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Purpose Driven Companies in the United States

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Chapter [XX]. Purpose Driven Companies in the United States

Alicia E. Plerhoples*

Abstract. The United States is the birthplace of benefit corporations precisely because of American society's over-reliance on the private sector to solve societal problems. U.S. federal and state regulation continuously fails to provide robust social safety nets or prevent ecological disasters. American society looks to companies to do such work. U.S. social enterprise entities attempt to upend the U.S. legal framework which binds fiduciaries to focus on shareholder value. These entities are permitted, and sometimes required, to take into account environmental, social, and governance ("ESG") impacts of their operations, essentially internalizing ESG costs that would otherwise be paid by American communities and the environment. This chapter traces social enterprise development under U.S. law, starting with a brief discussion of corporate law as a creature of state law. It then provides an overview of the two major types of social enterprise entities in the United States: (1) the Delaware Public Benefit Corporation, and (2) the California Special Purpose Corporation. The chapter briefly discusses other types of U.S. social enterprise entities, including hybrid ventures, worker cooperatives, and the low-profit liability company. The chapter concludes with a discussion of responses to companies' ESG efforts by legal scholars, asset managers, and the U.S. Securities and Exchange Commission. These responses and the uptake of publicly traded public benefit corporations indicate a seismic shift forward in the use of ESG frameworks in the United States.

Summary. 1. Introduction. – 2. Fiduciary Duty and Federalism. – 3. The Delaware Public Benefit Corporation. – 3.1 The Accountable Capitalism Act. – 4. The California Special Purpose Corporation – 5. Other Social Enterprise Entities – 6. Conclusion: Seismic Shifts Forward

1. Introduction

The United States is the birthplace of benefit corporations precisely because of American society's over-reliance on the private sector to solve societal problems. U.S. federal and state regulation continuously fails to provide robust social safety nets or prevent ecological disasters. American society looks to companies to do such work. And yet, companies will never voluntarily do what is needed to slow the climate crisis, end economic inequality, or achieve racial and gender justice, three major activist shareholder demands during the 2021 proxy season.¹ Neither corporate law nor market forces require companies to internalize such external costs. As an example, while the Walmart family is worth \$148.8 billion, Walmart workers cost the U.S. \$6.2 billion

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¹ For highlights from the 2021 proxy season, see Shirley Westcott, 2021 Proxy Season Review (2021). <https://corpgov.law.harvard.edu/2021/08/05/2021-proxy-season-review/>. Accessed 7 March 2022.

annually in public assistance.² Similarly, a U.S. company might, for example, have called for racial justice in the wake the killing of George Floyd by a Minneapolis police officer, but rebuke shareholder proposals to conduct a racial equity audit of its own practices and policies that adversely impact Black Americans. Corporate directors share an explicit acknowledgement that a firm can be profitable by declaring its social and environmental values but a tacit acknowledgment that a firm cannot go too far in pursuing social or environmental impact without harming shareholder value. With employer-provided healthcare and less public spending on social safety nets than most industrialized countries,³ Americans remain at the mercy of companies whose primary pursuit is profit.

The innovation of social enterprise entities such as the benefit corporation and the special purpose corporation attempt to upend the U.S. legal framework which binds fiduciaries to focus on shareholder value. These entities are permitted, and sometimes required, to take into account environmental, social, and governance (“ESG”) impacts of their operations, essentially internalizing ESG costs that would otherwise be paid by American communities and the environment. This chapter traces social enterprise development under U.S. law, starting with a brief discussion of corporate law as a creature of state law. It then provides an overview of two major types of social enterprise entities in the United States: (1) the Delaware Public Benefit Corporation, and (2) the California Special Purpose Corporation. This chapter also discusses (i) the model benefit corporation act in comparison to the Delaware Public Benefit Corporation, (ii) the trend in shareholder proxy proposals for public companies to convert to public benefit corporations, and (iii) the proposed Accountable Capitalism Act. The chapter briefly examines other types of U.S. social enterprise entities, including hybrid ventures, worker cooperatives, and the low-profit liability company. The chapter concludes with a discussion of responses to companies’ ESG efforts by legal scholars, asset managers, and the U.S. Securities and Exchange Commission. These responses and the uptake of publicly traded public benefit corporations indicate a seismic shift forward in the use of ESG frameworks in the United States.

2. Fiduciary Duty and Federalism

U.S. corporate law does not exist as a single body of law. Rather, U.S. corporate law relies on a federalist system; corporate governance is primarily regulated by a company’s state of incorporation or registration, although there are exceptions such as long-arm statutes, federal securities regulations, and capital markets’ requirements. U.S. social enterprise law, therefore, varies state by state. Under Delaware corporate law, corporate directors’ fiduciary duties are owed to the corporation and shareholder primacy reigns supreme. Management under a shareholder primacy regime sees corporate directors advancing and prioritizing shareholder interests over non-

² Americans For Tax Fairness, *How Taxpayers Subsidize America’s Biggest Employer and Richest Family* (2014). <https://americansfortaxfairness.org/files/Walmart-on-Tax-Day-Americans-for-Tax-Fairness-1.pdf>. Accessed 7 March 2022.

³ Samantha Valenta, *Safety Nets: An International Comparison* (2019). <https://newlaborforum.cuny.edu/2019/06/05/safety-nets-an-international-comparison/>. Accessed 7 March 2022.

shareholder interests. However, under Tennessee law, for example, fiduciary duties are broader and the primary purpose of a corporation can encompass multiple purposes, including creating social value.⁴ Thirty-three U.S. states have adopted constituency statutes that allow corporate directors to take into account the interests of persons or groups other than its shareholders.⁵ Nonetheless, constituency statutes are viewed as not providing investors with sufficient notice as to when a corporation will pursue constituents' interests over shareholder value. Constituency statutes are also permissive, not mandatory. For these reasons, many states with constituency statutes have also adopted new entity forms like the benefit corporation in order to put investors on notice of the multi-stakeholder nature of their investments and to require balancing shareholder and stakeholder interests.

3. The Delaware Public Benefit Corporation

Unlike other states' corporation statutes, Delaware General Corporation Law does not contain a constituency statute. Adoption of an entity form that specifically allows directors and managers to consider non-shareholder interests was the most viable route for expanding the social enterprise sector under Delaware law. Three years after the first introduction of the benefit corporation under Maryland law, Delaware adopted the public benefit corporation (PBC), a corporate form that is similar to but distinct from the model benefit corporation act relied upon by other states.⁶

Why focus on Delaware law to discuss benefit corporations in the U.S.? Delaware is the preeminent U.S. state with respect to corporate law. Firms that seek access to capital and financial markets look to Delaware for well-established case law, a judiciary that specializes in business law, a modern statute, a pro-business legislature, and the ability to conduct business in another state without paying Delaware corporate income tax.⁷ 67.6% of Fortune 500 companies are registered in Delaware and 93% of U.S.-based initial public offerings in 2020 were completed by companies domiciled in Delaware.⁸ In the State of Delaware's press release announcing adoption of the public benefit corporation law, Delaware's Secretary of State highlighted what Delaware could bring to bear on the benefit corporation movement: "This law will provide benefit corporations with the stability, efficiency and predictability that are the hallmarks of Delaware corporate law."⁹ By adopting its own form of benefit corporation, Delaware's role as a corporate leader would not be preempted by other states.

Directors of a Delaware PBC must manage the corporation in a manner that balances (i) stockholders' pecuniary interests, (ii) the best interests of those materially

⁴ Tenn. Code Ann. § 48-103-204

⁵ Alexander 2018, p. 138

⁶ Del. Code Ann. tit. 8 § 362(a)

⁷ Black, Jr. 2007

⁸ Jeffrey W. Bullock, Del. Sec'y of State, Del. Div. of Corp. 2020 Ann. Rep., 1 (2020), <https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2020-Annual-Report.pdf>.

⁹ State of Delaware Press Release (2013), State of Del., Governor Markell Signs Public Benefit Corporation Legislation (July 17, 2013) <http://news.delaware.gov/2013/07/17/governor-markell-signs-public-benefit-corporation-legislation/>

affected by the corporation's conduct, and (iii) the public benefit¹⁰ identified in its certificate of incorporation.¹¹ A Delaware PBC varies significantly from the benefit corporation which has been adopted in 36 states and Washington, D.C.,¹² and based on the model benefit corporation act that was drafted by lawyer William Clark on behalf of B Lab, the nonprofit organization which provides private certifications of B-Corps and lobbies for benefit corporation adoption.¹³ Like the model benefit corporation act, the Delaware version embraces stakeholder governance by requiring directors to balance shareholder and non-shareholder interests.¹⁴ Unlike the model benefit corporation act, incorporators and shareholders of a Delaware PBC must state a specific public benefit within the corporation's charter. Requiring a specific public benefit was likely intended to enhance accountability, but it also reduces commitment to a holistic social and environmental impact.¹⁵ Directors of Delaware PBC pursue a specific mission rather than the broad general public benefit¹⁶ imposed by the model benefit corporation act. The differences between the Model Benefit Corporation Legislation and the Delaware Public Benefit Corporation Law are set forth in Table 1.

<i>Model Benefit Corporation Act vs. Delaware Public Benefit Corporation Law</i> Table 1		
Statutory Provision	Model Benefit Corporation Act	Delaware Public Benefit Corporation Law
General Public Benefit	Required ¹⁷	Not required, nor mentioned in statute
Specific Public Benefit	Not required (optional) ¹⁸	Required to provide in charter ¹⁹
Third-Party Standard	Required ²⁰	Not required unless mandated in charter ²¹

¹⁰ Public benefit means "a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature." Del. Code Ann. tit. 8, § 362(b)

¹¹ Del. Code Ann. tit. 8, § 362(a)

¹² Data provided by B Lab at Benefit Corp Information Center, <http://www.benefitcorp.net/state-by-state-legislative-status>. Accessed 7 March 2022

¹³ Alexander 2018, p. 66

¹⁴ Sisodia et al. 2017

¹⁵ Murray 2014, p. 353

¹⁶ General public benefit means "a material positive impact on society and the environment, taken as a whole, from the business and operations of a benefit corporation assessed taking into account the impacts of the benefit corporation as reported against a third-party standard." Model Benefit Corp. Legis. § 102

¹⁷ Model Benefit Corp. Legis. § 201(a)

¹⁸ Model Benefit Corp. Legis. § 201(b)

¹⁹ Del. Code Ann. tit. 8, § 362(a)(1)

²⁰ Model Benefit Corp. Legis. § 401(a)

²¹ Del. Code Ann. tit. 8, § 366(c)(3)

<i>Model Benefit Corporation Act vs. Delaware Public Benefit Corporation Law</i> Table 1		
Benefit Report to Shareholders	Provide to shareholders annually ²²	Provide to shareholders biennially ²³
Benefit Report to Public	Required to be made public ²⁴	Nor required to be made public unless mandated in charter ²⁵
Benefit Director	Required for public companies ²⁶	Not required, nor mentioned in statute
Fiduciary Duty to Beneficiaries	Directors have no fiduciary duty to beneficiaries to create public benefit; directors have no personal monetary liability for failure to create public benefit ²⁷	Directors have no fiduciary duty to beneficiaries to create public benefit ²⁸
Benefit Enforcement Proceeding / Derivative Suit	Benefit enforcement proceeding is the exclusive remedy to enforce public benefit ²⁹	Ability to bring derivative suit for failure to balance stockholder and non-stockholder interests the same voting threshold as other derivative actions against a conventional corporation.
Conversion	Two-thirds vote of outstanding stock ³⁰	Majority vote of outstanding stock ³¹

Delaware has modified its public benefit corporation law twice. It made significant changes to the Delaware PBC in 2020. First, Delaware changed the threshold for conversion of a corporation into a PBC from 90% of outstanding stock in the original 2013 law, to two-thirds majority in a 2015 amendment, to majority vote in the 2020 amendment to the PBC law.³² Delaware eliminated the statutory appraisal rights of stockholders who did not vote for the conversion.³³ Delaware also amended the PBC law to make clear that a director's failure to balance shareholder and non-shareholder interests (as required by Section 365(a) of the PBC law) cannot lead to personal liability derived from a 102(b)(7) carveout claiming lack of good faith.³⁴

²² Model Benefit Corp. Legis. § 402(a)

²³ Del. Code Ann. tit. 8, § 366(b)

²⁴ Model Benefit Corp. Legis. § 402(b)

²⁵ Del. Code Ann. tit. 8, § 366(c)(2)

²⁶ Model Benefit Corp. Legis. § 302

²⁷ Model Benefit Corp. Legis. §§ 301(c)(2) and 305(b)

²⁸ Del. Code Ann. tit. 8, § 365(b)

²⁹ Model Benefit Corp. Legis. § 305(a)

³⁰ Model Benefit Corp. Legis. § 104(a)

³¹ Del. Code Ann. tit. 8, § 251.

³² Littenberg et al. 2020

³³ Littenberg et al. 2020

³⁴ Del. Code Ann. tit. 8, § 365(c).

Finally, Delaware also amended the PBC law to make the derivative suit threshold the same as other Delaware corporations.³⁵

Practitioners have credited these amendments with an expansion in the number of Delaware PBCs.³⁶ At the beginning of 2020, there were three publicly traded PBCs; by the end of 2021 there were at least twelve.³⁷ Sustainable retail brands such as Allbirds and Warby Parker are publicly traded public benefit corporations. Companies like Warby Parker state on their initial registration forms with the U.S. Securities Exchange Commission that their “duty to balance a variety of interests may result in actions that do not maximize stockholder value.”³⁸ While Delaware law does not require a PBC to conduct a third-party assessment of its specific public benefit, some publicly traded companies are choosing to. Indeed, Delaware PBC and sustainable footwear company Allbirds worked with ESG thought-leaders from companies, rating agencies, academia, and investment firms to create the Sustainability Principles and Objectives Framework (SPO Framework) for late-stage private companies preparing to go public and wanting to disclose their ESG principles and metrics.³⁹ The SPO Framework goes beyond any specific public benefit and is holistic, similar to a general public benefit. The SPO Framework covers ESG commitments around climate and environment, corporate governance, value chain, people management, and transparent assessment.⁴⁰ Company self-assessment is not allowed. Allbirds chose Institutional Shareholders Services (ISS), the largest proxy advisory firm, to independently assess and verify Allbirds’ performance against the SPO Framework.⁴¹ Companies like Allbirds who take on additional stakeholder accounting clearly see the Delaware PBC law as the floor and not the ceiling with respect to their ESG efforts. Indeed, an independent, third-party assessment mimics the requirement of the model benefit corporation act.

Further evidence of PBCs gaining ground come during the 2021 proxy season. 19 shareholder proposals were submitted asking public companies to convert to a PBC.⁴² While none of the proposals were successful, organizations like The Shareholder Commons, an influential nonprofit that promotes a sustainable economy, continue to launch investor campaigns to get companies to convert to PBCs. For example, The Shareholder Commons sought a shareholder proposal for Fox Corporation to convert to a PBs with the reasoning that media companies should forgo profits derived from misinformation that threatens democracy and instead adhere to

³⁵ “Any action to enforce the balancing requirement of § 365(a) of this title, including any individual, derivative or any other type of action, may not be brought unless the plaintiffs in such action own individually or collectively, as of the date of instituting such action, at least 2% of the corporation’s outstanding shares or, in the case of a corporation with shares listed on a national securities exchange, the lesser of such percentage or shares of the corporation with a market value of at least \$2,000,000 as of the date the action is instituted.” Del. Code Ann. tit. 8, § 367.

³⁶ Littenberg et al. 2020

³⁷ Marquis 2021

³⁸ Warby Parker, Form S-1 (Aug. 24, 2021).

³⁹ Sustainability Principles (2021)

⁴⁰ Id.

⁴¹ For full text of the ISS assessment of Allbirds, see

<https://www.isscorporatesolutions.com/file/documents/spo/spo-20211004-Allbirds.pdf>.

⁴² Gibson Dunn 2021, p. 27

journalistic integrity.⁴³ In its 2022 proxy voting guidelines, BlackRock, the world's largest asset management firm, states that it will only support shareholder proposals for PBC conversion that protect shareholder interests and specify how shareholder and stakeholder interests will be impacted; even then, it will only do so on a case-by-case basis.⁴⁴

3.1 The Accountable Capitalism Act

Although innovations in social enterprise law have primarily been left to state legislatures, there have been efforts in the U.S. Congress to bring all major U.S. public companies into line with ESG principles. The Accountable Capitalism Act was introduced to the U.S. Senate by Senator Elizabeth Warren in August 2018 and reintroduced in January 2020.⁴⁵ The Act would require very large American corporations to obtain a federal charter to become a U.S. corporation, with requirements based on the model benefit corporation legislation.⁴⁶ The directors of federally chartered American corporations would have to consider the interests of all relevant stakeholders, not just shareholders, when making decisions.⁴⁷ The Accountable Capitalism Act categorizes a large entity as one that (i) is organized as a corporation, body corporate, body politic, joint stock company, or limited liability company, (ii) engages in interstate commerce, and (iii) has annual revenue over \$1 billion.⁴⁸

The Act would also require the federally chartered corporation (i) to have a board that includes substantial employee participation, (ii) to abide by restrictions on the sale of company shares by directors and officers, and (iii) obtain shareholder and board approval for all political expenditures.⁴⁹ Under these general requirements, specific standards must be met. The Act aims to prioritize employees' interests by having a federally chartered corporation's employees elect at least 40% of its board of directors.⁵⁰ To discourage stock-based compensation and reduce the traditionally exclusive focus on shareholder returns, corporate executives' shares must to be held for at least five years after they are received, and at least three years after a share buyback.⁵¹ To ensure that corporate political activity truly represents a consensus among stakeholders, corporate political activity must be specifically authorized by both

⁴³ For full text of The Shareholder Commons' shareholder proposal for Fox Corporation, see <https://theshareholdercommons.com/media-markets-and-systemic-risk/>.

⁴⁴ BlackRock 2022, p. 20.

⁴⁵ S. 3348 – 115th Congress: *Accountable Capitalism Act* (Aug. 8, 2018); accessible at <https://www.congress.gov/bill/115th-congress/senate-bill/3348/text>; see also S. 3215 – 116th Congress: *Accountable Capitalism Act* (Jan. 16, 2020), accessible at <https://www.congress.gov/bill/116th-congress/senate-bill/3215/text?r=2&s=2>.

⁴⁶ See *id.*

⁴⁷ S. 3215 – 116th Congress: *Accountable Capitalism Act* § 5C.

⁴⁸ S. 3215 – 116th Congress: *Accountable Capitalism Act* § 4A.

⁴⁹ Summary: S. 3215 – 116th Congress (2017 – 2018), CONGRESSIONAL RESEARCH SERVICES, accessible at <https://www.congress.gov/bill/116th-congress/senate-bill/3215?r=2&s=2>.

⁵⁰ Accountable Capitalism Act One-Pager, Office of Senator Elizabeth Warren (2018), <https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act%20One-Pager.pdf>.

⁵¹ *Id.*

75% of shareholders and 75% of board members.⁵² Finally, the Act would also establish the Office of U.S. Corporations, which would have various duties such as reviewing and granting charters for all large entities.⁵³

The Act gained traction when Senator Warren campaigned for president in the Democratic primary preceding the 2020 presidential election.⁵⁴ On January 16, 2020, Senator Warren introduced an updated version of the Act (S. 3215), but it did not receive a referral to a specific committee or vote.⁵⁵ Federally chartered corporations seem implausible given ongoing partisan gridlock in Congress.

4. California Special Purpose Corporations

Although benefit corporations are the most well-known new corporate form to fuse profit with purpose, other forms abound in the U.S., most notably the California Special Purpose Corporation. Through the Corporate Flexibility Act of 2011 (the “Act”), California became the sixth state to adopt a law recognizing benefit corporations and the first to recognize what the state initially called a “flexible purpose corporation” (an “FPC”).⁵⁶ The Act amended the California Corporations Code to allow companies formed as benefit corporations and FPCs to balance profit-maximizing goals with social goals.⁵⁷ While both benefit corporations and FPCs allow corporations to pursue a purpose outside of and in addition to profit-maximization, the two forms differed in how they defined permissible additional purposes.

California FPCs were formed for the purpose of achieving a specific, flexible purpose.⁵⁸ Permissible specified purposes included (a) charitable and public purpose activities that could be carried out by a nonprofit public benefit corporation, or (b) the purpose of promoting positive short or long-term effects (or minimizing adverse short or long-term effects) on (i) the FPC’s employees, suppliers, customers and creditors; (ii) the community and society; or (iii) the environment.⁵⁹ Directors of FPCs were guided, but not required, to consider the short and long-term prospects of the FPC, the best interests of FPC, and the purpose for which the FPC is formed when making decisions.⁶⁰

In 2014, California passed a bill that renamed the Corporate Flexibility Act of 2011 the “Social Purpose Corporations Act” and what were formerly known as FPCs became special purpose corporations (“SPC”).⁶¹ An SPC must state that it is organized as an SPC and must include “SPC” or “social purpose corporation” in its name.⁶²

⁵² Id.

⁵³ Id.

⁵⁴ See Leonhardt 2018

⁵⁵ S. 3215 (116th): Accountable Capitalism Act, GovTrack
<https://www.govtrack.us/congress/bills/116/s3215>. Accessed 11 Jan. 2022

⁵⁶ S.B. 201, 2011-12 Leg., Reg. Sess. (Cal. 2011) (enacted); A.B. 361, 2011-12 Leg., Reg. Sess. (Cal. 2011) (enacted); Westaway 2011.

⁵⁷ See id.

⁵⁸ S.B. 201, 2011-12 Leg., Reg. Sess. (Cal. 2011) (enacted)

⁵⁹ Cal. Corp. Code § 2602

⁶⁰ S.B. 201, 2011-12 Leg., Reg. Sess. (Cal. 2011) (enacted)

⁶¹ S.B. 201, 2013-14 Leg., Reg. Sess. (Cal. 2014) (enacted)

⁶² Cal. Corp. Code § 2602

Unlike benefit corporations, SPCs may select a narrow purpose or purposes (a “Special Purpose” or “Special Purposes”) to pursue in addition to shareholder maximization.⁶³ SPCs are required to either (1) state their specific social purpose in their articles of incorporation or (2) include a statement that the corporation has the purpose of promoting the positive effects of (or minimizing the negative effects of) the SPCs activities upon any of the following: (i) the SPC’s employees, suppliers, customers, and creditors; (ii) the community and society; or (iii) the environment.⁶⁴ Where benefit corporation directors must consider the impact of their decisions on the general benefit, defined broadly by statute, SPC directors may focus on the best interests of the corporation and on their chosen narrowly tailored focuses.⁶⁵

SPC boards must include a discussion and analysis (an “MD&A”) of the corporation’s performance with respect to its special purpose set forth in the SPC’s annual report.⁶⁶ The MD&A must identify and discuss actions taken to achieve the corporation’s special purpose and discuss any standards used to measure special purpose objectives and the process for selecting these standards.⁶⁷ SPCs are also required by law to provide shareholders with a “Current Report” within 45 days of: (i) any significant expenditures used to further the corporation’s special purpose; (ii) any withholding of expenditures in furtherance of special purposes; or (iii) deciding that the special purpose has been satisfied and should no longer be pursued.⁶⁸

Amending an SPC’s stated purpose requires approval from two-thirds of the shareholders of each voting class, or by a greater number of shareholders if required by the articles.⁶⁹ Similarly, a reorganization or merger that would materially alter or eliminate the special purpose or purposes requires approval from 2/3 of the shareholders, unless otherwise specified by the articles.⁷⁰ SPC shareholders are also entitled to maintain derivative lawsuits to enforce duties of directors to weigh additional factors between their fiduciary duties of care and loyalty to the corporation.⁷¹

There are over 80 SPCs (and over 20 FPCs) that are active in California and whose activities span industries and social purposes.⁷² LifeArk, Spc. is an SPC that registered in 2017 and whose special purpose is to create “safe, sustainable and affordable homes for people living in low-income, marginalized communities around the world.”⁷³ Higher Grounds Coffee House SPC, Inc. is a California SPC that offers a less concrete purpose: to provide “an atmosphere that allows others to experience faith,

⁶³ Cal. Corp. Code § 2513

⁶⁴ Cal. Corp. Code § 2602

⁶⁵ Cal. Corp. Code § 2700

⁶⁶ Cal. Corp. Code § 3500

⁶⁷ Id.

⁶⁸ Cal. Corp. Code § 3501

⁶⁹ Cal. Corp. Code § 3000

⁷⁰ Id.

⁷¹ Cal. Corp. Code § 2701

⁷² Business Search, Cal. Sec’y of State, <https://businesssearch.sos.ca.gov/>. Accessed 1 Nov. 2021 (select “Corporation Name” in Search Type, then search “SPC”, “Social Purpose Corporation”, “FPC”, and “Flexible Purpose Corporation” in Search Criteria, and filter results by state and activity status).

⁷³ Articles of Incorporation of LifeArk, SPC, a Social Purpose Corporation, <https://businesssearch.sos.ca.gov/Document/RetrievePDF?Id=04088089-23316465> (Dec. 4, 2017).

hope, and love.”⁷⁴ Homeboy Recycling is an SPC that provides B2B electronics recycling services nationwide and offers job training and placement programs to formerly gang involved and previously incarcerated men and women.⁷⁵ Homeboy Recycling has two special purposes: (i) to help minimize the impact of electronic waste on society by conducting socially responsible recycling; and (ii) to assist members of society facing barriers to employment.⁷⁶ As these three diverse SPCs show, SPCs can vary widely in purpose and in sector.

6. Other U.S. Social Enterprise Forms

6.1 Hybrid Ventures

Whereas a conventional corporation may pursue profit and a nonprofit organization may pursue a charitable mission, some social enterprises pursue dual missions that are co-equal. This dual-mission purpose is distinct from a commercial firm that seeks to consider their ESG impacts on various stakeholders. The dual-mission organization typically is pursuing a charitable or quasi-charitable mission and funding that mission through revenue-generating activities. Although the hybrid venture purpose could be carried out as a public benefit corporation or special purpose corporation, there may be benefits to obtaining tax-exempt status, which is not available to a PBC or SPC. Nonetheless, nonprofit organizations that are tax-exempt under Section 501(c)(3) of the U.S. tax code (most commonly “public charities”) are subject to the nondistribution constraint, meaning that they cannot distribute profits. Furthermore, the U.S. tax code limits the amount of revenue-generating activity a public charity can engage in if it is not closely tied to its charitable purpose.⁷⁷ The U.S. Internal Revenue Service (“IRS”) can also deny or revoke the tax-exempt status of a public charity that engages in revenue-generating activity that is beyond the scope of its exempt purpose.

For example, the IRS denied tax-exempt status to an organization that operated a grocery store staffed by “hard-core unemployed” persons because its commercial grocery store operations went far beyond the scope of its exempt purpose: training the unemployed.⁷⁸ The grocery store was conducted in large part for the purpose of providing a low-cost retail grocery outlet in the community as an end in itself.⁷⁹ As such, the commercial operations were larger than reasonably necessary to accomplish its charitable purpose.⁸⁰ Importantly, the IRS found that the operation of a grocery store

⁷⁴ Articles of Incorporation of Higher Grounds Coffee House SPC, Inc.,

<https://businesssearch.sos.ca.gov/Document/RetrievePDF?Id=04070520-23000340> (Sept. 8, 2017).

⁷⁵ Homeboy Recycling, <https://homeboyrecycling.com/about-us/social-impact/>. Accessed 3 Nov. 2021

⁷⁶ *Articles of Incorporation of a Social Purpose Corporation*,

<https://businesssearch.sos.ca.gov/Document/RetrievePDF?Id=03959573-21477276> (Nov. 4, 2016);

Homeboy Recycling, <https://homeboyrecycling.com/about-us/social-impact/>. Accessed 3 Nov. 2021

⁷⁷ For a definition and discussion of unrelated taxable business income, see Treas. Reg. § 1.513-1(d)(2); Hopkins 2005, p. 42

⁷⁸ Rev. Rul. 73-127, 1976-1 C.B. 221.

⁷⁹ Id.

⁸⁰ Id.

where food is sold to needy residents at marked-down prices is not in itself a charitable purpose under common law doctrine or the U.S. tax code.

When a social enterprise seeks to pursue a social or environmental mission but is prevented from engaging in substantial commercial activities as a nonprofit organization, a hybrid venture is a viable option. A common hybrid venture structure entails two entities—a 501(c)(3) tax-exempt nonprofit corporation and a for-profit entity (typically a corporation or benefit corporation)—that form a parent-subsidary relationship. The nonprofit entity wholly or partially owns the for-profit subsidiary. A hybrid venture enables the social enterprise to preserve its tax-exempt status and charitable purpose but distribute profits (and potentially raise capital) through the for-profit entity.⁸¹ It is difficult to quantify the number of hybrid ventures in the United States due to the diffuse nature of company records in a federalist system. There are approximately 1.5 million nonprofit organizations registered in the United States⁸² and it is likely that only a fraction of these are hybrid ventures.

6.2. Worker Cooperatives

Worker cooperatives are an older form of entity than most other social enterprise entities. Some date back to the Civil War and were a means of creating economic stability, particularly among farmers, including those in black communities, in the rural South.⁸³ U.S. worker cooperatives have experienced a resurgence with an estimated 30% growth since 2019.⁸⁴ Worker cooperatives are companies owned, run, and controlled by and for the benefit of their members to realize economic, social, and cultural needs and services.⁸⁵ Key features of worker cooperatives include democratic member-control, typically through equal voting rights, and member economic participation through profit-sharing. Worker cooperatives can be categorized as social enterprises which focus on ESG efforts because they return economic power to labor rather than to shareholders or managers. According to a national census of worker cooperatives conducted in 2021, the average top-to-bottom pay ratio of U.S. worker cooperatives is 2:1 compared to traditional corporations' 320:1 with the average starting wage \$5 more than the highest state minimum wage.⁸⁶

The New York Cooperative Corporation Law, adopted in 1985, exposes the benefits of worker cooperatives, including (1) increased job satisfaction, (2) increased productivity, (3) economic benefits from workers' own labor, (4) the creation of new jobs, and (5) greater community economic stability.⁸⁷ More recently, New York City local government has been active in growing the worker cooperative sector by

⁸¹ A hybrid venture adds administrative complexity and risks. A for-profit subsidiary can jeopardize its nonprofit parent's tax-exempt status if it is merely an instrumentality of the parent without a real and substantial business function. The two entities must maintain separate operational, administrative, and legal functions to preserve the nonprofit parent's tax-exempt status. I.R.C. § 512(b)(13)(d)(i)(I).

⁸² Urban Institute 2019, para. 2

⁸³ Gordon Nembhard 2014, p. 48.

⁸⁴ United States Federation of Worker Cooperatives 2021, p. 2

⁸⁵ Gordon Nembhard 2014, p. 2

⁸⁶ United States Federation of Worker Cooperatives 2021, Census, para. 3; United States Federation of Worker Cooperatives 2021, State of the Sector, p. 2

⁸⁷ N.Y. Coop. Corp. Law § 80 (McKinney 2021)

providing technical, financial, and legal support to worker cooperatives through the Worker Cooperative Business Development Initiative (“WCBDI”) which it launched in 2015.⁸⁸ Successful New York worker cooperatives include Cooperative Home Care Associates (“CHCA”), the largest worker cooperative in the U.S.⁸⁹ CHCA was founded in 1992 and provides home care services and training throughout Manhattan, Brooklyn, and the Bronx in New York.⁹⁰ CHCA started with 12 personnel yet has grown to over 2,000 staff and provides pro bono home health aid and personal care assistant training to over 600 low-income women annually.⁹¹ CHCA is also a certified B-Corp with an Impact Score of 140.2 out of 200, which illustrates that B-Corp certification, discussed elsewhere in this text, is compatible with worker cooperatives.⁹²

6.3 Low-Profit Limited Liability Company

Another form of social enterprise is the low-profit limited liability company or L3C. The L3C is a limited liability company formed to attract investment from both the private and nonprofit sectors, and specifically comply with IRS rules on program-related investments (PRIs) by private foundations.⁹³ Although investments, private foundations use PRIs to pursue charitable purposes and not monetary gains. A L3C must be organized to advance one or more charitable or education purposes defined in the U.S. tax code and cannot have a significant purpose of producing income.⁹⁴ As a limited liability company, L3C members have flexibility to agree through contract how the company is governed and financed. L3Cs are not eligible for exemption from income tax as 501(c) tax-exempt organizations are. L3Cs have not found much success in the United States because the IRS never sanctioned their presumptive use by private foundations for PRIs.⁹⁵ Without such presumptive approval, private foundations still seek IRS preapproval for PRIs. Moreover, conventional limited liability companies can be used to meet the same charitable purpose as L3Cs.

6. Conclusion: Seismic Shifts Forward

Despite the growth of social enterprise entity forms, corporate ESG efforts face a high degree of skepticism among American legal scholars who note the lack of transparency and accountability that legal entity innovations confer. Brakman Resier and Dean highlight the “trust gap” between investors and the various forms of social enterprise entities discussed in this chapter—why would an investor invest in a

⁸⁸ For information about WCBDI, see Worker Cooperative Business Development Initiative (2020) A Report on the Sixth Year of the Worker Cooperative Business Development Initiative.

https://www1.nyc.gov/assets/sbs/downloads/pdf/about/reports/worker_coop_report_fy20.pdf. Accessed 8 March 2022

⁸⁹ Dewan 2014, para 3.

⁹⁰ Cooperative Home Care Associates. <https://www.chcany.org>. Accessed 8 March 2022

⁹¹ Id.

⁹² B Lab, Cooperative Home Care Associates Overall B Impact Score.

<https://bcorporation.net/directory/cooperative-home-care-associates-chca>. Accessed 8 March 2022

⁹³ Callison and Vestal 2010, p. 282

⁹⁴ See e.g., Illinois’s Low-Profit Limited Liability regulations, 805 Ill. Comp. Stat. Ann. 180/1-26.

⁹⁵ Brakman Reiser and Dean 2017, p. 64

company that prioritizes neither the investor nor the stakeholder and makes social or environmental commitments that are difficult to monitor and enforce?⁹⁶ Where corporate directors are not fiduciarily bound to shareholders, and non-shareholder stakeholders have no legal recourse, corporate directors may find it hard to internalize social and environmental externalities. Additionally, the lack of universal, regulated standards for measuring ESG efforts are breeding grounds for fraud and greenwashing.

Despite these criticisms, there has been a seismic shift towards ESG management, monitoring, and disclosures since the first benefit corporation legislation was enacted. U.S. capital markets are moving forward with ESG frameworks. BlackRock claims to embrace stakeholder theory and the importance of material ESG factors to achieving long-term value creation.⁹⁷ In its 2022 proxy voting guidelines for U.S. securities, BlackRock states that it may vote against (i) boards that fail to adequately manage or disclose material ESG factors and (ii) boards that do not provide proper oversight of material ESG risk factors.⁹⁸ BlackRock's proxy voting guidelines also makes clear that it supports executive compensation plans that incentivize long-term valuation creation which necessarily requires mitigating ESG risks.⁹⁹ Additionally, BlackRock's proxy voting guidelines recommends that companies use and disclose ESG metrics based on the Sustainability Accounting Standards Board or similar reporting standards.¹⁰⁰

The SEC is responding to public companies' ESG efforts as well and is expected to propose a rule requiring climate and possibly other ESG-related disclosures in public company filings. In 2021, Acting SEC Chair Allison Herren Lee directed SEC staff to review public companies' existing climate-related disclosures and assess their compliance with existing federal securities laws.¹⁰¹ Acting Chair Lee also sought public comments on climate-related disclosures to facilitate the SEC's rulemaking.¹⁰² The comments were favorable towards mandatory climate-related disclosures that are material, including quantifying direct and certain indirect greenhouse gas emissions. Notably, the comments called for the use of metrics that are consistent with existing ESG measurement standards.¹⁰³ While focused on climate-related risks, SEC rules on other ESG related risks are not off the table.

One cannot deny the power that BlackRock, as the world's largest asset manager, and the SEC can wield in shifting public companies and capital markets to embrace ESG management, monitoring, and disclosures. Whether the emerging ESG frameworks model themselves on public benefit corporations or other social enterprise entities is yet to be determined.

⁹⁶ Brakman Reiser and Dean 2017, p. 66-74

⁹⁷ BlackRock 2022, p. 18

⁹⁸ BlackRock 2022, p 3

⁹⁹ BlackRock 2022, p. 13

¹⁰⁰ BlackRock 2022, p. 16

¹⁰¹ Herren Lee Feb. 2021, para. 1

¹⁰² Herren Lee Mar. 2021, para. 1

¹⁰³ Karg K et al. 2021, p. 2

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