State Legislation to Support Social Enterprise

Jenny Kassan, Katovich Law Group

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Problem: Can Companies Be "Socially Responsible" Without Risking Shareholder Lawsuits?

For-profit social enterprise managers want to consider issues such as environmental sustainability, the well-being of the local community in which they operate, the promotion of workplace democracy, etc. when making decisions but are afraid that if they put these concerns ahead of the maximization of shareholder profits, they could be sued for breaching their duties to shareholders.

The duty of directors and officers to make decisions that are in the best interest of company shareholders results in "shareholder primacy" – the tendency for companies to put the maximization of shareholder wealth above all other considerations, including those related to social and environmental responsibility.[1]

However, shareholder primacy does not completely constrain directors and officers to put shareholder profits first. Under current law, day-to-day decisions of corporate boards are subject to the business judgment rule. This rule protects directors and officers from being held liable if they make a decision that results in shareholder losses as long as they acted in good faith and with reasonable care for the best interests of the company.

Thus, the business judgment rule provides broad latitude for officers and directors to make decisions that benefit the environment, the community, and their workers even if there is a negative effect on returns to shareholders.

However, it is unclear where a court would draw the line between a decision protected under the business judgment rule and a decision that so benefits non-shareholders at the cost of shareholder returns that it would be considered a breach of the duty to shareholders. Furthermore, when a company is targeted for a takeover, courts often hold corporate boards to a stricter standard and require them to make the maximization of shareholder return the number one priority.

Thus leaders of companies that want to operate in a socially responsible manner are hamstrung by the legal uncertainties surrounding such practices.

Legislative Solutions to the Shareholder Primacy Problem

1. Stakeholder Statutes (a.k.a. Constituency Statutes)

In the wake of a wave of hostile takeovers, many states (approximately 30) adopted statutes that either permit or require directors and (sometimes) officers to consider the interests of stakeholders other than shareholders when making decisions.

[1] Example of a state statute that codifies shareholder primacy: "A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders . . . ." California Corporations Code Section 309(a).

There are several variations of stakeholder statutes. The following are just two examples:

"A director of a corporation . . . shall consider, in determining what he reasonably believes to be in the best interests of the corporation, (1) the long-term as well as the short-term interests of the corporation, (2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation, (3) the interests of the corporation's employees, customers, creditors and suppliers, and (4) community and societal considerations including those of any community in which any office or other facility of the corporation is located. A director may also in his discretion consider any other factors he reasonably considers appropriate in determining what he reasonably believes to be in the best interests of the corporation." Connecticut General Statutes 33-756(d).

"In discharging the duties of the position of director under this chapter, a director of an issuing public corporation, in considering the best interests of the corporation, shall consider the long-term as well as the short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation." Arizona General Corporation Law 10-2702.

Criticisms of stakeholder statutes include the following:

- They can provide an excuse for directors to promote their own interests
- It is unclear if they would protect a board of a company operating outside of the state in which it is incorporated if that state did not have a stakeholder statute
- Some critics do not like the fact that it covers ALL corporations, rather than allowing opt in
- Institutional Shareholder Services, Inc., a corporate governance advisory firm, counts incorporation in a state with non-shareholder constituency provisions as a negative factor when calculating its Corporate Governance Quotient, which purports to measure the quality of corporate governance.

B Corporations

In states that have constituency statutes, social enterprises have the option of forming B Corporations.

A B Corporation is not a statutory entity; rather it is a model that businesses can choose to use when drafting their start up documents. The model was created by a nonprofit organization called B Lab. To become a B Corporation, an entity incorporates the following language into its articles of incorporation:

> In discharging his or her duties, and in determining what is in the best interests of the Company and its shareholders, a Director shall consider such factors as the Director deems relevant, including, but not limited to, the long-term prospects and interests of the Company and its shareholders, and the social, economic, legal, or other effects of any action on the current and retired employees, the suppliers and customers of the Company or its subsidiaries, and the communities and society in which the Company or its subsidiaries operate, (collectively, with the shareholders, the ***"Stakeholders"***), together with the short-term, as well as long-term, interests of its shareholders and the effect of the Company's operations (and its subsidiaries' operations) on the environment and the economy of the state, the region and the nation.

> Nothing in this Article express or implied, is intended to create or shall create or grant any right in or for any person or any cause of action by or for any person.
>
> Notwithstanding the foregoing, any Director is entitled to rely upon the definition of "best interests" as set forth above in enforcing his or her rights hereunder and under state law, and such reliance shall not, absent another breach, be construed as a breach of a Director's fiduciary duty of care, even in the context of a Change in Control Transaction where, as a result of weighing other Stakeholders' interests, a Director determines to accept an offer, between two competing offers, with a lower price per share.

Companies that want to identify themselves as B Corporations and use the B Corporation logo must, in addition to adding the language above to their formation documents, meet social responsibility and environmental sustainability criteria and pay an annual licensing fee.

It is not recommended to form or operate a corporation whose articles contain the B Corporation language in a state that does not have a stakeholder statute. However, a corporation that adopts a board resolution stating that it will amend its articles with the B Corporation language when the state in which it is located adopts a stakeholder statute can be certified as a B Corporation. In addition, LLCs in any state may incorporate B Corporation language into their operating agreements and receive certification.

For more information, see www.bcorporation.net.

Code for Corporate Citizenship

Also related to the concept of stakeholder statutes is the Code for Corporate Citizenship developed by attorney Robert Hinkley, also known as the 28 Words: "But not at the expense of the environment, human rights, public health and safety, dignity of employees, or the welfare of the communities in which the corporation operates." Hinkley advocates that this language be added to the corporation statutes of all 50 states following the provision requiring boards to act in the best interests of the corporation and its shareholders.

2. New Corporate Forms

The H Corporation in California

After California Governor Schwarzenegger vetoed a constituency statute in 2008, a group of lawyers and advocates for socially responsible business got together to design a new corporate form, called the H Corporation.

The H Corporation is a new corporate form that is separate and distinct from all existing forms in California – a whole new chapter of the Corporations Code. A new entity that is created under the statute will be required to specify in their articles of incorporation at least one purpose promoting social or environmental objectives that directors and managers may consider in addition to shareholder economic interests when determining what is in the best interests of the H Corporation and its shareholders. Decisions and actions of the directors and managers that consider those purposes will be protected from claims of breach of fiduciary duties.

To offset and complement the expanded scope of directors' and managers' protected decision-making, expanded requirements of transparency and shareholder communication are included in the statute. The

H Corporation will be required to disclose financial and other information to its shareholders, with additional measurement and reporting of the impact or "returns" of actions vis-à-vis such corporations' social or environment purposes. An H Corporation's shareholders will have the right to elect and remove directors and to enforce the corporation's adherence to its purposes – but other parties will not have such rights of action.

For more information, contact Susan MacCormac at Morrison & Foerster – smaccormac@mofo.com

The Socially Responsible Corporation in Minnesota

A group called Citizens for Corporate Redesign in Minnesota has promulgated a statute to create a new type of entity called the Socially Responsible Corporation.

The legislation includes the following:

- Defines the "public interest" as the general public well-being of present and future generations including, but not limited to, the economy, natural environment, public health, public safety, human rights, educational and other human developmental opportunities, and the general well-being of the local, state, national, or world community.

- Defines "stakeholder" as (1) a shareholder; (2) an employee; (3) a customer; (4) a supplier; or (5) a creditor.

- The articles of incorporation of the corporation must state either: (1) the corporation's specific social responsibility goals or values regarding promotion of either the public interest or the well-being of stakeholders other than shareholders, or both; (2) one or more components of the public interest or of stakeholder interests other than shareholders, to which the corporation will give special consideration; or (3) that the corporation will act in accordance with the requirements of the statute.

- In discharging his or her duties, a director shall, in determining the best interests of the corporation, consider: (1) the interests of the corporation's shareholders, employees, customers, suppliers, and creditors; (2) the economy of the state and nation, community and societal considerations, including the public interest as defined in the statute; and (3) the long-term as well as short-term interests of the corporation and its stakeholders including the possibility that these interests may be best served by the continued independence of the corporation.

- The directors of a corporation must include directors whose role as directors includes representation of, and advocacy for, the interests of the corporation's employees and of the public interest as defined in the statute.

- At least 20 percent of the corporation's directors must represent and advocate for the corporation's employees. These directors must be nominated and elected by the employees, through a process specified in the bylaws.

- At least 20 percent of the corporation's directors must represent and advocate for the public interest. These directors must be elected by the other board members, after seeking input from persons or groups representing the public interest.

- The board shall provide opportunities for advisory input from stakeholders other than shareholders.

- If the corporation is a publicly held corporation, the corporation shall produce and publish an annual public interest report at the same time as it files its annual financial report required under federal securities laws. The public interest report must summarize the corporation's actions undertaken within the preceding year that benefit the public interest and stakeholders other than shareholders and must describe how the corporation takes into account those interests.

- The corporation shall provide educational programs for its officers, directors, and other employees regarding their special duties under the statute.

The bill can be found here:
https://www.revisor.leg.state.mn.us/bin/bldbill.php?bill=S0510.0.html&session=ls86

3. Cooperatives

Entrepreneurs that want to provide voting rights to stakeholders such as employees and/or customers may want to consider forming a cooperative. Cooperative statues vary widely state by state, allowing start-ups to choose the statute that best meets their needs. Cooperatives, if they meet certain requirements regarding the payment of patronage dividends to their members, have a tax advantage over C Corporations under Subchapter T of the Internal Revenue Code. Dividends paid to the patrons of the cooperative (such as employees or customers) in proportion to the amount of their patronage are not subject to the corporate double tax.

Wisconsin's relatively new cooperative statute is particularly interesting. The statute is a "hybrid" cooperative statute that includes many features from the limited liability company model. This new model was created in response to the fact that under the traditional cooperative statute, it is virtually impossible to attract outside investment from non-patrons due to severe limits on voting rights for such investors.

Wisconsin's Chapter 193 authorizes the creation of membership interests for investors who are not patrons of the cooperative. Such investor-members' voting rights may not exceed a total of 49 percent but the bylaws may provide such members with the power to veto certain unusual decisions such as merger or dissolution. And the investors' may not receive more than 70 percent of the profit allocations and distributions of the cooperative.

A cooperative formed under Chapter 193 may elect to be taxed as a partnership under Subchapter K of the Internal Revenue Code, or as a cooperative under Subchapter T.

For a neat co-op example, see: www.cooppower.coop

Other Legislation That Promotes Social Enterprise

1. Subsidy Fairness

State and local governments spend billions each year in subsidies to bring "economic development" to their jurisdictions. These subsidies often result in extreme waste. Some egregious examples include

- Nashville provided $200 million in incentives to Dell to convince the company to build a manufacturing facility there. Three years later, Dell announced that it was eliminating all manufacturing operations in Nashville.

- Indianapolis provided $320 million in incentives to United Airlines for locating a facility there that closed five years later.

Subsidies such as these are usually provided to large multinational corporations with no allegiance to the state or locality providing the incentives. There is a growing movement to impose accountability measures on subsidy recipients and, more importantly for social enterprises, to allow smaller, locally-owned, socially responsible businesses to compete for business assistance dollars.

An organization called Good Jobs First is a leader in this movement and proposes the following reforms (many of which have been adopted by states and localities throughout the country):

- Disclosure laws require states to release company-specific information on the type and amount of subsidies they grant, the benefits companies have promised to create, and the track record of companies in complying with those obligations.

- Clawbacks, also called recapture provisions, are clauses in subsidy laws that require a company to return all or part of the value of a subsidy if the company fails to meet the obligations agreed to as a condition of receiving the award.

- Job quality standards are requirements that subsidized companies create full-time positions paying livable wages and/or providing health insurance and other benefits.

For more information, see the Good Jobs First web site: www.goodjobsfirst.org

2. Securities Regulation Reform

Securities laws are a major impediment to the growth of social enterprises. While originally enacted in the 1930s to protect investors, our system of security regulation is so complicated and onerous that it is virtually impossible for a small business to receive equity investments from anyone other than the founders and others who are actively involved in day-to-day management.

While now may not be the best time to propose an exemption from securities regulation, a few brave souls are doing just that.

For example, Michael Shuman, author of *The Small-Mart Revolution* makes the following proposals:

- The Securities and Exchange Commission (SEC) and state securities regulatory bodies should create an exemption from regulatory requirements for small investments ($100 or less) in local small businesses (no more than $250,000 worth of stock, with all stock held by residents of the state in which the business is located)

- The SEC should allow local communities to set up stock exchanges exempt from the federal regulatory requirements to facilitate community residents purchasing and trading shares in small local businesses

For more information, see http://small-mart.org/legalize_localization

3. The L3C

The L3C is short for "Low Profit Limited Liability Company." The first L3C statute was enacted in Vermont in 2008 and now has been passed in four other states. The L3C was developed in response to a very specific concern related to the Internal Revenue Code's provisions governing foundations. Foundations are required to distribute five percent of the value of their net assets for charitable purposes each year. To meet this requirement, foundations primarily make grants to charitable organizations (organizations exempt from taxation under Section 501(c)(3) of the Internal Revenue Code). However, foundations are also permitted under the IRC to invest this five percent of net assets in for-profit entities that meet a three-pronged test:

1. The entity must be formed primarily for charitable or educational purposes,

2. No significant purpose of the entity is the production of income or the appreciation of property,

3. No purpose of the entity is to conduct legislative or political activities.

(Internal Revenue Code (IRC § 4944(c) and Treas. Reg. § 53.4944–3)

The investment (called a Program-Related Investment or PRI) may produce significant income or capital appreciation so long as the production of income or the appreciation of property is not a significant purpose.

The option of making a PRI is very attractive for a foundation. Unlike grants, PRIs can produce significant returns. However, PRIs are relatively uncommon because foundations are unwilling to risk the uncertainty of having the IRS determine that a PRI it makes does not in fact meet the statutory requirements. Foundations that decide to make PRIs often feel compelled to seek costly Private Letter Rulings to prevent this risk. According to the Foundation Center, of the many thousands of grantmaking foundations in the United States, only a few hundred make PRIs.

In response to this unfortunate reality, a group of advocates for socially responsible business called Americans for Community Development wrote model legislation to create a new entity designed to meet the requirements for a PRI. Vermont was the first state to adopt this legislation and it has now been adopted in several more states. The Vermont legislation created a new entity called an L3C that is identical to a Vermont LLC except that it is "organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements:

(A) The company:

(i) significantly furthers 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); and

(ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.

(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(D)."

(11 V.S.A. § 3001(23))

It is hoped that foundations will make PRIs in L3Cs because they are specifically designed to meet the requirements for a PRI under the Internal Revenue Code. Legislation pending in Congress would explicitly allow foundations to make PRIs in L3Cs.

Any Questions or Comments?

Feel free to contact me at jenny@katovichlaw.com or (510) 834-4530.

We are developing our web site to be a resource for social enterprises – please visit us at katovichlaw.com.