out of this box. But for truly California-based firms, even this route often proved a pyrrhic victory, as many of the state's corporate law provisions apply to non-California corporations anyway, through the state's infamous long arm statute.<sup>5</sup> Similarly, embracing other socially oriented business forms, such as nonprofit status or L3Cs, posed multiple issues related to the explicit subordination (or elimination) of profit motive, awkward tax considerations, and the concomitant difficulty of attracting third party capital investors.

Consequently, prior to the new statutory innovations in social enterprise forms, many (if not most) socially minded California businesses tended to incorporate as domestic "plain vanilla" C-corporations, falling back substantially (and 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 arguably does not give discretion about *whether* to do so. Consequently, for decisions that patently sacrifice shareholder welfare for the benefit of other considerations (including social purposes), even the BJR provides wavering protection. Such clear tradeoffs between shareholder value and other goals

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2. See, e.g., DEL. CODE ANN., tit 8, §§ 101–02 (2014).

3. See, e.g., CAL. CORP. CODE § 202(b) (West 2014) (prescribing specific language for a general corporate purpose, and specifically prohibiting expansions of that purpose).

4. Although thirty states currently have such statutes, they are absent from both the California and Delaware codes for C-corporations. For a state-by-state accounting, see Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85 (1999).

5. CAL. CORP. CODE § 2115 (West 2014). 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, 1114 (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. See, e.g., *Lidow v. Superior Court*, 141 Cal. Rptr. 3d 729, 737 (Cal. Ct. App. 2012).

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.<sup>6</sup> 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 stark judicial calculus.

Finally, even assuming away all the above constraints, many reform proponents perceived existing corporate structures as providing inadequate means for making credible, long term commitments to a social purpose that remains immune to “mission creep.” In other words, if market conditions were to become too tempting or the demands of short-termism too pressing, proponents argued, the corporation could too easily redefine 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 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.

### B. *The California Reforms*

Although some reform in California seemed inevitable, the state’s ultimate decision to embrace 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.

As noted above, both the BC and FPC statutes in California require the corporation to articulate in its charter a public purpose (or purposes) beyond shareholder value, and to issue annual reports summarizing and assessing the corporation’s fealty to that articulated purpose. Moreover,

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6. 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 scant. Indeed, there appears to be no published opinion by a California state court at any level that rejects the doctrine, and the one published opinion that cites *Revlon* appears to do so approvingly. *Kirschner Bros. Oil, Inc. v. Natomas Co.*, 229 Cal. Rptr. 899, 907 (Cal. Ct. App. 1986) (citing *Revlon* in reaffirming the “board’s duty to its equity shareholders to maximize the sale price of the company”).

both statutes require a supermajority vote of shareholders (set by default at two-thirds) to alter, repeal, reorganize out of, or otherwise jettison the special purpose provision(s). Nevertheless, the two forms differ in a few important respects. First, FPCs give somewhat 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 . . . .”<sup>7</sup> In addition, the statutes differ in the process by which fidelity to the broader social purpose is measured and assessed. For example, although both require the production of annual reports, the assessment within a BC report must be conducted in accordance with an established, documented and measurable third party standard; the FPC form, in contrast, permits greater latitude in assessing 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.<sup>8</sup> 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’ BC statutes (albeit with some exceptions<sup>9</sup>)—a similarity no doubt catalyzed by the national scope and messaging of reform-minded corporations like B-Lab.

By contrast, 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 entails both benefits and costs. As to the former, FPCs are more likely to have a “look and feel” similar to other for-profit startups, a resemblance that may (in some circumstances) attract more financing interest from sources who value legal predictability and familiarity with existing corporate legal standards.<sup>10</sup> 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 be less susceptible to mission creep. A disadvantage that both forms face in some degree is their institutional novelty, and the lack of a well settled jurisprudence clarifying the interpretation and application of the underlying statutes, as well as the development of best practices in the

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7. CAL. CORP. CODE § 14601(b)(3)(c) (West 2014). Compare CAL. CORP. CODE § 2602(b), with § 14610(b). BCs may also adopt specific social purposes in addition to a broad one. *Id.*

8. *Id.* at § 14620(b).

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

10. See, e.g., Susan Mac Cormac & Heather Haney, *New Corporate Forms: One Viable Solution to Advancing Environmental Sustainability*, 24 J. APP. CORP. FIN. 1, 49–58 (2012).

operation and management of both forms. In this respect, it seems plausible that the BC form—by virtue of its relatively more established presence in other states—is likely to generate a more robust quantity of judicial opinions in the short to medium term.<sup>11</sup> Only time will reveal, of course, which of these relative costs and benefits will ultimately win the day (and for what type of form).

### III. THE 2012 CALIFORNIA NUMBERS

The California Secretary of State's office is the repository for all incorporations under California law. During 2012, according to the Secretary's staff, there were over 60,000 new incorporations (regardless of corporate form). Given the novelty of the new statutory reforms, moreover, the Secretary's staff allowed us to work with them to track all new incorporations that specifically have opted into Benefit- or Flexible-Purpose-Corporation form for all of 2012 (as well as the first quarter of 2013). Most of our analysis concentrates on the first full year of effectiveness. In addition to assembling a list of BC and FPC incorporations, we also obtained the filings of each of these corporations, whether executed through an original charter, an amendment to an existing charter, or a conversion from a traditional corporation.<sup>12</sup> We are relatively confident that our sample includes the entire universe of California BCs and FPCs by the end of 2012.

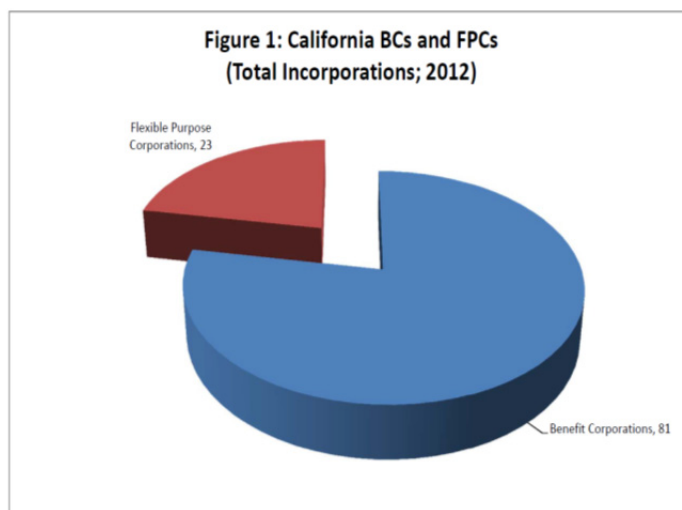
Figure 1 provides raw counts of BC and FPC incorporations within California during the calendar year. As illustrated by this Figure, a total of 104 corporate entities were organized under one of the two new statutes (a number that has now grown somewhat since). Although large enough a group to be analyzed statistically in a meaningful way, this is still a small number in the larger picture, constituting less than two-tenths of a percent of the new incorporations within California during the same period of time.

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11. It bears noting, however, that FPC-like statutes have also recently been proposed and adopted in a number of states. See, e.g., Cass Brewer, *Social Enterprise Law Update and Map*, SOCENTLAW (Aug. 11, 2014), <http://socentlaw.com/2014/08/social-enterprise-law-update-and-map>.

12. For a list of incorporations, as well as links to their filings, see BERKELEY CENTER FOR LAW, BUSINESS AND THE ECONOMY, <http://www.law.berkeley.edu/belbe.htm> (last visited Sept. 5, 2014).



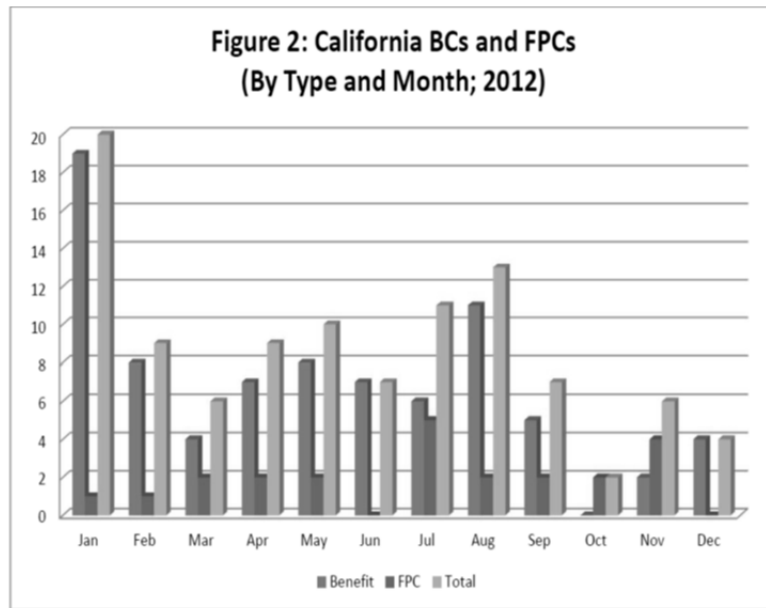


As Figure 1 further shows, entities choosing to file under one of the two new statutory forms preferred the BC form on nearly a four-to-one basis over the FPC. Neither the reasons behind this preference nor whether this preference will persist over time is entirely clear. Because the BC form was backed by a far larger and more cohesive national corporate reform movement, it should perhaps not be surprising that it enjoyed greater popularity among clients (and their attorneys) upon promulgation.

Figure 2 perhaps provides a small window into this question, tracking incorporations on a monthly basis throughout 2012. This Figure suggests that the strong preference for the BC over the FPC was particularly marked during the first few months in which the statutes were effective, possibly suggesting an “inventorying” phenomenon, in which prospective BCs were already queued for incorporation before the statute’s effective date.<sup>13</sup> In later months, while the BC still appears to maintain a narrow advantage, the FPC has retained some popularity.

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13. Many of the nineteen 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.



As a whole, however, neither form enjoyed what might be called an explosion of popularity as the year progressed. Moreover, given that there were over 60,000 new statutory business entities created in 2012 alone in California, it is reasonable to question whether the numbers thus far represent much of a success at all. It is to this question we now turn.

As the discussion above suggests, the number of California businesses that have incorporated as a BC or FPC is numerically modest, even as it included some well-known firms (such as the outdoor clothing and gear company Patagonia).<sup>14</sup> The first quarter calendar year 2013 did not add much to the mix. There were a total of 115 of either type of firm formed up to the end of the first quarter in 2013.<sup>15</sup> And, by the time of this writing, 185 California-based BCs are listed on the BC informational website<sup>16</sup> (We are still compiling data on uptake of FPCs during the remainder of 2013). By comparison, the number of companies that form as other entities in California dwarfs these numbers: California BCs and FPCs formed in year one amount to less than *one-fifth of one percent* of all companies filing formation documents in that year. When viewed in this light, it appears that California clearly got off to a slow start.

14. Data available from authors upon request.

15. Data available from authors upon request.

16. See Find a Benefit Corp, BENEFIT CORP INFORMATION CENTER, <http://benefitcorp.net/find-a-benefit-corp> (last visited Sept. 5, 2014).

## IV. INTERPRETING THE EMPIRICAL STATE OF PLAY

It is fair, given the relatively modest numbers described above, for one to question whether the social enterprise business forms recently promulgated by California and elsewhere have been much of a success *at all*. Although we are (in some ways) sympathetic to this type of academic skepticism, one must be careful about being too quick to make definitive pronouncements early on in an experiment. This caution is particularly warranted in statutory experiments: indeed, virtually *any* time a new statutory framework emerges, significant uncertainties invariably attend how private parties, financiers, regulators, courts, and other policy makers are likely to receive the innovation. Even mildly risk averse entrepreneurs may have some inclination to delay their embrace of social entrepreneurship forms, waiting to observe the fates of early adopters—the proverbial canaries in the business entity coalmine. Three aspects of the current state of play suggest that the jury is almost certainly out on whether the ongoing experiment will reap significant rewards. We discuss them below.

A. *California's Quick Ascent*

First it is important to note that when measured against other states' uptake numbers, California quickly took the lead, with roughly thirty percent of the total number of U.S. BCs registered in the state, currently 185 (by our count) of 1121 total.<sup>17</sup> In New York, which enacted its BC law on the same date as California, only twenty-four BCs are currently registered.<sup>18</sup> Similarly, Maryland, which was the first state to enact a BC law in 2010, attracted only thirty-nine BCs and Benefit LLCs in the first three years, and currently there are roughly eighty-eight registered there.<sup>19</sup> California's only close rival appears to be Delaware, where the vast majority of U.S. public companies are registered, and where fifty-five companies elected to become BCs in the first three months since the August 2013 enactment of the "public benefit corporation," and 121 companies are currently registered.<sup>20</sup> These companies include several nationally established companies like Method Products and Plum Organics. This state-to-state comparison suggests that the uptake in California may not be as poor as thought; or at the very least that uptake is no less popular than it is in other states.

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17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*; Alicia Plerhoples, *Delaware Public Benefit Corporations 90 Days Out: Who's Opting In?*, 14 U.C. DAVIS BUS. L.J. 2 (2014). See also DEL. CODE ANN. tit. 8 §§ 361–68, available at <http://delcode.delaware.gov/title8/c001/sc15>; Press Release, State of Del., Governor Markell Registers Delaware's First Public Benefit Corporations (Aug. 1, 2013), available at <http://news.delaware.gov/2013/08/01/governor-markell-registers-delawares-first-public-benefit-corporations>.

### B. Finding Appropriate Benchmarks

Second, it may be helpful to juxtapose the ongoing experiment in social enterprise forms not to the well-developed market for traditional incorporations, but rather to an historical case study, which can provide perspective and a benchmark for assessment. An obvious candidate, and one studied at great length by Professor Ribstein, concerns a slightly less recent (but significant and widespread) “experiment” in new business forms: the rise of the LLC model.<sup>21</sup> As we argue below, when examined from this perspective, social entrepreneurship forms have—if anything—enjoyed greater popularity than the early LLC models. We subdivide our assessment into (1) state level diffusion measures and (2) firm level uptake.

Consider first the diffusion of social entrepreneurship business statutes across different states, in comparison to the adoption of LLCs that began over three decades ago.<sup>22</sup> In March 1977, Wyoming became the first state to enact an LLC law. As Kobayashi and Ribstein point out, “[i]n the fifteen year period between 1977 and the end of 1991, only eight states had passed limited liability company statutes.”<sup>23</sup> Florida, the second state to pass an LLC statute, waited until 1982, and Colorado, the third state, waited another eight years until 1990.<sup>24</sup> Kobayashi and Ribstein point to a consequential tax ruling in 1988<sup>25</sup> that helped establish greater security of the LLC’s passthrough status, at which point the floodgates opened substantially; “forty-seven states and the District of Columbia had passed limited liability company statutes by the end of 1994.”<sup>26</sup> By the start of 1997, every state had enacted a version of an LLC statute.<sup>27</sup>

By comparison, the rise of the new social enterprise forms seems quite fast. In the not quite four years since Maryland first promulgated its BC statute, twenty-seven states and Washington DC have passed a version of the law including: Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Minnesota, Nebraska, Nevada, New Hampshire, New

21. See generally LARRY E. RIBSTEIN, *THE RISE OF THE UNINCORPORATION* (2009).

22. Analysis inspired by Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 *ECON. INQUIRY* 464 (1996).

23. *Id.* at 470 n.24 (noting that only Hawaii, Massachusetts, and Vermont had not enacted LLCs).

24. See *id.*; Alejandro Miyar, *New Year Bulletin: Florida’s Revised LLC Act*, *LAW IN THE SUNSHINE STATE* (Jan. 7, 2014), <http://floridalaw.foxrothschild.com/corporations/new-year-bulletin-floridas-revised-llc-act/>; Gary S. Joiner, *Choosing the Best Form for Your Colorado Business Entity*, FRASCONA, JOINER, GOODMAN AND GREENSTEIN, P.C., <http://www.frascona.com/resource/gsj103entity.htm>.

25. *Id.* See also Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in *BUS. TAX STORIES*, 295, 296 (Steven A. Bank & Kirk J. Stark eds., 2005).

26. Kobayashi & Ribstein, *supra* note 22, at 470.

27. Hamill, *supra* note 25, at 297. See State by State Legislative Status, *BENEFIT CORPORATION INFORMATION CENTER*, <http://www.benefitcorp.net/state-by-state-legislative-status> (last visited Sept. 5, 2014).

Jersey, New York, Oregon, Pennsylvania, Rhode Island, South Carolina, Utah, Vermont, Virginia, Washington, West Virginia, and Washington DC.<sup>28</sup> Moreover, the rate of state uptake cannot—like the LLC’s growth—be tied to a watershed legal/regulatory ruling. Indeed, what is notable about the current state of play is just how few bona fide precedents there are in this area. Thus, if one were to take statutory diffusion rates across state jurisdictions as a primary benchmark of “success,” the LLC got off to a significantly slower start than have social enterprises.

Another vantage point from which to assess success is the historical *firm level* uptake of the LLC form relative to social enterprise forms. Here again, the available data suggest that LLCs got off to a much slower start. Wyoming, for instance, enacted its LLC law specifically for a single oil company,<sup>29</sup> and for the next decade averaged a meager four LLCs per year.<sup>30</sup> Florida, which enacted its law five years after Wyoming and was hoping to attract new capital, attracted only two LLCs within in the first year.<sup>31</sup> In fact, as Susan Hamill notes, over the first decade—“before the entity finally received partnership status” in 1988—fewer than one hundred LLCs had formed.<sup>32</sup>

Keatinge and Ribstein identify this lagging uptake pace as “a result of the lingering uncertainty as to both the tax treatment and the protection of the entity’s members from personal liability.”<sup>33</sup> In particular, uptake did not begin to rise until the IRS issued Revenue Ruling 88-76 in 1988, which classified LLCs as partnerships granting them favorable tax treatment and jumpstarting their rise to prominence around the country.<sup>34</sup> In 1994, the IRS issued Revenue Procedure 95-10, allowing LLCs “to enjoy the same flexible standards as limited partnerships when applying the classification regulations.”<sup>35</sup> The IRS finalized the rules in 1996, making permanent the LLC partnership classification for tax purposes; these rules still apply today.<sup>36</sup>

The effect of the 1988 Revenue Ruling was dramatic. Prior to the ruling the yearly number of LLC formations was in single digits; however, after the ruling, states saw a great number of filings in the first year after enacting the LLC. For example, in the first year and half after Arizona enacted its law in 1992,<sup>37</sup> 1336 LLCs were formed within the

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28. See State by State Legislative Status, *supra* note 27.

29. See Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW 375, 383–84, n.45 (1992) (citing Thomas N. Long, *The Wyoming Limited Liability Company 9–10* (1989) (unpublished paper) (on file with Wyoming Secretary of State)); see also Hamill, *supra* note 25, at 307 (identifying the Hamilton Brothers Oil Company as inventing the LLC model in Wyoming).

30. See Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 403 n.46 (1996).

31. Keatinge et al., *supra* note 29, at 383–84 n.45.

32. Hamill, *supra* note 30, at 402.

33. Keatinge et al., *supra* note 29, at 383–84.

34. Hamill, *supra* note 25, at 302.

35. *Id.*

36. *Id.* at 303.

37. Arizona enacted LLC law in June 1992. ARIZ. REV. STAT. ANN. § 29-601 *et seq.* (2014).

state, as compared to the single digit uptake seen in Wyoming and Florida after their respective LLC promulgations.<sup>38</sup>

This fast growth continued throughout the 1990s. In 1993, when the IRS first began a census of LLCs, there were 17,335 LLCs registered with the IRS—1.2 percent of the total number of registered companies.<sup>39</sup> By 1998, the number of LLCs had skyrocketed to over twenty-five percent of the total number of companies, an impressive feat by any measure of uptake.<sup>40</sup> This growth pattern—years of stagnation followed by sudden upsurge once regulatory uncertainties are clarified—similarly counsels caution in interpreting early data on social enterprises.

Moreover, even if one were to “stack the deck” and assume that LLCs grew faster than they actually did in early years, the individual take-up rates of social enterprises would still (by our estimate) compare favorably. Consider Figure 3 below, which depicts a specimen exponential growth curve of the population of LLCs across firms from its year of first inception in Wyoming (1977) through the first reliable economic census of LLCs (1993). The Figure assumes—contrary to fact—that (1) LLCs grew at a constant exponential rate between those years, and (2) that there were fifty LLCs formed in the first year of promulgation in Wyoming. Both assumptions clearly overestimate early uptake of the LLC form given the discussion above, and thus both lean decidedly in the direction of overestimating LLC take-up. Nevertheless, as the figure suggests, the imputed population of LLCs in the fourth year post-promulgation (around 150) still falls far short of the current population of statutory social entrepreneurship forms (which by our count is around 1200 nationwide). Indeed, in California alone, the total number of such forms already exceeds the imputed amount given in the figure.

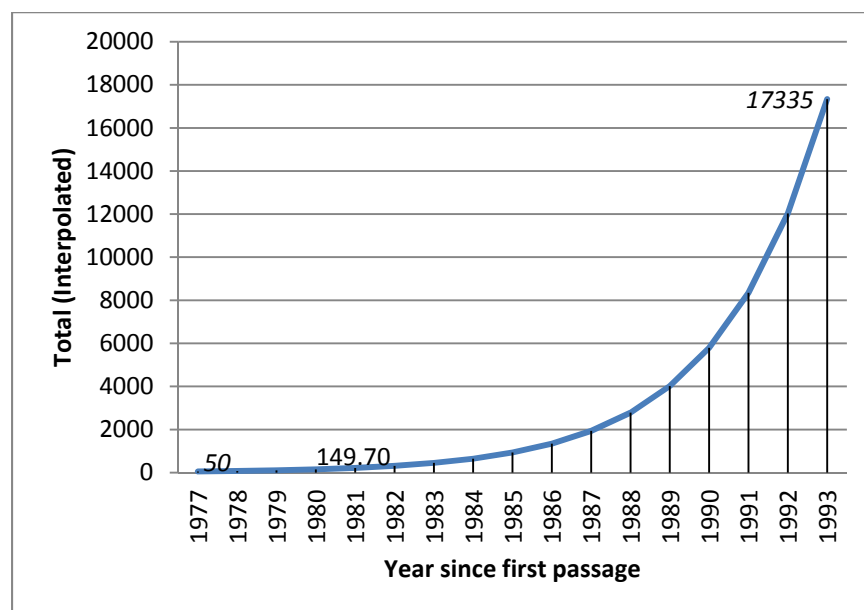
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38. ACC Entity Formation Statistics, KEYT LAW, LLC, <http://www.keytlaw.com/azllclaw/forming-llcs/acc-stats/> (last visited Sept. 5, 2014).

39. See Bill Pratt & Maureen Parsons, *Partnership Returns, 2001*, STAT. INCOME BULL. 46, 54 (Fall 2003), available at: <http://www.irs.gov/pub/irs-soi/01partnr.pdf>.

40. *Id.*

FIGURE 3: INTERPOLATED FIRM LEVEL TAKEUP OF LLC FORMS



At least as a benchmark for assessing the reception of BCs and FPCs, the arc of the LLC uptake path suggests that the jury is (and should be) decidedly out on the ultimate success of the new forms. They have yet, for example, to develop a set of judicial precedents and regulatory rulings that would provide the same degree of comfort that LLCs waited nearly two decades to receive.

### C. Assessing Uptake in California

Regardless of the arguably favorable comparison to historical LLC uptake, or the relative success of California compared to other states, advocates of the new corporate forms in California had likely hoped for a more definitive California “bear hug” by new businesses, since the state is an acknowledged hotbed of social entrepreneurship generally.<sup>41</sup> If the uptake of BCs and FPCs is indeed lower than hoped, what could be the cause? Reasons for the low level of uptake could include the increased risk investors and entrepreneurs associate with a brand new type of legal entity, confusion over California’s two different social enterprise laws, questions over the necessity of the new corporate form, and even opposition by the nonprofit community. This section looks briefly at each of these potential reasons and how they contribute to the slow uptake.

41. See Deborah L. Cohen, *Entrepreneurial Hotbeds: A Mix of Science and Luck*, REUTERS (Oct. 19, 2011, 12:05 PM), <http://www.reuters.com/article/2011/10/19/us-column-cohen-hotbeds-idUSTRE79I4T120111019>.

1. *Legal risk*

Starting or investing in a business always includes an element of risk, and determining the risk profile of a company and investment involves both sensitive analysis and personal judgment. Additional risk, whether generated through a new right of action, a cash flow constraint, or mere confusion, hurts the company's prospects of finding investment. For smaller companies, this could hamper their growth and prevent their success; for larger companies, this could hurt their market position and decrease overall firm value.

One source of risk is a new right of action created by BC laws and the concomitant concern over litigation exposure.<sup>42</sup> In California, as in most other states that have enacted such a law, the BC form adds a new right of action against the company's board of directors for failure to adhere to the standards.<sup>43</sup> One of the implications of the new right of action is the possibility of a lawsuit brought against the company or the board of directors for failure to adhere to the social purposes enumerated in the company charter and the BC statute.<sup>44</sup> As described by Ian Kanig, "if the [board] makes a particular business decision that ultimately harms the provision of public benefit, shareholders and (minority) directors could file suit under the express private right of action set forth by the benefit enforcement proceeding."<sup>45</sup> Although legally possible, a search of Westlaw reveals that there has been but a single lawsuit citing to either the BC or FPC laws, which indicates that there remain unsettled legal and doctrinal issues around the new corporate entity.<sup>46</sup>

This risk is exemplified by "an additional procedural duty lurking beneath the surface of the benefit corporation statute."<sup>47</sup> As Kanig argues, "each material action by the board of directors is capable of both *substantive* and *procedural* review."<sup>48</sup> The substantive review analyzes a particular business decision under the so-called business judgment rule, which generally gives substantial protection to the board of directors. The procedural review, however, "escapes the deference of the business judgment rule" and requires "strict procedural liability" such that "the board of directors must make some affirmative, evidentiary showing of nonshareholder consideration for all material decisions."<sup>49</sup> This means that if the company fails to adhere to the social purposes listed in the statute and its charter, then a lawsuit could be brought against the com-

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42. CAL. CORP. CODE §§ 14620–23 (West 2014).

43. *Id.* § 14623.

44. *Id.* § 14620(b).

45. Ian Kanig, *Sustainable Capitalism Through the Benefit Corporation: Enforcing the Procedural Duty of Consideration to Protect Non-Shareholder Interests*, 64 HASTINGS L.J. 863, 898 (2013). See CAL. CORP. CODE § 14620(b) for an explanation of the benefit enforcement proceeding.

46. Search done on November 15, 2013. The single case cite was irrelevant however, as it dealt with a separate and unrelated issue.

47. Kanig, *supra* note 45, at 898.

48. *Id.* (emphasis added).

49. *Id.* at 899.



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pany to force adherence. According to Kanig, the “plaintiffs in a benefit enforcement proceeding should be able to restrain further corporate action” until the evidence is provided.<sup>50</sup> In this way the procedural arm of the benefit enforcement proceeding avoids the deference to the company decision makers required by the business judgment rule.<sup>51</sup> As such, this factor likely increases the perceived litigation risk profile of BCs, contributing to the slow adoption of the new entity.

Unlike the BC model, the FPC model is a much more modest departure from conventional corporate law, and it creates no new right of action, even though (as shown above) it has enjoyed relatively less popularity in California.<sup>52</sup> While this may be in part due to the larger national push that BCs have received through certifying groups such as B-Corp, it also suggests that fear of legal exposure alone probably does not explain take-up patterns.

## 2. *Cash Flow Demands*

Another salient issue regarding new corporate forms is more general cash flow risk from business operations, including both demands on expenditures as well as claims on earnings. Through our informal conversations with social entrepreneurs, investors, and lawyers, there remain significant outstanding questions in the minds of even socially/environmentally oriented entrepreneurs about the cost implications associated with becoming and maintaining a BC or a FPC. These questions might include:

- What direct costs will the social mission impose on operating revenues?
- How much will it cost for the third party certification scheme?
- How much will it cost in additional materials, process, and oversight to comply with the standards?
- How might the company change in a way that would harm its investor interests?
- How does the corporation’s legal form affect investors’ exit options (through acquisition, conversion, or public offering)?

Many investors facing these sorts of questions would balk at the open ended nature of the costs, which they may not understand how to calculate and the company may not be able to explain fully how to contain. The costs associated with fulfilling the third party certification and adhering to the company’s mission, in addition to the certification fees themselves, can quickly become overwhelming, adding thousands of dollars to the budgets of cash strapped startups or market sensitive companies. At a more unsentimental level, paying living wages costs more than

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50. *Id.*

51. *Id.*

52. *See supra* Figure 1.

paying minimum wages, and postconsumer recycled paper is more expensive than ordinary paper.

While independent certification schemes are not new for corporations seeking to adhere to social, environmental, or human rights,<sup>53</sup> the new legal entities in California that codify social and environmental standards—the BC and FPC—go further than other schemes.<sup>54</sup> For companies large and small attempting to attract investors, the risk associated with dedicating an unknown but significant portion of revenues—a cash flow asset—to the social or environmental purpose and certification may deter investors, which could further contribute to the perceived low uptake.

### 3. *Confusion*

In addition to the increase in risk associated with new business forms, the fact that California has two distinct new entities that purport to accomplish the same goal adds confusion to the laws around social enterprises.<sup>55</sup> One source of risk is the uncertainty of the longevity of these corporate forms. While having more options is intuitively more desirable, sometimes a single scheme (and less choice) can better exploit network externalities, developing more quickly and more sensibly without distraction from competing statutory forms. Advocates of each of the laws highlight the differences and assert the need for both entities; however, entrepreneurs and investors may not want to face the choice given the possibility that the entity they opt for may not survive. In a sense, few have the taste for becoming a canary in the social enterprise coalmine.

### 4. *Necessity*

Compounding this uncertainty is the question of necessity. As Kanig notes, the BJR, which governs most business decisions, is quite deferential to the management and board of the company. The *Revlon* duty, which requires a company to maximize the short term value of the company, applies most saliently to public companies when the sale of a company becomes inevitable and there is a change of control.<sup>56</sup> Because

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53. See, e.g., various schemes implementing the United Nations Guiding Principles on Business and Human Rights such as Social Accountability International ([www.sa-intl.org](http://www.sa-intl.org)) and Business for Social Responsibility ([www.bsr.org](http://www.bsr.org)), as well as older certification schemes such as the International Labor Organization ([www.ilo.org](http://www.ilo.org)), Fair Labor Association ([www.fairlabor.org](http://www.fairlabor.org)), Fairtrade International ([www.fairtrade.net](http://www.fairtrade.net)), and Workers Rights Consortium ([www.workersrights.org](http://www.workersrights.org)).

54. See, e.g., Kanig, *supra* note 45, at 892, 899–901.

55. See, e.g., John F. Olson, *Two New Corporate Forms to Advance Social Benefits in California*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG. (Nov. 17, 2011, 10:23 AM), <http://blogs.law.harvard.edu/corpgov/2011/11/17/two-new-corporate-forms-to-advance-social-benefits-in-california/>.

56. See *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994); *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 565 A.2d 280 (Del. 1989); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

there are no public BCs or FPCs,<sup>57</sup> *Revlon* does not pose significant impediments to the BJR in this context, although it may apply with greater force if ownership of these entities becomes more widely distributed. Moreover, conventional corporate entities can often take advantage of private contracting solutions to enshrine social missions—such as through long term leases in which failure of the lessee to adhere to articulated social purposes can trigger automatic termination.

On the other hand, while the BJR gives the company flexibility to pursue a social purpose, as noted above it does not *require* the company to do so. Certain investors or entrepreneurs might want to bake the social purpose more completely into the company's DNA so that future boards and officers have little option but to adhere to it. It is possible to accomplish this (at least in some measure) contractually, such as through contracts and leases with third parties (or affiliated entities) that allow for reversionary or march-in rights of the counterparty should the corporate entity stray from its social purpose. While this sort of approach has gained some popularity of late, it entails somewhat elusive commitment devices (e.g., if parties expect simply to renegotiate/reexecute the deal after a termination event is triggered, the triggering clause would have little deterrent effect). By opting into a BC or FPC structure, a business entity makes a concrete commitment to a social purpose that is difficult to back out of, finesse, or renegotiate, and some impact oriented investors or social entrepreneurs could well see this commitment device as a necessity.

##### 5. *Opposition*

A final (albeit possibly overhyped) source of resistance to these new corporate forms is opposition by the nonprofit and charitable communities. During the legislative debates around AB 361 (the BC bill) and SB 201 (the FPC bill) there was testimony and opposition by several nonprofit advocacy organizations.<sup>58</sup> After passage, there has continued to be tension between the two groups. In 2012 in San Francisco, for example, proposed legislation to incentivize BCs was opposed to by the California Association of Nonprofits (“CAN”).<sup>59</sup> CAN's chief executive officer has repeatedly questioned the need to provide “nonprofit-like preferences” and advantages to for-profit companies that are not legally required to adhere to “nonprofit-like restrictions and oversight.”<sup>60</sup> This conflict be-

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57. See uptake data from Talley, *supra* note 1.

58. See, e.g., AB361 Bill Analysis prepared for Assembly Committee On Judiciary Hearing, May 3, 2011, p.2, (regarding opposition by California Association of Nonprofits), available at [http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab\\_0351-0400/ab\\_361\\_cfa\\_20110502\\_125826\\_asm\\_comm.html](http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_0351-0400/ab_361_cfa_20110502_125826_asm_comm.html) (last visited Sept. 5, 2014).

59. See, e.g., Mark Hrywna, *Benefit Corporation in California Meets Chill in San Francisco*, NON PROFIT TIMES (Mar. 23, 2012), <http://www.thenonprofittimes.com/news-articles/benefit-corporation-in-california-meets-chill-in-san-francisco/> (citing opposing statements by the California Association of Nonprofits).

60. *Id.*

tween the charitable community and the social enterprise community has dampened the enthusiasm around the new corporate forms and perhaps contributed to the sluggish uptake.

There are many other factors that contribute to the underwhelming rate of uptake of BCs and FPCs. The combination of increased risk around litigation, legal duties, and cash flow, as well as confusion between the two entities, questions around the necessity of the new forms, and opposition by the nonprofit community, creates a thick restraint around their development and spread. Despite this, however, there is, in fact, cause for hope that these new corporate forms will see an increasing rate of uptake—as with the rise of the LLC, underwhelming initial uptake does not necessarily portend failure.

## V. CONCLUSION

In this Article, we have taken Larry Ribstein's pioneering lead in the analysis of alternative business forms to take a critical look at the rise of new social enterprise corporate forms. We have demonstrated that while *firm level* uptake appears modest in absolute numbers, and opposition and questions about necessity persist in segments of the business and nonprofit communities, the comparison to the emergence of the LLC is revealing. There has been a far more rapid increase of states that have enacted social entrepreneurship forms in contrast to the rather slow adoption of the now-ubiquitous LLC form: since Maryland adopted the first socially responsible corporate form in 2010, over half of states have followed suit. In addition, much of the confusion caused by competing forms (the Benefit Corporation and the Flexible Purpose Corporation) is dissipating as the two forms move closer together as in, for example, the Delaware Public Benefit Corporation. And even at the firm level, the rate of uptake into these new forms compares quite favorably to the LLC. Furthermore, the consumer support of these laws lends credibility to the conclusion that these new corporate forms are here to stay. Although the economic impact may never be as great as that of the LLC, these new forms may well help invigorate the nation's nascent social enterprise economy. At the very least, they deserve a spot in the policy conversation that we shall carry on in Professor Ribstein's absence.

