

The Emergence of New Corporate Forms

The need for alternative corporate designs integrating financial and social missions

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Many believe that the prevailing corporate form focuses on maximizing profit for stockholders at the expense of other stakeholders—specifically employees, the community in which it operates, and the natural environment. Even corporations that strive to integrate corporate social responsibility (CSR) into operations face constraints on their ability to pursue deep social responsibility, primarily as a result of the fiduciary obligations of their boards of directors. Federal or state governments offer one possible solution through legislation to create a new corporate which would embed social purpose into the DNA of future corporations. This new form could be structured as either a for-profit charity, a socially conscious corporation, or some

combination of both. Such hybrid models have both strengths and weaknesses. This paper will suggest which models hold the greatest promise for acceptance by business, investors, lawyers, civil society, and government.

Understanding the Problem

During the semi-finals of the Global Social Venture Competition (GSVC), a student-led business plan

contest sponsored by the Haas School of Business at Berkeley, a panel of judges reviewed 14 business plans for social venture

organizations, defined as entities that generate profits and feature a social or environmental return on investment. The high caliber of the business plans was impressive, with the nascent entrepreneurs articulating how to address a variety of social problems—the electricity needs of developing countries, nutritious school lunches, or an alternative cash crop to combat poverty in Sub-Saharan Africa. However, the entrants clearly were constrained by the rigid legal structures which framed their business models: for-profit corporations or tax-exempt organizations.

The inadequacy of this rigid line—dividing for-profit vs. nonprofit—has been recognized by two different movements gaining momentum in the last decade. For-profits are beginning to pursue social missions like nonprofits, and nonprofits are taking on profitable subsidiaries much like for-profits.

The emergence of these two movements raises questions about the adequacy of existing corporate forms. Are there significant limitations to for-profit and nonprofit models that prevent organizations from successfully blending profit making with social mission?

The business plans submitted to the GSVC demonstrate that social and environmental values can be incorporated successfully into for-profit corporations without changing a firm's legal structure. There are several reasons for this. First, there is a compelling business case for the adoption of CSR principles. Second, the business judgment rule covering the behavior of boards can, in some cases, promote both stockholder profitability and social and environmental values. Third, there are investors drawn to businesses that provide a social or environmental return.

However, because the CSR movement is relatively recent, it remains an open question as to whether these reasons are sufficiently compelling to overcome the problems inherent in the current legal forms. Unfortunately, it is likely that because for-profit companies only have one stakeholder to whom management and the board owe a fiduciary duty—the stockholder—the existing for-profit corporate form may preclude more fundamental change.

On the other side of the dividing line we see the “social enterprise” movement, where selected nonprofits are increasingly

One possible solution is to create a new corporate form that embeds social purpose into the DNA of future corporations.

incorporating market drivers into their business models. Many types of organizations, from medical centers to trade organizations, are finding ways to generate revenue from socially beneficial offerings within the tax-exempt structure. In some cases, like Underwriters Laboratories, the government has enacted legislation to expand the scope of an exempt purpose to maintain the entity's tax-exempt status. Other non-profits, like Pacific Community Ventures, have established wholly-owned, for-profit subsidiaries that generate non-exempt revenues and allocate a portion of the profits to the nonprofit parent.

Corporate Social Responsibility initiatives are not likely to stimulate change fast enough to address the major issues facing us today.

However, social enterprises are hobbled by many legal constraints, including a seemingly arbitrary designation by the IRS of what is considered tax-exempt revenue, and the labyrinth of legal rules that regulate their activities. In addition, nonprofits are required to articulate a fairly narrow public purpose in their articles, and in states such as California, they are not permitted to change this purpose without attorney general approval. They

also lack access to financial markets, relying instead on philanthropy. And without stakeholders who have an ownership interest, they lack effective incentives to achieve the efficiency necessary to compete and create change on a broader scale.

Unfortunately, the CSR and social enterprise movements are not likely to stimulate change in business fast enough to address the plethora of environmental and social issues facing us today. How can we address the problems inherent in the existing corporate forms? This analysis will look at a variety of approaches.*

Part I: Expansion of Existing Corporate Forms

The for-profit corporation is primarily defined by its relationship with its stockholders. Unlike banks and other creditors, stockholders typically have no right to be repaid for their investment and are, instead, *residual*

claimants, entitled to whatever value is left after creditors have been repaid. The primacy of the stockholder derives from the theory that only residual claimants have an appropriate incentive to maximize the total value of the corporation, because other stakeholders are motivated only to satisfy their fixed claims.¹ Fiduciary duties of care, loyalty, and obedience are designed to safeguard against loss of stockholder value. The relationship between the corporate entrepreneur and the supplier of capital serves as the engine that drives the for-profit corporation in its existing form. Significantly, these two constituents also generate the impulse for changes in corporate forms.

CSR Policies Within the Current Legal Framework

CSR initiatives are a good place to begin examining the shortcomings of the existing corporate structure. It has been comparatively easier for start-up companies with a social mission to attract investors, because these companies do not already have an established stockholder base. Companies such as Revolution Foods and World of Good focus not only on stockholder value but on providing healthy and organic lunches for low-income school children, or selling ethically sourced housewares and accessories.

It has been more difficult for large, publicly traded corporations to incorporate CSR principles deep into the fabric of their operations. The easiest case occurs when CSR initiatives are profit-generating or provide clear cost savings. As the March 22, 2007 issue of *FORTUNE* magazine gushes, the business case for CSR can be compelling, because CSR products can outperform existing products and build goodwill with customers and employees.²

As a matter of corporate law doctrine, managers have discretion to adopt CSR initiatives even when they cannot be cast as a means of maximizing stockholder returns over the long run.³

*Many of the companies mentioned in this article are clients of Morrison & Foerster. All information provided is public and/or has been included with their permission.

Managers have broad discretion in their duty to act in the best interests of the corporation.

There are insufficient metrics for measuring social and environmental returns, leaving investors to focus on stock price.

Only in liquidation events (where the company is on the brink of sale or dissolution) are the best interests of the corporation equivalent to immediate stockholder profit maximization.⁴ Unfortunately, boards of directors and management of many corporations have not welcomed this expanded view of the traditional business judgment rule.

Although there are many opportunities for CSR, actual accomplishments have thus far not made high-impact change. There are many reasons for this, which vary by type and size of corporation. For small, socially oriented companies, access to capital markets can be limited for social enterprises that embrace a “double, triple or quadruple bottom-line” philosophy, which might be perceived as offering lower returns. There are insufficient metrics for measuring social and environmental returns, leaving investors to focus on stock price. And as companies grow and need more capital, the corporate

focus on CSR may fade unless the entrepreneur and later-stage funders can agree on possible trade-offs between profitability and social or environmental mission.

For public companies, the threat from stockholders may arise less from litigation and more from a takeover by a private equity fund or hedge fund determined to wring more profits out of the enterprise. In addition, the increasing prevalence of stock options in executive pay packages means management has little incentive to pursue CSR initiatives unless they immediately enhance profitability. Also, the shortened tenure of CEOs and the ever-present threat of dismissal means the pressures run in a single direction, toward greater profitability, not toward greater social responsibility.

Given these constraints, CSR policies by themselves are unlikely to trigger the systematic and widespread changes that society needs, within the short time horizon that we have.

Shareholder Activism

One existing tool stockholders have to encourage social and environmental change is the shareholder resolution, included in the company’s proxy statement. Public companies communicate with their stockholders annually via proxy statements, which identify management’s slate of candidates for the board and seek stockholder consent on proposed corporate actions, such as mergers. Simply submitting a stockholder proposal may begin a dialogue with a corporation to achieve improvements. For example, the Hershey Company, in response to a stockholder proposal from Walden Asset Management, agreed to create a broad-based supplier code of conduct focused on child labor in the cocoa industry. Satisfied with the results, Walden withdrew its proposal.⁵

Other proposals result in conflict with management. For example, stockholders of International Paper were given the opportunity at the May 2006 annual meeting to consider a proposal that the board prepare a report to assess the feasibility of increasing the use of post-consumer recycled fiber and adopting Forest Stewardship Certification. Management opposed the proposal.⁶

While in many cases a powerful tool, shareholder resolutions are limited in their effectiveness by the fact that the SEC can give management the power to exclude stockholder proposals from proxy statements. Among other things, the proposal may be excluded if it relates to what is considered ordinary business, a category often cast in an over-broad way.⁷ Going directly to shareholders, outside the proxy statement, is prohibitively expensive. For these reasons, the shareholder resolution mechanism is unlikely to achieve significant CSR improvements.

Alternatives Offered by Private Equity/Venture Capital Firms

Another force for change is the emerging class of funders that value the CSR mission of corporations and are willing to invest accordingly. These include: (1) “angel investors” who invest early on; (2) venture capitalists or private equity firms that invest during the interim phases of corporate growth; and (3) large institutional stockholders, willing

to hold shares in large public companies with appreciable CSR accomplishments.

In this spectrum, some for-profit investment institutions operate in parallel to charitable grant-making institutions. These institutions (e.g., the Bay Area Equity Fund, an affiliate of JP Morgan/Chase and the Omidyar Network) exist because they believe that investments can make money *and* promote social and environmental objectives, or because they find traditional philanthropic grant-making less effective for certain kinds of endeavors.

If these kinds of investors wish to incorporate social elements into their investing agreements, they have a great deal of freedom to do so. Importantly, funders typically will demand the contractual power to eject or sideline an ineffectual chief executive. Other contractual elements that the double-bottom-line funder and the entrepreneur may consider are:

- a) charter agreements that the board of directors will include members with CSR-industry specific expertise;
- b) rights for the investor to sell its investment to the corporation if the corporation strays from its CSR mission;
- c) voting provisions that require the funder's consent for the corporation to change its strategy;
- d) tools that aid the board in resisting takeovers by financial buyers;
- e) requirements that the corporation report its performance on specified CSR criteria; and
- f) bylaw provisions committing the corporation to maintain membership in a CSR standards organization, procure inputs only through responsible channels, or make corporate donations to CSR nonprofits.⁸

Though theoretically possible, such contractual agreements remain relatively uncommon. Off-the-shelf corporate provisions remain the norm. The difficulty and unfamiliarity of negotiating investing agreements on a case-by-case basis represents a significant hurdle to using this route to effect substantial change.

Stimulating Economically Sustainable Nonprofit Organizations

While for-profits struggle to incorporate social mission in effective ways, nonprofits face the opposite problem. They struggle to incorporate profit-making within the nonprofit framework. There are various ways they are doing so.

Nonprofits Generating Revenue Without Structural Change

Many nonprofits today creatively and successfully generate revenue or seek funding without altering their tax-exempt structures, using a variety of methods. For example, Underwriters Laboratories (UL) generates a good portion of its revenue through fees received from a safety certification process. Others, such as Business for Social Responsibility (BSR), generate revenue from membership fees, conference fees, and a store that sells books and other materials on CSR.

In addition to these successful revenue-generating models, companies can utilize program-related investments (PRIs). A PRI permits foundations to support a charitable activity by making a financial investment—such as a loan, loan guarantee, or equity investment—which generates a potential return on capital.⁹ While this is a useful cross-over tool—from the charitable to the profit-making side of the line—in practice it is limited because, to qualify as a PRI, an investment must meet stringent tests, including these:

- It must further the charitable purpose of the nonprofit making the PRI.
- It must significantly further the foundation's tax-exempt activities.
- It normally would not be made by a fiduciary because the risk/return profile does not meet the “standard prudent investor” criterion.
- It can result in substantial income or appreciation as long as obtaining that income or appreciation is not the goal of the foundation making the investment.¹⁰

Although available and rather flexible, PRIs are generally not utilized as a tool for social benefit purposes for a number of reasons:

1. A targeted vehicle has not been created specifically to receive and use PRIs.
2. There is no method of marketing PRIs so that smaller and less-sophisticated foundations, trusts and investors can invest in a small portion of a specific PRI.
3. The PRI requires documentation similar to the documentation necessary for a market-rate business investment, increasing legal and other expenses.¹¹

In addition to these limits on the use of PRIs, there are other significant limitations on nonprofits that wish to behave more like for-profit firms. Tax-exempt organizations—whether public charities or private foundations—face strict rules on how donors may make contributions and obtain tax deductions, which often limits flexibility in receiving funds. Both public charities and private foundations are subject to rules regulating self-dealing transactions. In addition, both public charities and private foundations may not engage in business activities that are substantially unrelated to their charitable purpose, because doing so means risking their tax exemption. Also, income from insubstantial unrelated business activities is taxable at corporate rates.

Although nominally tax-exempt, private foundations pay a 1 percent or 2 percent tax on their annual income and must distribute at least 5 percent of the fair market value of their assets annually, or face a penalty tax. The investments of public charities are constrained by legal requirements with respect to management of charitable assets, and foundations are further subject to strict percentage restrictions on ownership of corporate stock (and thus may not have a corporate subsidiary). Foundations also must pay a penalty tax on certain investments, such as high-risk investments, that are deemed to jeopardize their assets or charitable purpose.

Given all these constraints, nonprofits lack the flexibility of for-profit operations and, as a result, are not able to compete as effectively in the marketplace.

Nonprofits Establishing Hybrid Structures

To get around some limitations, an increasing number of nonprofits are establishing hybrid structures, which can take various forms:

- A nonprofit can establish a wholly-owned for-profit subsidiary.
- A nonprofit can make a minority investment in, or establish a contractual relationship with, a for-profit.
- A nonprofit can enter into a joint venture (typically in the form of a limited liability company) with a for-profit.

In each case, the nonprofit spins off its for-profit affiliate and receives direct benefit from it in the form of investment returns, donations, or services. The social entrepreneur may consider a hybrid form, for a wide range of reasons.

First, certain types of income that the nonprofit generates may not be tax-exempt, and too much of such revenue could put 501(c)(3) status in jeopardy.

Second, the social entrepreneur may want to change his or her business model. For instance, Drive Neutral is a 501(c)(3) nonprofit that allows consumers to neutralize their carbon emissions through large-scale sustainable projects, and it generates income through tax-exempt donations or purchases of carbon-offsets. It is considering changing its business model by forming a for-profit subsidiary that provides consulting and other services.¹²

Third, the social entrepreneur may realize that he or she can attract un-tapped for-profit funding sources by establishing a hybrid organization. The for-profit affiliate can sell stock to investors, can provide dividends (if the nonprofit is a stockholder), and can make donations and provide services to the nonprofit. However, there is risk in the long run if the original investors sell to new stockholders who do not embrace the social mission.

Finally, 501(c)(3) organizations that are structured as public charities may look to hybrid models in the wake of the Gates

Foundation grants. The size of the grants will require that many recipients register as private foundations as opposed to public charities, and the management of these tax-exempt entities may not have the resources, or the desire, to comply with the rigorous IRS foundation rules.

Hybrid structures give social entrepreneurs the flexibility to attract funding from private, for-profit sources, without jeopardizing the parent's charitable status.

Like social entrepreneurs, double-bottom-line investors may choose a hybrid structure for similar reasons, where they want the flexibility to make under-market or market-rate investments in for-profit entities with a social or environmental mission. Two prominent examples here are Pacific Community Ventures (PCV) and Omidyar Network. PCV is a 501(c)(3) nonprofit organization, that “helps companies [in California] in traditionally overlooked areas to gain access to capital, business advice, and critical business resources that will accelerate company growth.”¹³ To expand its scope, PCV formed Pacific Community Ventures Investment Partners, a for-profit entity.¹⁴

There are certain advantages to the hybrid structure. It gives social entrepreneurs the flexibility to attract funding from private, for-profit sources.¹⁵ And if implemented properly, creating a for-profit arm eliminates the risk of jeopardizing the nonprofit parent's charitable status.¹⁶ It also can insulate the nonprofit from liabilities related to the for-profit's activities.¹⁷ Perhaps most importantly, the profits, donations, or services from the for-profit affiliate or subsidiary can help alleviate the dependence of a nonprofit on the whims of philanthropists and foundations.

While there are many benefits to a hybrid structure, there are also constraints. Hybrid entities require additional resources, including fees for attorneys and other advisors to create and operate two distinct entities.¹⁸ The hybrid structure also may raise public relations issues (i.e., that the nonprofit's charitable reputation is tarnished by profits).¹⁹ In addition, any income from rents, royalties, or interest that flows to the nonprofit will result in Unrelated

Business Taxable Income (or UBTI), if the nonprofit owns more than 50 percent of a subsidiary for-profit.²⁰ Finally, upon the dissolution of the subsidiary, the transfer of any appreciated assets to the nonprofit parent will constitute a sale of the assets, which is taxable at the subsidiary level.²¹

New Fund-raising Techniques by Nonprofits

A recent development in nonprofit fundraising is the use of private placement services from seasoned veterans. The Non-Profit Finance Fund (NFF)—a 501(c)(3) which provides financial analysis and unsecured, non-equity financing for nonprofits—recently launched NFF Capital Partners, a for-profit subsidiary.²² It offers private placement services for nonprofits and social enterprises seeking equity funding.²³

Another example is the for-profit Calvert Group of socially responsible mutual funds, which operates a nonprofit subsidiary, the Calvert Social Investment Foundation. This foundation offers to investors the unique Calvert Community Investment Note, which permits individuals to make low-risk loans at rates between 0 and 3 percent, with the funds invested in a professionally managed loan fund. The funds are used to make affordable loans to over 200 nonprofits and social enterprises, such as FINCA International, a microcredit organization operating in 60 countries, or Peoples' Self-Help Housing, a leading nonprofit developer.

Experimentation With New Corporate Forms

While all these examples show the latent flexibility available under current law, they also point up the limitations inherent in the existing legal framework, where the law leads business people and investors to envision a rigid dividing line between for-profit activities and social mission. To address the limitations of current legal forms, a myriad of new legislation or new proposals for company designs have been suggested recently. In the for-profit arena, these include amending charter requirements and creating new forms of social enterprise corporations. In the nonprofit community, these include new corporate forms, designations, and laws affecting tax-exempt entities.

Novel Proposals in the For-Profit Arena

Changing Charter Requirements

State laws which establish charter requirements for corporations have been and may be further updated to strike a new balance between society and corporations. One proposal is that states impose caps on corporate returns to stockholders. While the cap could be structured in many ways, one idea proposes that equity holders hold time-limited rights in their shares, much as patents

and copyrights are limited in time rather than perpetual.²⁴

Shann Turnbull has suggested limiting stockholding rights to 20 years, a period during which stockholders would insist on receiving dividends, since they would no longer have equity in the retained earnings. Stakeholders—such as employees and the community in which the company operates, among others—would become the residual claimants.

Management still would be required to operate the company efficiently because, in order to finance new projects, management would need to attract new investment capital as opposed to relying

on retained earnings. Under the proposed scheme, corporations that adopted this form would enjoy a reduced level of corporate tax, which would boost dividends and compensate for the lost equity. One possible downside is that projects with long development horizons would have difficulty attracting funds using this corporate design. That would make this design inappropriate for corporations that engage heavily in research and development, such as the pharmaceutical industry, where the period during which investors are entitled to dividends may not coincide with the profitable period under patents. In addition, fewer investors may be willing to purchase stock in which there is no chance of a long-term return, making them less valuable than traditional shares of stock. Another issue with changing the charter requirements in one state is that corporations may then elect to incorporate in a different state.

A new community of companies branded as B Corporations—beneficial to society—would help lower costs in attracting investors and customers.

In addition to creating new mandatory charter requirements, some are recommending the establishment of new voluntary charter arrangements. One idea offered by Jay Coen Gilbert of B-Lab is to create a corporate charter under existing law that would be available for adoption by social ventures.²⁵ The concept is to create a community of companies branded as B Corporations—corporations beneficial to society—which would help attract both investors and customers. The brand would simplify investors' diligence on a corporation's CSR commitment and negotiation of operating principles, thus lowering the transaction costs of capital formation. In return for these benefits, companies would be required to incorporate stakeholder governance provisions into their legal framework, and to clear a hurdle of social and environmental performance standards.

On the plus side, a package of workable corporate design documents could significantly reduce the costs of establishing a socially responsible company and negotiating terms of investment. A similar arrangement is found with the National Venture Capital Association, which offers model forms for venture finance documents, commonly used by lawyers. If the brand sponsor keeps tabs on its community of B Corporations, it could develop experience with the issues that arise and help managers find solutions to common difficulties.

However, there are limits to the branded charter and B Corporation. To the extent that the branded charter prohibits activities that other corporations may engage in, or requires express commitments where other entities have informal relationships, the branded charter form could be less flexible. This could be a disadvantage if it prevents entrepreneurs from choosing the most efficient solution to a problem or requires more complex negotiations with stakeholders to execute strategies. In markets where the branded charter firm competes with other firms, it could be fatal.

Another alternative—as was explored earlier in this paper—is for individual corporations to negotiate socially responsible charter provisions with their funders. For example, a corporation may write a bylaw requiring the corporation to buy only fair-trade goods, or to

maintain membership with a standards body that certifies compliance with environmental or social standards.

A Minnesota proposal would allow corporations to use the letters “SRC,” for Socially Responsible Corporation, after their name.

There are many problems with all of the custom charters described above, whether they be voluntary or mandatory, and therefore we do not believe that they should be adopted by for-profit corporations. First, there is no guarantee that the provisions of the charter of a state will be upheld in other states, given the prevalence of long-arm statutes (as in California). For example, if a company incorporates in Oregon but does business in California and includes provisions in its charter that limit fiduciary

duties to stockholders, such charter may not be upheld by California courts.

In addition, there is a danger that unique features could later conflict in ways that are not appreciated at the time of adoption, and, as with the B Corporation, such features could become a competitive disadvantage. B Corporations or companies with custom charters will likely have more restricted access to traditional capital markets, given the restrictions in operations that could affect profitability. The operational elements embedded in the custom charter could become obsolete over time (e.g., if a standards body is captured by the lowest common denominator) or become a point of contention (e.g., fair-trade may mean different things to different corporate constituents). Further, it is possible that the custom elements will not generate the desired outcomes. For example, reserving board seats for stakeholders does not ensure their opinions will be heeded. Apart from the prospect of future problems, custom features also increase the costs of negotiations at the outset of the corporation’s existence.

*Minnesota Socially Responsible Corporation*²⁶

Another proposed approach is to legislate into existence a new voluntary corporate form, which the Minnesota State Legislature

proposed in 2006. Under H.F. No. 4161 (introduced in the 2005-2006 session) and S.F. No. 1153 (introduced in the 2007-2008 session), the Minnesota State Legislature introduced the Minnesota Responsible Business Corporation Act.²⁷ Under the act, a corporation would have the ability to designate itself as a Socially Responsible Corporation, using the letters “SRC” after its corporate name rather than the standard letters “Inc.” The aim of the legislation is to create a design that integrates a dual focus on both financial success and social responsibility.²⁸

The legislation includes the following features:

- (a) In determining the best interests of the corporation, directors and officers *must* consider (in no particular order of importance), the interests of the corporation’s stockholders, employees, customers and creditors; the “public interest”²⁹; and the long-term as well as short-term interests of the corporation and its stakeholders.³⁰
- (b) Employees will elect 20 percent of the board of directors, and an additional 20 percent of seats will be reserved for public interest directors (who are also required to balance the interests of all stakeholders).
- (c) If publicly traded, corporations will be required to issue an annual “Public Interest Report” along with their annual report.
- (d) The board is required to provide opportunities for stakeholders to provide advisory input at regular stakeholder meetings and through a web site or email listserve.
- (e) The corporation is required to train its officers, directors, and employees regarding the special duties to stakeholders.
- (f) To prevent courts from overriding the legislation, the law explicitly carves out the application of the common law of agency, under which the officers and directors are required to act almost solely in the interests of the stockholders by maximizing the corporation’s profits.³¹

There appear to be more benefits to this form than the others discussed above. First, it provides input from non-traditional stakeholders to allow the board to be better informed when making its decisions. It also gives employees and the public interest a voice

at management level. Further, like the B Corporation, the corporation has the opportunity to brand itself as a CSR entity to attract customers and possibly investors. Finally, it may protect directors from stockholder lawsuits when directors satisfy their stakeholder duties, and it may protect against frivolous stakeholders' suits (through the balancing of interests requirements).³²

Despite its benefits, this voluntary approach is fraught with many of the same issues as the adoption of custom charters. Companies that chose the new form may face a lack of flexibility, possible conflicts with future business plans, and more limited access to capital markets. Also, an external regulation (even one that is voluntary) may require greater ongoing enforcement costs.³³ Finally, it is unclear whether the new design would be recognized and provide protection against shareholder litigation if the company were to conduct significant operations in other states.

International Efforts

Across the pond, the British government created a voluntary legal structure in 2005 to bridge the gap between the for-profit and nonprofit worlds, the Community Interest Company (CIC).³⁴

A CIC is a limited liability company that is designed for use by those who want to conduct a business for the community benefit, and not purely for private financial advantage.³⁵

Features of the CIC include:

- a) requirements to pass a "community interest test" and operate under an "asset lock," which ensures that the CIC is established for community purposes and that the assets and profits are used to meet such purposes;
- b) requirements to file an annual report to detail payments to directors, dividends paid on shares, interest paid on loans, and how the CIC has included the involvement of stakeholders in its activities; and
- c) unlike charities, CICs do not enjoy tax-exempt status.³⁶

The benefits of this new corporate form include branding awareness, flexibility in commercial activities (e.g., some CICs can pay dividends to individual stockholders, subject to a cap), lower legal costs from adopting a standardized form, and more limited

regulation. The major constraints include the lack of beneficial tax treatment, the rigidity of the structure, the more limited access to capital markets, and the focus on expansion of the nonprofit as opposed to the for-profit market segment.³⁷

Low Profit Limited Liability Company (L³C)

Straddling the line between the for-profit and nonprofit worlds is yet another proposed solution: the Low Profit Limited Liability Company (L³C). L³C, tagged as "the for profit with a nonprofit soul," would act in a way that furthers its mission, like a nonprofit, as opposed to maximizing stockholder value. In addition, this new form will purportedly operate "with the simplicity and clarity of thought of a for profit."³⁸ The reasons behind the development of the L³C are the creation of an easy vehicle (i.e., L³C itself) and a stable, reputable market for PRIs (through highly regarded securities brokers), to alleviate the constraints on the use of PRIs discussed above.³⁹ A foundation may transfer money into the L³C using a PRI, then later sell its stake to another foundation or donor and recycle its profits from the PRI into another PRI project.⁴⁰ The profits that the L³C generates can be used for its own programs and to pay dividends to its investors.⁴¹

The L³C model has three main advantages:

- a) No new legislation would be needed (as the LLC is recognized in all 50 states, and PRIs are already incorporated into the tax code).⁴²
- b) The L³C will arguably increase the use of the PRI vehicle, offering an additional fundraising tool to foundations and charitable trusts.
- c) It offers a brand to the PRI, which may also help increase its effectiveness and employment.

The structure also has limitations. PRIs are still restricted investment tools. They can be used for certain types of investment—low-cost or affordable housing or loans, museums, downtown redevelopments, educational projects, research and the like—but not others. Further, based on the views expressed by foundations about the current use of PRIs, building the L³C brand may be a difficult, long, and costly process.

Novel Proposals in the Nonprofit Arena

Changes to the nonprofit form are motivated by a desire to encourage self-sustaining charitable enterprises, and by a philosophical view that the for-profit form attracts better entrepreneurs.

One proposal is to create for-profit charities, which would be distinguished by several characteristics: permitting managers to keep a portion of profits, allowing donors to deduct contributions from income taxes, and exempting the corporation's income from taxation. The entrepreneur's income and share of earnings would presumably still be taxed at the individual level. Proponents of this proposal say that as long as the government offers tax subsidies to any corporation, entrepreneurs who engage in charitable activities should be subsidized regardless of the corporate form they choose (e.g., consumers could deduct from their taxes the additional cost attributable to fair trade beans when buying coffee at Starbucks).⁴³ The argument is that for-profit entrepreneurs have a greater incentive toward efficiency, because they can keep the savings. But this assumes that nonprofit entrepreneurs enjoy fundraising and are indifferent to the trade-off between raising more money and spending less.

The problem with this proposal is that with a for-profit company, the distinction between charitable and noncharitable purposes may be a hard line to draw, particularly given the prevalence of green-washing (actions which provide a positive public relations spin but have little real impact). Another risk of this plan is that it could serve as a justification for abolishing the tax privilege of nonprofits.

Yet another proposal is to permit an IRS certification for organizations—either for-profit or nonprofit—that operate in a businesslike manner and have a charitable mission. Capital could flow from both market sources and foundations, and the investment could be structured as a loan, grant, equity investment, or PRI. The rules governing the taxability of revenue generated by the organization do not change. This proposal aims to strike a compromise to satisfy funders, whose investment decisions are influenced by their tax implications, as well as entrepreneurs, who would like access to the broadest possible group of investors.

Preferred Pathways

In this time of ferment, there are many proposals being floated and experiments underway today. As yet, it is unclear whether any of the proposals can create large-scale change quickly.

On the nonprofit side, the various types of hybrids do work. Incorporating more for-profit business principles into *certain types* of revenue-generating nonprofit models will serve the nonprofit community well. Yet nonprofits on the whole remain a very small percentage of the overall economy and will never have the power to effect widespread change.

On the for-profit side, the problems inherent in new voluntary or mandatory charters, or the B Corporation, could frustrate their effectiveness. Proposed new forms—incorporating profit-making with social mission—may work for small-scale for-profits with a strong social mission. Yet the “legacy problem” represents one of the great challenges of retaining a social mission over time. Many socially oriented for-profits find that their social mission is dependent on founders' fervor, and when founders retire or sell, their social legacy is often lost as more traditional owners and managers take over.

None of the proposed forms or legislation will serve as a viable option for the multinational corporations that are the most powerful forces in the world today. New hybrids and social enterprises likely will be used primarily to expand the nonprofit community.

The operations of larger, for-profit corporations can be transformed significantly by the adoption of CSR principles. In addition, we must be optimistic that boards and management (with court approval and guidance) will exercise their business judgment in expansive ways that embrace the concerns of stakeholders, broadening company mission beyond a sole focus on return on investment for stockholders. However, there are two fundamental issues with sole reliance on the existing corporate tools. First, the process will take too much time. The current fiduciary duties have evolved through legislation and judicial activism over the past 100 years. Now, there is a need for quick action to align corporate purpose and practices

with social and environmental issues. Second, given that CSR has only recently been embraced fully by certain large multinational corporations, it is too early to tell if an increased emphasis on employees, community, and the environment can serve to change the *fundamental* way a corporation operates – primarily because the stockholder remains the sole *legally recognized* stakeholder.

What changes do we recommend that may serve to effect the greatest transformation of the corporation most quickly?

First, instead of relying on modifications of charters or the creation of hybrids, legislation should create new fiduciary duties—covering both public and private corporations—that favor employees, the community, and the natural environment. The legislation must be federal or adopted in all 50 states (if there is no federal preemption), although one or two states could serve as pilots for the new regime. The largest obstacle will be creating a means for the board and management to weigh the different and often diverging interests of stakeholders effectively when making decisions. To ensure accountability, the legislation must include clear metrics to measure the impact of the corporate actions on various stakeholders. One proposal is the analytic hierarchy process developed by Thomas Saaty,⁴⁴ which would create a matrix decision-making tool to help in balancing financial and non-financial stakeholder interests.

Second, we recommend government action to increase corporate disclosure and accountability on environmental issues. Universal disclosure requirements should be adopted by the *world* stock exchanges, with NASDAQ, NYSE, AIM, and the Tokyo Stock Exchange taking the lead. The effect of a corporation's actions on all stakeholders—including the local and world community, employees, and the natural environment—clearly should be included in the definition of “materiality.” Stockholders would then be able to evaluate such factors, the expanded impact would be understood more widely, and connections between social impact and long-term profitability would become more clear. Enforcement would be critical. Corporations would need to face real and substantial penalties for failure to disclose according to the new guidelines. Fortunately, such a

disclosure framework already is being developed through the Global Reporting Initiative sustainability reporting guidelines.

Third, it's vital to recognize that redesigned corporate forms are not the only route to creating corporate responsibility, particularly when quick change is needed. Also needed are new government regulations, particularly to address environmental degradation and climate change. Governments should regulate the environmental impact of all economic actors (including government and quasi-governmental entities), not just private corporations. And they should impose a uniform burden on all companies operating in the U.S., to minimize the likelihood that firms will re-incorporate off-shore to avoid compliance. (We recognize the extra-territorial extension of U.S. laws will not be well received on the international stage and will face enforcement complexities.)

The challenges presented by the inadequacies of current corporate legal forms can and must be solved, for the 21st century will require corporate forms that incorporate a responsibility to a wide range of stakeholders, not just to stockholders alone. There is a clear case to be made for the creation of new corporate forms, yet the complete answer to the puzzle is not yet fully in hand. Many promising alternatives are already in play, as this analysis has shown. The ferment of existing experimentation needs to continue, as new ways of thinking about innovative corporate designs continue to evolve. ■

FOOTNOTES

¹ Michael Bradley, Cinda A. Schipani, Anant K. Sundaram, and James P. Walsh, “The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads,” 14 J. Law & Contemp. Prob. 9, 37-38 (1999).

² For a thorough account of how industrial processes and technologies can be upgraded, see Paul Hawken, Amory Lovins & L. Hunter Lovins, *Natural Capitalism: Creating the Next Industrial Revolution* (1999).

³ See Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. Law Rev. 733-869, 743 (2005).

⁴ The seminal Delaware case setting forth this proposition is *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

⁵ See Anne Moore Odell, “Chocolate Giant Commits to Responsible Supplier Code” (March 8, 2007) (available at <http://www.socialfunds.com/news/article.cgi?sfArticleId=2245>).

⁶ International Paper Co., Definitive Proxy Statement Schedule 14A (available at

http://www.secinfo.com/d14D5a.v21dj.htm#_toc46065_8

⁷ See 17 C.F.R. § 240.14a-8 (Exchange Act Rule 14a-8).

⁸ For example, the for-profit corporation Give Something Back provides in its bylaws that all profits will be donated. See Eve Kushner, “The Greater Good: East Bay Companies live by the triple bottom line: profits, the planet and people,” *The Monthly* (December 2006) (available at <http://www.themonthly.com/feature12-06.html>).

⁹ Thomas J. Billitteri, *Non-profit Sector Research Fund, Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach?: Highlights from an Aspen Institute Roundtable*, January 2007; Robert M. Lang, *The Non-profit is No Longer King: The New Way to Organize Socially Responsible & Mission Driven Organizations*, L³L, a project of The Mary Elizabeth & Gordon B. Mannweiler Foundation Inc., 2005.

¹⁰ Supra note 22.

¹¹ Supra note 22.

¹² <http://www.driveneutral.org/>.

¹³ www.pcv.org.

¹⁴ Supra note 32.

¹⁵ See Fitzpatrick interview, supra note 28.

¹⁶ Wexler, supra at 243.

¹⁷ Wexler, supra at 243.

¹⁸ Wexler, supra at 243.

¹⁹ Strom, supra note 28.

²⁰ Wexler, supra note 25 at 243.

²¹ Wexler, supra at 243.

²² <http://www.non-profitfinancefund.org/details.asp?autoId=5>.

²³ <http://www.non-profitfinancefund.org/details.asp?autoId=85>.

²⁴ Shann Turnbull, “The Case for Introducing Stakeholder Corporations,” available at <http://ssrn.com/abstract=436400>.

²⁵ Coen’s proposal is described in Billitteri article, supra note 22.

²⁶ We have learned of a proposal introduced in North Carolina to create new socially responsibility corporations, but have yet to locate any relevant information.

²⁷ Marjorie Kelly, *Creating a Voluntary Legal Design for the Responsible Corporation: Minnesota Responsible Business Corporation Act*, Citizens for Corporate Responsibility, Minneapolis; MN Bill S.F. No. 1153.

²⁸ Supra note 47.

²⁹ Under MN Bill S.F. No. 1153, “public interest” is defined 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 development opportunities, and the general well-being of the local, state, national, or world community.”

³⁰ Also, under MN Bill S.F. No. 1153, a “stakeholder” is defined as “(1) a shareholder; (2) an employee; (3) a customer; (4) a supplier; or (5) a creditor.”

³¹ Supra note 47.

³² Kelly, supra note 47.

³³ Kent Greenfield, *From Metaphor to Reality in Corporate Law*, Stanford Agora: an Online Journal of Legal Perspectives, Volume 2, Issue 1, at 67.

³⁴ <http://www.cicregulator.gov.uk/>; See Billitteri article, supra note 22.

³⁵ Supra note 54.

³⁶ Supra note 54.

³⁷ Supra note 54.

³⁸ Supra note 22.

³⁹ Supra note 22.

⁴⁰ Supra note 22.

⁴¹ Supra note 22.

⁴² However, the IRS approval of projects and understanding the L³C model will be sought.

⁴³ Anup Malani and Eric A. Posner, “The Case for For-Profit Charities,” (2006).

⁴⁴ Thomas L. Saaty, *Decision Making for Leaders: The Analytic Hierarchy Process for Decisions in a Complex World* (1988).