

Date of Hearing: June 28, 2011

ASSEMBLY COMMITTEE ON JUDICIARY
Mike Feuer, Chair
SB 201 (DeSaulnier) – As Amended: March 14, 2011

SENATE VOTE: 37-1

SUBJECT: FLEXIBLE PURPOSE CORPORATIONS

KEY ISSUE: SHOULD BUSINESSES THAT WISH TO PURSUE CHARITABLE OR PUBLIC PURPOSES, IN ADDITION TO PRODUCING SHAREHOLDER PROFIT, HAVE THE ABILITY TO VOLUNTARILY INCORPORATE OR REORGANIZE INTO A NEW FORM OF CORPORATE ENTITY KNOWN AS A FLEXIBLE PURPOSE CORPORATION?

FISCAL EFFECT: As currently in print this bill is keyed fiscal.

SYNOPSIS

According to the author, the California Corporations Code lacks flexibility for corporations seeking to combine the for-profit philosophy of a traditional corporation with a higher "special purpose" that is charitable, serves the public, or otherwise benefits the environment, the community, or society. To address this need, this bill authorizes in California a new form of corporate entity known as a flexible purpose corporation (FPC), the form of which, the author contends, would provide greater flexibility for the corporation to combine profitability with broader social or environmental "special purpose." Under this bill, provisions of the General Corporation Law that govern other for-profit corporations also apply to FPCs except as otherwise expressly stated by this bill. The bill would revise the fiduciary duty of the corporate directors of a FPC to include consideration of both shareholder profit and non-financial, special purpose-related interests, but the bill does not give shareholders any special right of action to enforce the special purpose. Instead, the bill envisions that by introducing some flexibility to the fiduciary duty, FPC directors exercising ordinary business judgment would continue to be protected from liability by the business judgment rule for decisions that further the special purpose but do not necessarily maximize shareholder value. To promote corporate transparency and ensure that shareholders are able to evaluate whether the FPC is achieving its special purpose(s), this bill requires the FPC to prepare and publish annually on its website an extensive "management discussion and analysis" report that details the corporation's special purpose objectives, activities, and expenditures in the previous year.

The bill is supported by an assortment of businesses, venture capital firms, non-profits, and advocates for sustainable business and socially responsible investing, among others. These proponents assert that benefit corporations offer entrepreneurs and investors the option to invest in businesses that meet higher standards of corporate purpose, the result of which is likely to be the creation of broad social and environmental benefits for the California public. The bill is opposed by associations of non-profit groups, who argue that before any bill authorizing the formation of alternative corporate entities such as FPCs is passed, the Legislature should conduct an informational hearing to study the potential impact such legislation might have on the non-profit community. Specifically, these opponents express concern that this bill may result

in resources being siphoned off from existing non-profits, presumably if philanthropy dollars are redirected from charitable contributions to investment in FPCs.

SUMMARY: Authorizes and regulates the formation and governance of a new form of corporate entity known as a flexible purpose corporation (FPC). Specifically, this bill:

- 1) Authorizes, under a new division of the Corporations Code, one or more natural persons, partnerships, associations, or corporations to form a flexible purpose corporation by executing and filing articles of incorporation with the Secretary of State.
- 2) Requires the articles of incorporation of an FPC to state its flexible purposes, which may be one or more of the following:
 - a) One or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out.
 - b) The purpose of promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of, the FPCs activities upon its employees, suppliers, customers, and creditors, the community and society, the environment, or any combination of the above.
- 3) Requires that a proposed amendment to the articles shall be approved by at least two-thirds of the outstanding shares of each class if the amendment would materially change any special purpose of the FPC already stated in the articles.
- 4) Requires that each existing company wishing to become an FPC through conversion or reorganization to take an affirmative vote of at least two-thirds of each of its classes of shareholders, or a higher vote threshold, if required in the articles of incorporation.
- 5) Establishes that shareholders of an existing corporation converting to an FPC would be entitled to dissenter's rights as specified under Chapter 13 of Division 1 of the Corporations Code.
- 6) Provides that a director shall perform his or duties in good faith, in a manner the director believes to be in the best interest of the FPC and its shareholders, and with that care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.
- 7) Permits a director, in discharging his or her duties, to consider and give weight to, as the director deems relevant, certain factors including the short-term and long-term prospects of the FPC, the best interests of the FPC and its shareholders, and the purpose of the FPC as stated in its articles.
- 8) Relieves from liability a person who performs the duties of a director, in accordance with the above specified provisions, for any alleged failure to discharge the person's obligations as a director, and allows the liability of a director for monetary damages to be eliminated or limited by the articles of the FPC, as provided.

- 9) Does not authorize a special right of action for shareholders to sue for specific enforcement of the FPC's special purpose or purposes above or beyond those options currently available to shareholders under the existing General Corporation Law.
- 10) Requires the board to prepare, for inclusion with the FPC's annual report to shareholders, a specified management discussion and analysis (MD&A) concerning the FPC's stated special purpose or purposes, and requires the MD&A to be posted on the FPC's web site. Among other things, the MD&A must include:
 - a) An identification and discussion of the short-and long-term objectives of the FPC that relate to its special purposes, and an identification and explanation of any changes made to these special purpose objectives during the fiscal year;
 - b) An identification and discussion of material actions taken by the FPC during the fiscal year to achieve its special purpose objectives, the impact of those actions, including the causal relationships between the actions and the reported outcomes, and the extent to which those actions achieved the special purpose objectives for the fiscal year;
 - c) An identification and discussion of any material operating and capital expenditures incurred by the FPC during the fiscal year to achieve its special purpose objectives, and a good faith estimate of projected costs FPC expects to incur over the next three fiscal years in order to achieve its special purpose objectives.

EXISTING LAW:

- 1) Establishes the General Corporation Law to authorize and regulate the formation and governance of general corporations, including the duties and liability of corporate directors, the rights of shareholders, and amendment of the articles. (Division 1 of Title 1 of the Corporations Code, commencing with Section 100. All further references will be to this Code unless otherwise specified.)
- 2) Establishes the Nonprofit Corporation Law to authorize and regulate the formation and governance of nonprofit benefit corporations, nonprofit mutual benefit corporations, and nonprofit religious corporations, including the duties and liability of corporate directors, the rights of shareholders, and the respective purposes for which those nonprofit corporations may be lawfully formed. (Division 2 of Title 1, commencing with Section 5000.)
- 3) Authorizes and regulates the formation and governance of corporations for specific purposes, including but not limited to consumer cooperative corporations, small business financial development corporations, and professional corporations, and specifies the respective purposes for which those corporations may be lawfully formed. (Division 3 of Title 1, commencing with Section 12000.)
- 4) Requires that corporate directors perform their duties in good faith, in a manner the director believes to be in the best interests of the corporation and the shareholders, and with the care, including reasonable inquiry, that an ordinary prudent person in a like position would use under similar circumstances. (Section 309(a); Section 5231(a).)

- 5) Limits the liability of directors for negligence pursuant to the "business judgment rule", which stands for the principle that a director cannot be held liable for an erroneous decision or poor choice, in the absence of a showing of fraud, bad faith, or negligence, when the act or omission involves a question of policy or business judgment. (See, e.g., 9 Witkin, Summary of California Law 10th Ed., Sec. 102.)

COMMENTS: According to the author, the California Corporations Code lacks flexibility for corporations seeking to combine the for-profit philosophy of a traditional corporation with a higher "special purpose" that is charitable, serves the public, or otherwise benefits the environment, the community, or society. To address this need, this bill authorizes in California a new form of corporate entity known as a flexible purpose corporation (FPC), the form of which, the author contends, would provide greater flexibility for the corporation to combine profitability with broader social or environmental "special purpose."

Stated Need for the Bill: This bill is sponsored by the California Working Group for New Corporate Forms (the "Working Group"), who identify themselves as a self-appointed, diverse collection of corporate lawyers in California who come from academia, small and large corporate law firms, non-profit law firms and entrepreneurial organizations. According to the Working Group, for nearly 18 months its members have been deliberating and drafting a proposed new division of the Corporations Code to "facilitate the organization of companies with greater flexibility for combining profitability with a broader social or environmental purpose." In explaining the objective of the bill, the sponsor and the author state:

The use of a traditional corporation portends potential risk for directors making decisions on the basis of a Special Purpose, if done at the expense of maximizing financial returns for shareholders and outside the presumption of the business judgment rule. Although case law does not present a clear picture of exactly when and how liability arises (based on the facts and circumstances of each case), prudent counsel, responding to risk-averse directors, tend to draw conservative lines on how far a board might take a corporation in pursuit of a Special Purpose, at the expense of financial returns. Corporations, as a product of trust law, typically do not permit entrepreneurs to alter this dynamic through the articles of incorporation, because the rules are either statutorily embedded or judicially created as a part of a director's fiduciary duties to the shareholders and the corporation.

SB 201 creates a Flexible Purpose Corporation in California, which integrates the for-profit philosophy of the traditional corporation along with its statutory certainty and standardization, but seeks to address the issues noted above so that entrepreneurs and investors can avoid the difficult work of trying to integrate a Special Purpose mission within the scope of the business judgment rule and, instead, can work on building an organization from the start that integrates achieving profitability and accomplishing its stated Special Purposes without the traditional obstacles and considerations. . . . By authorizing the flexible purpose corporation, SB 201 provides a statutory safe harbor for directors and officers of companies seeking to meld the traditional goal of profitability with a Special Purpose of the company's choosing. This safe harbor does not currently exist for a traditional corporation formed under the General Corporation Law, which is typically favored over LLCs by institutional investors.

Relationship to General Corporation Law. The General Corporation Law (GCL), Division 1 of Title 1 of the Corporations Code, authorizes and regulates the formation and governance of general corporations, including the duties and liability of corporate directors, the rights of shareholders, and amendment of the articles. This bill authorizes the formation of a new corporate entity known as a flexible purpose corporation (FPC), in the process adding a new division, Division 1.5, to Title 1 of the Code. Section 2501 of the bill clarifies that the provisions of the GCL apply to FPCs except as otherwise expressly stated by this bill. This new division reproduces numerous sections of the GCL and mirrors many of its provisions, except where revised to necessarily differentiate FPCs from general corporations. In addition, this bill amends several chapters of the GCL to integrate references to FPCs into statutes authorizing the merger, conversion, or reorganization of existing entities into or out of another corporate form.

According to the Working Group, FPCs do not differ from corporations organized under the GCL except in the following ways: (1) FPC articles must set forth one or more qualifying special purposes; (2) Two-thirds vote of shareholders is needed to change or eliminate the special purpose, or to approve a change of corporate form into or out of an FPC; (3) Directors are protected from liability for decisions furthering the special purpose at the expense of profitability; (4) Shareholders have dissenters' rights in conversions or mergers; (5) FPCs must comply with expanded disclosure and reporting requirements with respect to its special purposes.

Flexible Purpose Corporations are distinguished by their special purpose mission. Unlike other types of corporations, FPCs are organized to allow the directors to pursue one or more "special purposes" in addition to creating profit for shareholders. FPCs must specify the special purpose in their articles of incorporation, which is designed to put shareholders and potential shareholders on notice that the FPC's directors may exercise their business judgment to engage in activities that take the special purpose into account, even if doing so will not necessarily maximize profitability for shareholders. The special purpose may be a "charitable or public purpose activity" that could be carried out by a nonprofit benefit corporation (pursuant to Section 5111), the definition of which is largely left to case law (see, e.g. *Younger v. Wisdom Soc.* (1981) 175 Cal. Rptr. 542, public purpose was "to contribute to the intellectual life of the nation"; *In re Los Angeles County Pioneer Soc.* (1953) 40 Cal.2d. 852, commemoration of historical events and collection and preservation of data of historical interest are charitable purposes.) Alternatively, the special purpose may be to promote the positive effects of (or mitigate the negative effects of) the FPC's activities upon its employees, suppliers, customers, and creditors, the community and society, the environment, or any combination of the above. Under this bill, two-thirds of the shareholders must vote to approve any proposal to change the special purpose, which can only be done by amending the articles of incorporation.

Two thirds of shareholders must approve conversion or reorganization of an existing corporation into or out of an FPC, but with guaranteed opt-out rights for dissenters. Existing provisions of the GCL authorize corporations to convert into other forms of corporate entities as long as the shareholders approve of the conversion by at least two-thirds of each class of outstanding shares of that converting corporation unless the articles of incorporation authorize a simple majority vote for conversion. (Section 1152.) With respect to the conversion, merger, or reorganization of a legal entity into a new FPC, or from a FPC into a different legal entity, this bill requires a supermajority vote of two-thirds of each class of voting share to effectuate the change of corporate form. Proponents contend that this high threshold is necessary to provide appropriate notice and protection to shareholders before making any decision to convert into (or out of) a flexible purpose corporation.

This bill also provides shareholders with dissenters' rights in the event of any material change in the special purpose, or any conversion or merger with a non-FPC that may cause the dissenter to wish to opt out and exercise his appraisal rights. Dissenters' rights, outlined in Chapter 13 of the GCL (commencing with Section 1300) are intended to afford those shareholders who disagree with the change in special purpose, or any proposed conversion or merger, the right to receive fair value for their shares. According to the Working Group, any change or conversion into a FPC that establishes the importance of the special purpose may substantially alter the expectations of shareholders or investors with respect to value of shares, and therefore such a change should require a higher vote threshold in order to protect these shareholders' interests. Accordingly, this bill finds a balance between protecting shareholders and enabling corporations to reorganize as FPCs to pursue corporate special purposes.

Directors of a FPC have the duty to consider the special purpose in their decisions, but shareholders are not given any special right of action to enforce the special purpose. Existing law provides a standard of care that a director must use in discharging his or her duties, namely that a director's duties must be performed in good faith, in a manner the director believes to be in the best interests of the corporation and the shareholders, and with the care, including reasonable inquiry, that "an ordinary prudent person in a like position would use under similar circumstances." (Section 309(a).) In addition, the traditional "business judgment rule" limits the liability of a director for an erroneous decision or poor choice, in the absence of a showing of fraud, bad faith, or negligence, when the act or omission involves a question of policy or business judgment.

This bill establishes the same standard of care for FPC directors (Section 2700(a) of the bill) but falls short of actually requiring the director to make decisions that result in furthering the special purpose. Instead the bill only provides that the director "may consider . . . and give weight to" the special purpose while discharging his or her duties. This important provision, which has no equivalent in the GCL, represents one of the central tenets of this bill, namely that the fiduciary duty of directors should include, not exclude, consideration of both financial and non-financial interests in the exercise of ordinary business judgment. According to the Working Group:

FPC directors and officers are afforded considerable flexibility in their decisions and actions, both within and outside of the ordinary course of business, subject to reasonableness and materiality standards of existing case law. Such decisions and actions need not necessarily favor any one purpose (including enhancing shareholder value) over any other. Rather, existing case law that imposes a reasonableness and materiality standard will also apply to the prioritization by directors and managers of one or more of the stated Special Purposes over others, including, in appropriate circumstances, favoring the achievement of a stated Special Purpose over the economic interests of the shareholders.

This bill does not, however, provide shareholders or other parties any special right of action for enforcement of the special purpose. The Working Group contends that providing a special right of action to enforce the special purpose runs counter to the larger objective of this bill to provide the directors of a FPC with greater discretion to pursue actions they feel are in the best interests of the FPC and its shareholders without being subject to increased liability for decisions that don't necessarily maximize profit. They note that under the current GCL, shareholders are already permitted to file suit for a director's breach of fiduciary duties, and that under this bill,

the fiduciary duty of directors includes the duty to adhere to the special purpose of the FPC. Therefore, according to the Group, a special right of action is unnecessary because current law will permit shareholders to enforce the special purpose by filing suit for breach of fiduciary duty.

In addition to filing suit for breach of fiduciary, the Committee notes that FPC shareholders also retain their ability under the GCL to seek replacement of directors as another potential method of enforcement, or they could simply vote with their money and divest from the FPC if they felt the special purpose was not being adequately furthered by the FPC directors. To be able to evaluate the corporation's performance with respect to the special purpose, however, shareholders and investors must have access to the proper information.

Reporting requirements on special purpose activities. To ensure access to this information, this bill requires the FPC to prepare and publish on its website an extensive annual report ("management discussion and analysis" report, or MD&A) discussing its special purpose objectives, activities, and expenditures in the previous year. Among other things, the FPC must discuss the material actions it has taken to achieve its special purpose objectives, the impact of those actions, and the extent to which those actions achieved the special purpose objectives in the previous year. The MD&A report also must disclose costs and expenditures incurred by the FPC, as well as projected expenditures to further the special purpose objectives.

According to the Working Group, these transparency requirements will ensure that shareholders have information needed to determine whether the FPC is adequately achieving its special purposes or not. Such a determination, however, would appear to necessarily be a subjective one because the directors are responsible for defining the parameters by which performance is to be evaluated in the MD&A report. Ultimately, the shareholders who utilize the information reported in the MD&A document must make a subjective decision whether the FPC is working appropriately to achieve the special purpose, or whether the answer to that question even matters in relation to the FPC's return on investment when considered together.

This bill appears complementary with AB 361 (Huffman): AB 361 (Huffman), which this Committee approved on May 3, 2011 by a vote of 7-2, seeks to create a new form of corporate entity known as a "benefit corporation" that, like this bill, is intended to provide new flexibility for the corporation to combine profitability with broader social or environmental corporate purpose. While the two bills seek to address the same problem—lack of flexibility under the current GCL—they propose two complementary "flavors" of alternate corporate form that businesses or entrepreneurs, depending on their particular needs, may elect to adopt if both bills are enacted. To the extent the bills differ on particular concepts and details, passage of both bills would actually appear to increase the available choices to companies and entrepreneurs seeking a more flexible form than the single rigid option currently authorized by the GCL for for-profit enterprises. According to the Working Group, it appears that the bills also complement each other by appealing to different constituents, stating in correspondence with the Committee: "Ultimately the Working Group believes that benefit corporations are primarily designed for use by private companies focused on sustainability that avail themselves of socially responsible capital, as opposed to companies seeking access to traditional capital markets."

ARGUMENTS IN OPPOSITION: This bill is opposed by the California Association of Nonprofits (CAN), the California Society of Association Executives (CalSAE), the Blood Centers of California, and California Church Impact. These opponents all take the position that more information should be gathered by the Legislature before it acts to authorize the formation

of this, or any unprecedented hybrid corporate form that may affect the non-profit sector. As summarized in the letter of opposition by CAN:

SB 201 and similar measures present historic and difficult choices that will affect the type, scope, and integrity of social, educational, cultural, and environmental services delivered to the people of California for decades to come. There are significant risks involved that need to be more closely examined, including opportunities for abuse and detrimental impacts on quality of life-saving resources, such as the blood supply. Those risks as well as opportunities need to be considered in a detailed and deliberate fashion simply not possible in the few short weeks allocated for legislative hearing and floor votes.

(All of the opponents named above) have united around one simple request: that the Legislature hold all legislation intended to introduce new corporate forms into the California code until those measures have been the subject of a public vetting process, including legislative hearings that will allow the legislature and the governor—as well as nonprofits, for-profits, and the public—to make informed decisions.

The opponents contend that this bill could produce harmful unintended consequences for the non-profit sector, including "siphoning off much-needed resources from effective existing nonprofits by redirecting donor dollars from charitable contributions to flexible purpose corporation investments." In response, the author and sponsor assert that the opponent's concern is misplaced because this bill is intended to provide an alternative to the standard for-profit corporation, not an alternative to the nonprofit corporation. They contend that the bill "will allow for-profit corporations to focus more on social and charitable impact and permit greater flexibility for those corporations to contribute to the charitable sector that CAN represents." They further contend that FPCs "will not divert resources from non-profits . . . primarily because foundations, charities or individuals will not be permitted to receive favorable tax treatment in connection with donations to FPCs, who instead must avail themselves of the mainstream capital markets."

California Church Impact argues separately that "we are supportive of Flexible Purpose Corporate principles, but we also know from past experience that non-profit status has been roundly and thoroughly abused by for-profit entities as a means of diverting profit to fund political and other activities. Until we can be assured that the FPC status would not permit diversion of money into questionable actions, we must remain in opposition." In response, the author asserts that the fear of potential abuse should be mitigated by the bill's inclusion of expanded requirements of transparency and public reporting with respect to the FPC's special purposes.

PREVIOUS LEGISLATION: AB 2944 (Leno) of 2008 would have allowed a corporate director, when making business decisions on behalf of the corporation, to consider several factors, such as the long and short term interests of the corporation and shareholders, the corporation's employees, suppliers, customers, and creditors, community and societal considerations, and the environment. AB 2944 was vetoed by Governor Schwarzenegger who stated that it "was a package of concepts that could produce unknown ramifications and the need for which have not been fully demonstrated."

SB 1463 (DeSaulnier) of 2010 would have created a new form of corporate entity known as a Flexible Purpose Corporation (FPC) in order to authorize corporations to participate in designated for-profit and not-for-profit activities. SB 1463 was referred to the Senate Judiciary Committee, but was not heard.

PENDING LEGISLATION: AB 361 (Huffman) seeks to create a new form of corporate entity known as a "benefit corporation" that, like this bill, is intended to provide new flexibility for the corporation to pursue a "public benefit", as defined, that does not necessarily maximize shareholder profit. AB 361 is currently awaiting hearing in the Senate Banking and Finance Committee.

REGISTERED SUPPORT / OPPOSITION:

Support

California Legal Working Group for New Corporate Forms (sponsor)
Benetech
Brightpath
Corporations Committee of the State Bar of California
GreenBiz
GreenOrder
iVeridis Corporation
Lawyers' Committee for Civil Rights of the San Francisco Bay
Leapfrog Network
Omidyar Network
OneSun
Pacific Community Ventures
Revolution Foods
Sierra Business Council
Social Profit Network
Source Trace Systems, Inc.
SPNCO, Inc.
The Troy and Alana Pack Foundation

Opposition

Blood Centers of California
California Association of Nonprofits (CAN)
California Church IMPACT
California Society of Association Executives (CalSAE)

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